Myths About the Estate Tax: Rhetoric versus Reality

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Executive Summary
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President Bush and many Congressional Republicans have argued that repeal of the estate tax is an essential element of their tax proposal. However, much of the rhetoric about the importance of repealing the estate tax seems to be based more on myth than on reality. The economic evidence discussed in this report contrasts the following myths and realities:

Myth: *The estate tax is a "death tax."*
Reality: The overwhelming majority of Americans face no tax liability under the federal estate tax when they die. Only very large estates are taxed.

Myth: *The estate tax is a "double tax" that significantly reduces the size of the capital stock and hampers economic growth.*
Reality: Unrealized capital gains that have never been taxed are a significant amount of the wealth in estates. The impact of the estate tax on investment and growth is ambiguous.

Myth: *Evasion and avoidance of the estate tax greatly reduce the amount of revenue that is collected, rendering the tax both inefficient and regressive.*
Reality: The estate and gift tax raises significant revenue and is highly progressive, even accounting for any distortionary costs associated with the tax.

Myth: *The estate tax is especially burdensome on family-owned businesses and farms.*
Reality: Only a small fraction of taxable estates consist primarily of small business or farm assets, and there are already special provisions to ease the burden of the estate tax on small businesses and farms. Forced liquidation due to the estate tax is extremely rare.

Myth: *Charitable giving would be unaffected by repeal of the estate tax.*
Reality: The most recent empirical evidence suggests that eliminating the estate tax would reduce both charitable bequests and charitable contributions by a noticeable amount.

Myth: *Repeal of the estate tax is affordable and is necessary to grant significant tax relief.*
Reality: The bills before the Congress as part of the 2001 tax debate understate the full cost of repealing the estate tax because they delay full repeal until the end of the 10-year budget window. Simply raising the exemption level would cut the revenue loss substantially while still benefiting many taxpayers.

Myth: *The estate tax can be easily replaced by a change in capital gains taxation.*
Reality: Modifying capital gains rules to more fully tax gains at death would add its own complexities and induce new forms of tax shelters.

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Myths About the Estate Tax:
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President Bush and many Congressional Republicans have argued that repeal of the estate tax is an essential element of their tax proposal. However, much of the rhetoric about the importance of repealing the estate tax seems to be based more on myth than on reality. Economic evidence and analysis show that reality is quite different from several popular myths.

Myth: ***The estate tax is a "death tax."***

Reality: The overwhelming majority of Americans face no tax liability under the federal estate tax when they die. Only very large estates are taxed.

About 2½ million adults died in 1999, but only 49,870 estates incurred a tax liability. In other words, fewer than 2 percent of adult deaths resulted in any estate tax liability.

Current law provides a "unified credit" that effectively exempts $675,000 from the estate and gift taxes, on top of the gift-tax exclusion of $10,000 per recipient per year. For married couples, the gift-tax exclusion and unified credit apply separately with respect to each spouse. Thus, a couple can transfer $20,000 per child tax free in *each year* of their lives, and an additional $1.35 million tax free as bequests. The unified credit is already scheduled to increase, in stages, to $1 million by 2006, so that a married couple could transfer up to $2 million without either spouse's estate incurring any estate tax liability.

Myth: ***The estate tax is a "double tax" that significantly reduces the size of the capital stock and hampers economic growth.***

Reality: Unrealized capital gains that have never been taxed are a significant amount of the wealth in estates. The impact of the estate tax on investment and growth is ambiguous.

Unrealized capital gains are not taxed under the federal income tax; thus, individuals who accumulate unrealized gains in their estates have not yet been taxed on those gains. Under current law, beneficiaries will never incur any income tax liability on these gains either. Economists James Poterba and Scott Weisbenner have recently estimated that 36 percent of wealth in all taxable estates is in the form of unrealized capital gains that will not be subject to the individual income tax. For estates that exceed $10 million, the figure is 56 percent.

In theory, the estate tax could discourage the buildup of wealth because, once wealth exceeds the exempted amount, only a portion of each additional dollar of saving is passed on to beneficiaries.

However, it could also encourage wealth accumulation to the extent that people have an after-tax target for the amount of wealth they would like to pass on.

To the extent that repealing the estate tax increased capital formation, it would have to do it by increasing national saving. But that outcome is highly uncertain for a number of reasons. First, for saving to increase, the positive effect of a larger return to saving (what economists call the “substitution effect”) would have to offset the negative effect of a reduced need to save to achieve any given target of wealth (what economists call the “income effect”). Second, even without any income effect, the positive response to the higher rate of return could be very small, depending on the motives for saving and bequests. Economists have identified a number of possible motives, with differing implications for whether repealing the estate tax would encourage or discourage saving—but they have not reached a consensus on which are the most important. As a recent Congressional Research Service report by Jane Gravelle and Steven Maguire explains, the overall effect of repeal on a decedent’s saving is never unambiguously positive, no matter what the motives explaining bequests, while the effect on the heirs’ saving can often be unambiguously negative (because an increase in or even the anticipation of receiving wealth encourages greater consumption out of current income).

Some economists believe that the estate tax inhibits other sources of economic growth. For example, a 1999 analysis by Douglas Holtz-Eakin 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. But as William Gale and Joel Slemrod 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. 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.

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 national saving unchanged. However, to the extent that repealing the estate tax is an alternative to greater debt reduction, this analysis is incomplete. The loss in national saving due to smaller debt reduction is very likely to exceed any gain from the repeal of the estate tax.

Myth: Evasion and avoidance of the estate tax greatly reduce the amount of revenue that is collected, rendering the tax both inefficient and regressive.

Reality: The estate and gift tax raises significant revenue and is highly progressive, even accounting for any distortionary costs associated with the tax.

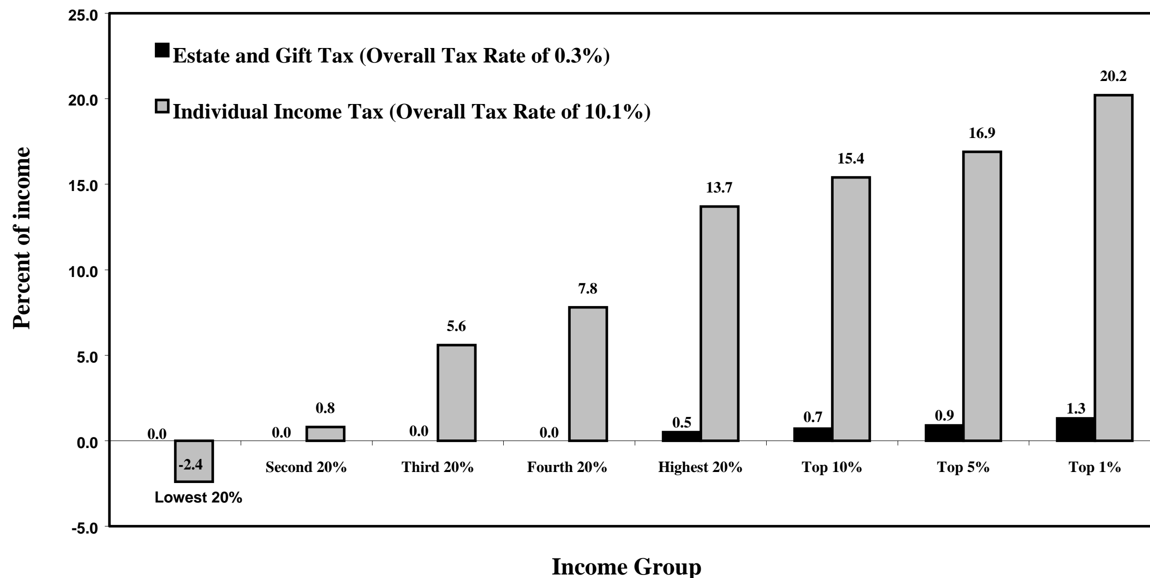
The federal estate and gift tax collected about $29 billion in revenue in 2000. In addition, the federal credit for state estate or inheritance taxes, which acts as a transfer to states that maintain their own estate or inheritance taxes, contributed about $6 billion to state tax revenues. The CBO estimates that the federal tax alone will raise $380 billion over the next ten years.

Economists recognize that taxes can impose efficiency costs in addition to the direct revenue effects. As discussed in the previous section, however, the evidence on whether saving and investment are much affected by the estate tax is mixed at best. Economists have come to learn that the kinds of distortions most likely to occur are associated with sophisticated tax and estate planning (for example, labeling given amounts of capital income in ways that minimize tax burdens) rather than effects on real economic decisions (such as choosing to save instead of consume). This view of which motivations matter most is supported by a number of papers in the conference volume examining the 1986 tax reform, *Do Taxes Matter?* edited by Joel Slemrod.

Some have used the fact that the largest estates pay slightly lower average tax rates than somewhat smaller estates to argue that the estate tax is not progressive. And in fact, tax data from 1999 indicate that the average tax rate paid by estates of $20 million or more was 19.7 percent of the gross estate value, which was lower than the 27.1 percent of gross value paid by estates valued between $10 million and $20 million. But this difference arises because the richest estates qualified for much higher deductions, mainly associated with their charitable bequests. In other words, the estate tax is progressive among estates according to the value of the *net* taxable estate. In absolute dollar terms, the estate tax collects far more tax from the largest gross estates than it does from estates in the next largest category.

Progressivity should be assessed across the entire income distribution, not just among those who pay any particular tax. In this proper context, the estate tax is by far the most progressive form of federal taxation. Receipts are highly concentrated in the highest income categories, as are any costs associated with avoidance. The estate tax is the most progressive because the distribution of bequeathed wealth is more concentrated than the distribution of wealth in general, which is already much more concentrated than the distribution of income. Although the estate tax is a much smaller share of overall federal tax receipts than is the income tax, the estate tax adds to the progressivity of the overall federal tax system because it is more progressive than the income tax (see chart on next page). The Treasury analysis shown in the chart follows the standard methodology of distributing the estate tax across decedents, but Gale and Slemrod have shown that the distribution is almost as concentrated when the tax is distributed to beneficiaries. This is because both the decedents and the beneficiaries of estates large enough to be subject to the estate tax tend to have high incomes.

Distribution of Estate and Income Tax Receipts by Income Group



Source: Cronin, Office of Tax Analysis, U.S. Treasury Department (1999)

Myth: ***The estate tax is especially burdensome on family-owned businesses and farms.***

Reality: Only a small fraction of taxable estates consist primarily of small business or farm assets, and there are already special provisions to ease the burden of the estate tax on small businesses and farms. Forced liquidation due to the estate tax is extremely rare.

Family-owned businesses and farms already get special treatment under the estate tax through three main channels: higher effective exemptions, tax deferral, and preferential valuation of assets. The Congressional Research Service report cited above estimates that only about 7.5 percent of farm owner decedents, and 4.4 percent of business owner decedents, pay taxes on their estates. The same report estimates that very few of these lack enough liquid assets to pay their estate tax: even without accounting for the special exemptions granted to these family-owned businesses and farms, only 3 to 4 percent of estates would be at risk for lacking enough liquid assets. Given the larger exemption available to small businesses and farms under current law, the 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." Indeed, the *New York Times* recently reported that an Iowa State University economist has not been able to find a single documented example of a family farm lost to the estate tax. Nor could the American Farm Bureau Federation cite an example.

In addition, small businesses and farms are even less likely than taxable estates in general to have paid capital gains taxes. Poterba and Weisbenner found that 82 percent of all business and

farm assets within estates larger than $10 million are unrealized capital gains. In other words, the vast majority of the value of large farm estates has never been taxed by the income tax system.

Myth: Charitable giving would be unaffected by repeal of the estate tax.

Reality: The most recent empirical evidence suggests that eliminating the estate tax would reduce both charitable bequests and charitable contributions by a noticeable amount.

One way to avoid paying the estate tax is to draw down one's potentially taxable estate by giving to charity, either during one's lifetime or as a charitable bequest at death. Thus, one concern about estate tax repeal is that it would reduce charitable giving.

As with the economic research on how taxes affect saving, the existing body of research examining the effects of the estate tax on charitable giving does encompass a broad range of predictions. But the most recent analyses using the most sophisticated econometric techniques find a positive and significant relationship between estate taxes and lifetime charitable giving. David Joulfaian, a Treasury Department economist, has estimated that eliminating the estate tax would reduce charitable bequests by about 12 percent, or about $1.3 billion in 1998. Pamela Greene and Robert McClellan, Congressional Budget Office economists, recently estimated that repeal of the estate tax would decrease charitable contributions (annual giving) by about 6½ percent.

Myth: Repeal of the estate tax is affordable and is necessary to grant significant tax relief.

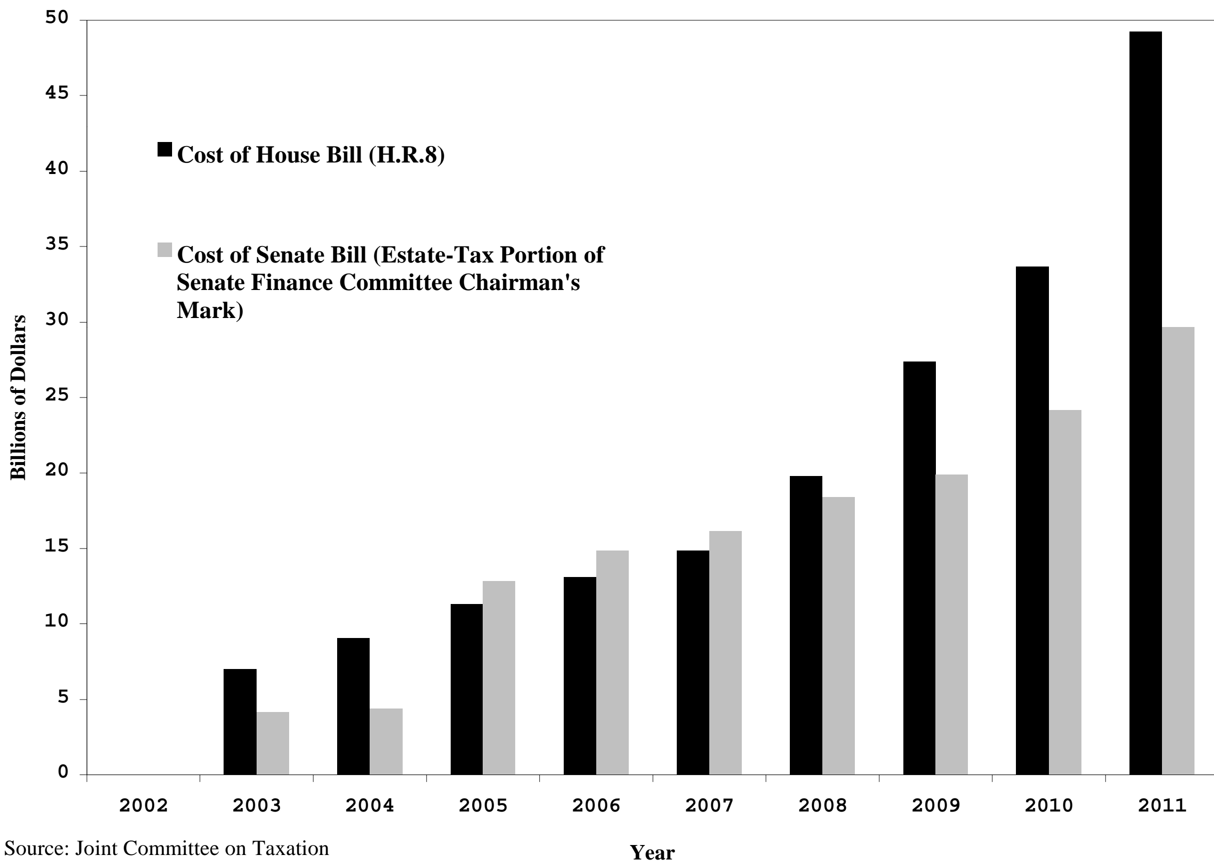
Reality: The bills before the Congress as part of the 2001 tax debate understate the full cost of repealing the estate tax because they delay full repeal until the end of the 10-year budget window. Simply raising the exemption level would cut the revenue loss substantially while still benefiting many taxpayers.

The House and Senate proposals to repeal the estate tax mask the permanent cost of repeal due to severe "backloading" (see chart on next page). With the estate tax not fully repealed until 2011 (the last year of the budget window), the 10-year cost greatly understates the fully phased-in cost of the plan. For example, the Joint Committee on Taxation estimated that the House version (H.R. 8) would cost $186 billion between 2002 and 2011—less than one-third of the 10-year cost they estimated for immediate repeal ($662 billion). The costs of repeal include interactions with other taxes reflecting tax avoidance strategies.

The Senate version tried to address the avoidance issue by repealing only the estate tax while preserving the gift tax. But pressure to repeal the gift tax could mount as well. Iris Lav of the Center on Budget and Policy Priorities estimates that if estate tax repeal leads to eventual gift tax repeal, the actual revenue loss from the Senate plan could be as much as 80 percent higher than the Joint Committee on Taxation's $144 billion estimate.

Federal estate tax repeal would hurt state budgets, too. Citizens for Tax Justice has estimated that states could lose up to $18.5 billion per year from repeal of the federal estate tax. Most of that loss arises from the loss of the federal credit for state estate and inheritance taxes, while part is due to the likely pressure there would be for states to repeal their own supplemental estate or inheritance taxes.

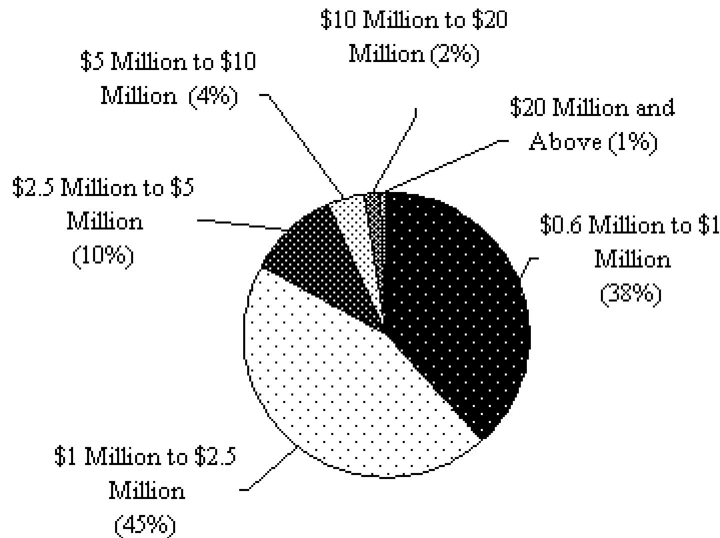
House and Senate Estate Tax Bills Hide the Permanent Cost of Repeal

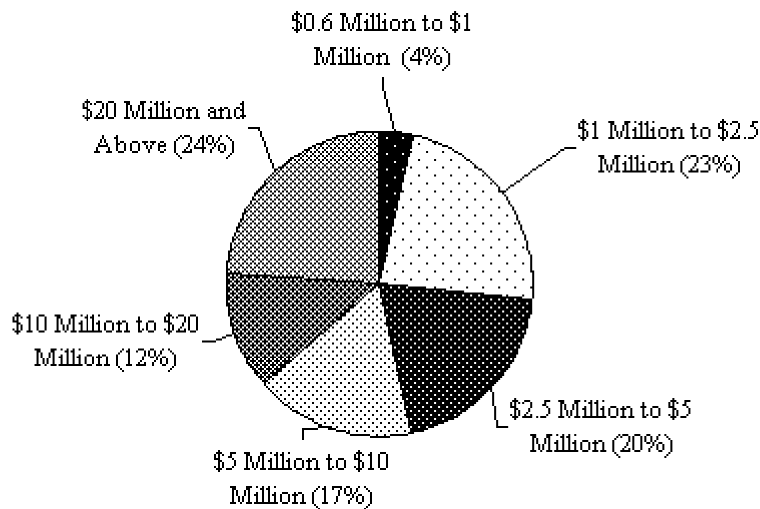


Source: Joint Committee on Taxation

An alternative to repeal that would greatly reduce the revenue loss would be to raise the exemption level. For example, raising the estate tax exemption to a level of $5 million per estate would exempt all but a few of the largest estates from taxation. Tax data indicate that in 1999, only 3,283 estates—about 6.6 percent of all taxable estates—had a value of $5 million or more (see chart on next page). These 3,283 estates paid over half of total estate tax revenues, implying that the cost of going to full repeal would be greatly higher than the cost of raising the exemption, but would benefit only a small additional fraction of currently-taxable estates. (Note that *all* taxable estates, including those 6.6 percent at the top, would benefit from the higher exemption, because only the portions exceeding $5 million would be taxable.)

The Small Fraction of Estates Over $5 Million Pay the Bulk of the Estate Tax





Note: Gross estates below about $600,000 were exempt from estate taxation because of the unified credit.
Source: JEC calculations based on Internal Revenue Service, Statistics of Income Division, May 2001.

Myth: ***The estate tax can be easily replaced by a change in capital gains taxation.***

Reality: **Modifying capital gains rules to more fully tax gains at death would add its own complexities and induce new forms of tax shelters.**

Current capital gains tax rules allow assets to be revalued when they are transferred at death, without either the estate or the beneficiary having to pay any income tax on the resulting capital gains (although those gains might be subject to the estate tax if the estate is large enough). If and when an heir eventually sells the asset and realizes a gain, the capital gains tax is paid on the difference between the sale price and the "stepped-up" basis. (The tax would be zero if the heirs sold the asset immediately.) Because one argument for keeping the estate tax has been that it serves as a backstop for the income tax, some specific repeal proposals include a "carry-over basis" provision that limits (but does not eliminate) the step-up allowed under current law. Experts believe that these changes to capital gains rules would replace only a small fraction of the revenues lost by estate tax repeal. Capital gains taxes can still be avoided as long as the capital gains remain unrealized. Moreover, tax attorneys have argued convincingly that new income-tax avoidance strategies will be devised, as the Joint Committee on Taxation has acknowledged in its revenue estimates. Implementing carry-over basis is also likely to increase, rather than decrease, the complexity of the overall tax system, even with repeal of the estate tax.

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