Joint Economic Committee Democrats

Senator Jack Reed (D-RI) – Ranking Democrat

Background Analysis **Updated June 2006**

Repealing the Estate Tax Would Not Promote Economic Growth

Proponents of estate tax repeal argue that eliminating the tax would significantly reduce taxes on capital, encourage saving and investment, reward entrepreneurship, and promote economic growth. This paper discusses why these claims are greatly exaggerated and even misleading:

Repeal would affect few families and have little impact on total capital accumulation. The estate tax is simply not a factor for most Americans. Very few estates are large enough to require the filing of an estate tax return; an even smaller number are large enough to owe any taxes. The tax itself is very small relative to family net worth. Repealing a tax with such limited scope will not make much difference in an economy with a capital stock as large as that of the United States.

Repeal would have a small and uncertain effect on private saving. There is no convincing evidence that repeal of the estate tax would increase private saving; economic theory provides plausible reasons why repeal might even decrease saving.

Repeal will reduce national saving and hurt economic growth. The loss of federal and state revenues from repeal of the estate tax would cause a reduction in public saving that would outweigh any increase in private saving. With no offsetting increases, national saving would fall; in the long run this would reduce the nation's capital stock and national income.

Repeal would have little impact on family-owned businesses and farms. Most family-owned businesses and farms are too small to owe any estate tax, and evidence is scant that estate tax considerations play an important role in entrepreneurial decisions.

Repeal will not provide substantial compliance cost savings. Arguments that the administrative and compliance costs of the estate tax are large and burdensome are greatly exaggerated, and repeal would provide no significant savings.

Repeal would affect few families and have little impact on total capital accumulation

Very few estates need to file an estate tax return, and even fewer estates owe any tax. About 60,000 estate tax returns were filed in 2004 and only about 30,000 estates incurred any tax. The number of taxable estates represented under 1.3 percent of adult deaths in the prior year (**Table 1**).

Most Americans leave modest estates when they die. Current rules for the estate tax exempt all but the largest estates. As of 2006, only estates valued in excess of $2 million need to file an estate tax return. Most estates that exceed the filing threshold still will not owe any tax. Current law allows an unlimited exemption for transfers to a surviving spouse or gifts to charities, and exempts the first $2 million of the remaining net estate after deducting debts, funeral expenses, and administrative expenses.

Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax exemption is scheduled to increase to $3.5

Table 1

Taxable Estate Tax Returns as a Percentage of Adult Deaths, 1998-2004

	Total Adult Deaths in Prior Year	Taxable Estate Tax Returns	Taxable Returns as a Percentage of Adult Deaths
1998	2,314,245	47,475	2.05
1999	2,337,256	49,863	2.13
2000	2,391,399	51,999	2.17
2001	2,403,351	51,842	2.16
2002	2,416,425	44,408	1.84
2003	2,443,387	30,626	1.25
2004	2,448,288	30,276	1.24

Source: Noto, Nonna A. "Estate and Gift Tax Revenues: Several Measurements", CRS Report RL32768, updated March 16, 2006.

million in 2009. In 2010 the tax is repealed, but is reinstated in its pre-EGTRRA form in 2011.

Because the exemption applies separately to each spouse in a married couple, through simple planning a couple can transfer $4 million (rising to $7 million in 2009) to their heirs without incurring any estate tax.

In addition to these tax-exempt bequests, individuals can make substantial tax-free transfers while they are still living. Gifts of up to $12,000 per recipient per year do not incur estate or gift tax. Thus a couple could transfer $48,000 tax-free each year to their two children ($12,000 per parent to each child), and considerably more if they also made transfers to their grandchildren and their children's spouses.

Among taxable estates, estates with the highest gross value pay most of the tax. Of the $21.5 billion paid in estate taxes in 2004, over 60 percent was paid by the less than 12 percent of estates with gross value in excess of $5 million (**Table 2**). The 1.7 percent of taxable estates valued at more than $20 million paid taxes of $5.6 billion, about one-quarter of the total.

Total estate taxes paid in any year represent a very small fraction of household net worth. The total net worth of the household sector exceeded $48.2 trillion in 2004.[1] The gross value of taxable estates was $107.7 billion in that year, about 0.2 percent of household net worth. The estate tax itself claimed about 0.04 percent of household net worth.

Among taxable estates, the average tax was 20 percent of the gross value of the estate (**Table 3**). The average tax rate was only 11 percent for estates with gross value of less than $2.5 million. The average tax rate was lower for estates valued at more than $20 million than for estates between $2.5 million and $20 million. This reflected large charitable deductions for the highest-valued estates. On average, taxable estates with gross assets of more than $20 million made $11.6 million in charitable bequests in 2004, substantially reducing the size of their taxable estates.[2]

Table 2

Distribution of Returns, Gross Estate, and Estate Tax, by Size of Gross Estate (Taxable Returns Filed in 2004)

Size of Gross Estate (millions)	Percentage Distribution		
	Returns	Gross Estate	Net Estate Tax
1 to 2.5	69.9	31.3	17.1
2.5 to 5	18.6	17.7	21.6
5 to 10	7.2	13.8	20.2
10 to 20	2.7	10.2	15.0
Over 20	1.7	27.0	26.1
Note:			
Total	30,276	$107.7 billion	$21.5 billion

Source: Internal Revenue Service, "Estate Tax Returns Filed in 2004 with Total Gross Estate Greater than $1 Million: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate," available at http://www.irs.gov/pub/irs-soi/04es01tc.xls.

Table 3

Average Gross Estate, Estate Tax, and Estate Tax Rate, by Size of Gross Estate (Taxable Returns Filed in 2004)

Size of Gross Estate (millions)	Average Gross Estate (dollars)	Average Net Estate Tax (dollars)	Net Estate Tax Rate (percent)
All Taxable Returns	3,557,000	710,000	20.0
1 to 2.5	1,592,000	174,000	10.9
2.5 to 5	3,384,000	826,000	24.4
5 to 10	6,884,000	2,008,000	29.2
10 to 20	13,617,000	3,991,000	29.3
Over 20	55,831,000	10,793,000	19.3

Source: Internal Revenue Service, "Estate Tax Returns Filed in 2004 with Total Gross Estate Greater than $1 Million: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate," available at http://www.irs.gov/pub/irs-soi/04es01tc.xls.

Repeal would have a small and uncertain effect on private saving

While it might seem plausible that repealing the estate tax would increase private saving, the effects of repeal are uncertain. If the estate tax were repealed, people eventually leaving a bequest could save more or less than before, depending upon their reasons for saving. With repeal of the tax, those receiving an inheritance are likely to save less.

The reasons people leave bequests are complex and not well understood. For those who plan to leave a bequest, repealing the tax provides conflicting incentives. There is some incentive to save more because each dollar saved contributes more to the eventual bequest. However, because it is no longer necessary to save as much to leave the same bequest as before (or even a larger bequest), people may end up saving less, particularly if they have a target amount that they wish to bequeath.

But not all bequests are planned. Some people leave bequests by "accident" simply because they accumulate more than they need to meet their needs in old age. For these accidental savers, repeal of the estate tax should have no impact on saving.

While the effect of repealing the estate tax is uncertain for people leaving a bequest, the effect on recipients is unambiguous. As a number of studies have documented, an increase in or even the anticipation of receiving wealth encourages less work and saving among inheritors, particularly those receiving large inheritances.[3] That is, people who receive inheritances can work less and save less while enjoying the same or higher standard of living.

It is sometimes argued that the estate tax is a particular disincentive to saving and capital formation because it taxes wealth that has already been subject to the income tax. While the estate tax can contribute to a higher marginal tax rate on some investment, a significant fraction of wealth transferred through inheritance has not been subjected to the income tax, because it is in the form of unrealized capital gains. Under current law, wealth passed onto heirs can escape the income tax entirely, because the tax basis for any assets with unrealized capital gains is "stepped-up" to its current value. This eliminates any income tax on appreciation of the asset that occurred prior to the transfer. Thus, heirs are subject to a capital gains tax on these assets only if they later realize the gains (sell the assets), at which point the capital gains tax applies only to the appreciation that occurred subsequent to the time of the inheritance.

Under the current provisions for estate tax repeal in 2010, capital gains would no longer automatically escape taxation, because the tax basis would no longer step up when the assets are transferred to heirs. Instead, inherited assets would retain their original basis. The law, however, provides a $1.3 million exemption to this carry-over basis rule with an additional $3 million exemption for transfers to a surviving spouse. Those amounts will be added to the basis of existing assets when they are transferred. The exemption ensures that most people will still pay no tax on the unrealized capital gains in the wealth they inherit. In some cases, where the estate consists of very large accrued capital gains and/or substantial debt, the tax on capital gains with carry-over basis could exceed the tax that would have been paid under the estate tax.

One study estimated that 36 percent of wealth in all taxable estates was in the form of unrealized capital gains that were not subject to the individual income tax.[4] For estates that exceeded $10 million, the figure was 56 percent. Small businesses and farms were even less likely than taxable estates in general to have paid capital gains taxes. The study found that 82 percent of all business and farm assets within estates larger than $10 million were unrealized capital gains. In other words, the majority of the value of large estates and the vast majority of large farm estates have never been taxed by the income tax system.

Repeal would reduce national saving and hurt economic growth

Economic analysis of the effects of estate taxes or marginal tax rates on economic growth are often based on revenue-neutral exercises, in which any revenue loss from the estate tax is assumed to be offset by a revenue gain somewhere else that leaves public saving unchanged. However, to the extent that repealing the estate tax is financed through increased government borrowing, this analysis is incomplete.

The ten-year cost of repealing the estate tax masks the permanent cost of repeal. The Joint Committee on Taxation (JCT) estimates that repealing the estate tax this year would cost $369 billion between 2007 and 2016 but that the cost of permanent repeal would be $79 billion in 2016 alone.[5] If the annual cost of permanent repeal were to grow only at the same rate as the economy, the revenue loss in the first full decade after repeal would be close to $800 billion.[6] Debt financing would add another $200 billion of interest costs.

Federal estate tax repeal would hurt state budgets, too. Prior to EGTRRA, federal law provided a credit for state estate and inheritance taxes, which allowed estates to reduce their federal estate tax liability dollar for dollar, up to a certain percentage of the federal liability (16 percent for estates over about $10 million). Most states collected a "pick up" tax on the estate based on the dollar amount of the federal credit, as reported on the federal estate tax return. Some states levied their own inheritance tax and collected an additional tax to absorb any remaining federal credit. EGTRRA gradually phased out the credit for state estate and inheritance taxes and replaced it with a deduction beginning in 2005.

While some states have taken action since the passage of EGTRRA to prevent their estate tax revenues from disappearing when the federal credit ended or when the federal estate tax is repealed in 2010, others have reduced or eliminated their tax. The loss in estate tax revenue is expected to exceed $4 billion in 2007.[7]

These losses in government saving are huge relative to any plausible estimate of the stimulus to private saving from repeal of the estate tax. On balance, the net effect of repealing the estate tax will almost surely be a decline in national saving that would hurt capital formation and growth.

Repeal would have little impact on family-owned businesses and farms

Farms and family-owned businesses already get special treatment under the estate tax through two main channels: tax deferral and preferential valuation of assets. Family-owned business can pay the estate tax in installments over 10 years, after deferring payments for up to 5 years. The estate pays only interest for the first five years, with a low interest rate of 2 percent applying to approximately the first $1 million in taxable value. Finally, family farms and certain other businesses can value their land at its value in current use rather than fair market value. To qualify for current-use valuation, heirs must continue to use the land in its current use for at least 10 years.

It is rare that a farm or family-owned business estate is taxable. Only 350 taxable estates—less than 3 percent of the 12,600 taxable estates—are projected

Table 4

Gross Estate and Estates with Farm and Business Assets Equal to at Least Half of Gross Estate (Taxable Returns 2006)

Size of Gross Estate	Number of Returns	Gross Estate (millions)	Net Estate Tax (millions)	Percent of Returns	Percent of Gross Estate	Percent of Net Estate Tax
All Taxable Returns	12,600	98,233	18,328	100.0	100.0	100.0
Returns with Farm or Business Assets	350	7,185	1,374	2.8	7.3	7.5

Source: Urban Institute-Brookings Tax Policy Center, Tables T06-0020 and T06-0022.

to have farm and business assets equal to at least half of the gross estate value in 2006 (**Table 4**). Very few of the farm or business estates that would pay estate taxes lack enough liquid assets to pay the estate tax. Even without accounting for the special exemptions granted to these family-owned businesses and farms, only 3 to 4 percent of all estates would be at risk for lacking enough liquid assets. Given the special provisions available to small businesses and farms under current law, a Congressional Research Service analysis concludes that the fraction of these businesses that would be forced to liquidate to pay the tax is "almost certainly no more than a percent or so." [8] The Congressional Budget Office estimated that 13 or fewer farm estates would have needed to liquidate any assets to pay the estate tax in 2000 if the exemption was at its 2009 level of $3.5 million.[9]

Even if few small businesses actually pay the estate tax, it is possible that the tax could inhibit business expansion. For example, a 1999 analysis examined a sample of business owners and found a negative correlation between potential estate tax liability (based on the owners' current level of wealth) and employment growth in those businesses.[10] But as other researchers have pointed out, this analysis did not control for the effect of the owner's age and may simply be picking up the natural "life cycle" of businesses.[11] In other words, older owners are more likely to have higher wealth, but they are also more likely to own businesses that have reached a stable size (due to the age of the business rather than the burden of potential estate taxes). In fact, one interpretation of this analysis is that the causation runs the other way: it's not that potential estate tax liability causes firms to grow more slowly, but rather that the fastest-growing, "entrepreneurial" businesses are not the ones that would face the estate tax at all.

Repeal would not provide substantial compliance cost savings

It is sometimes argued that the economic costs of complying with the estate tax are greater than the revenue raised by the tax, suggesting that we would be better off without the tax. But the size of these compliance and administrative costs, and the implications for the economy, have been greatly exaggerated and mischaracterized.

Compliance costs are a small fraction of estate taxes collected. For example, Charles Davenport and Jay Soled combine Internal Revenue Service (IRS) estimates of the costs of administering gift and estate taxes with survey information from tax and estate practitioners, in order to estimate the combined cost of administration, planning, and compliance. They conclude that the total cost of all these activities is only 6 to 9 percent of revenues.[12] Although the range of estimates in the literature as a whole is very broad (in fact reaching up to 100 percent of revenues), the more reliable estimates—given data sources and methodology—are on the lower end of the range.[13] But whatever the number, these are estimates of the entirety of estate tax compliance costs, most of which goes toward the incomes of lawyers, financial planners, and IRS employees. For the most part, these represent redistribution within the economy but not a net loss to the economy.

Most of these costs would not disappear if the estate tax were repealed. Estates would still need to be settled and income taxes filed. Davenport and Soled explain that the process and effort going into estate planning "would not be substantially different if there were no estate tax." Other estate tax attorneys have said that many new types of tax-avoidance schemes would emerge upon repeal of estate and gift taxes, with the focus shifting toward the income tax system and ways to reduce or avoid capital gains taxes. In fact, because of the way EGTRRA changes the treatment of capital gains in return for repeal of the estate tax, the reporting requirements and associated compliance costs will not be reduced. Instead, the emphasis of the IRS will merely shift from determining the value of the taxable estate of the decedent to establishing the "carryover basis" for assets transferred at death.[14] Thus, suggestions that the variety of compliance costs associated with the estate tax would simply disappear if the tax were repealed are extremely unrealistic.

Endnotes

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[3] Brown, Jeffrey R., and Scott Weisbenner, "Is a Bird in the Hand Worth More than a Bird in the Bush? Intergenerational Transfers and Saving Behavior." Harvard University, 2001; Holtz-Eakin, Douglas, David Joulfaian, and Harvey Rosen, "The Carnegie Conjecture: Some Empirical Evidence." *Quarterly Journal of Economics*, vol. 108, May 1994. pp. 413-35; and Weil, David N., "The Saving of the Elderly in Micro and Macro Data." *Quarterly Journal of Economics*, vol. 109. February 1994, pp. 55-81.

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[5] Joint Committee on Taxation, "Description of the Revenue Provisions Contained in the President's Fiscal Year 2007 Budget Proposal," JCS-1-06, March 2006, p. 314.

[6] Joel Friedman, "The High Cost of Estate Tax Repeal," Center on Budget and Policy Priorities, June 5, 2006, p.1.

[7] Duncan, Harley, "State Responses to Estate Tax Changes Enacted as Part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)," Federation of Tax Administrators, October 24, 2002, available at http://www.taxadmin.org/fta/rate/estatetax.html.

[8] Gravelle, Jane G. and Steven Maguire, "Estate and Gift Taxes: Economic Issues," Congressional Research Service Report for Congress, #RL30600, updated June 1, 2006.

[9] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

[10] Holtz-Eakin, Douglas, "The Death Tax: Investments, Employment, and Entrepreneurs," *Tax Notes* 84(5), pp. 782-92, August 2, 1999.

[11] Gale, William G. and Joel Slemrod, "Rethinking the Estate and Gift Tax: Overview," in *Rethinking Estate and Gift Taxation*, William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., Brookings Institution Press, 2001.

[12] Davenport, Charles and Jay A. Soled, "Enlivening the Death-Tax Death-Talk," *Tax Notes*, July 26, 1999, pp. 591-631.

[13] See Gale and Slemrod, "Rethinking the Estate and Gift Tax: Overview."

[14] Noto, Nonna A., "Estate and Gift Tax Law: Changes Under the Economic Growth and Tax Relief Reconciliation Act of 2001," CRS Report for Congress, RL31061, updated January 29, 2002.

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