The American Voice 2004: A Pocket Guide to Issues and Allegations

Issues and Allegations: Estate Tax

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WHY WE USE "CONSERVATIVE" AND "LIBERAL"

At a Glance...

The conservative view:

- The estate tax exemption has not kept up with inflation and thus increasingly affects the middle class.
- Families are forced to sell farms and small-businesses to pay estate taxes.
- Estate taxes are bad for the economy because they reduce incentives to save and invest.
- Repealing the estate tax would spur economic growth.
- Higher capital gains tax revenues stemming from this increased growth would compensate for the loss of revenues from an estate tax repeal.
- Charitable giving depends more on the health of the economy than on estate tax deductions.
- Estate taxes generate little federal revenue

The liberal View:

- Hereditary transfer of concentrated wealth is incompatible with American values and democracy.
- Eliminating the estate tax would shift a greater tax burden onto low- and middle-income taxpayers.
- Estate taxes are paid only by the wealthiest 2 percent of Americans.
- Very few family farms or businesses are actually affected by the estate tax.
- Much of the wealth in taxable estates is capital gains that have never been taxed.
- The estate tax deduction for charitable contributions encourages philanthropy. Abolishing the estate tax will reduce charitable giving.
- The estate tax should be reformed, with an increased exemption, not repealed

Background

For the first century after its birth, the United States imposed estate taxes to prepare for or pay for wars. The first estates tax(1797-1802) funded the creation of a navy to defend the infant nation. From 1862 to 1870 an inheritance tax helped pay for the Civil War. From 1898 to 1902 an estate tax was used to finance the Spanish-American War.**[1]**

In 1906, President Theodore Roosevelt severed the link between estate taxes and military spending when he proposed an estate tax not to finance a war but to limit the amount of wealth one person could transfer to another as a matter of fairness. He proposed a progressive tax in which rates rose as the value of the estate increased. The tax was finally adopted in 1916, three years after the income tax was introduced and at a time when the reduction in global trade due to the outbreak of World War I caused import tariff incomes to fall.**[2]**

In the 1920s Congress lowered estate tax rates and raised the level of exemptions. During the Great Depression of the 1930s, it raised rates and decreased the level of exemptions. The estate tax was not substantially revised again until 1976, when taxes on estates, gifts and generation-skipping transfers were linked.**[3]**

As part of the 1976 changes in estate tax law, a significant change was made in the way capital gains on inherited assets are calculated. A capital gain is an increase in the value of an asset (e.g. stock, real estate other than one's primary residence, art collections) over its value when it was purchased (its "basis"). Capital gains are not taxable until an asset is sold. They are taxed at a special capital gains rate (currently 15 percent).

The taxable value of an estate is determined by the fair market value of its assets, which includes any unrealized capital gains (capital gains on assets that have not yet been sold). Estate taxes are higher than capital gains taxes, although when alive we must pay capital gains on all gains while estate taxes only those capital gains that exceed the estate tax exemption.

Before 1976, the basis for an asset that was part of an estate was "stepped-up" to its value at the time of inheritance. If one buys a stock at $10,000 and sells it for $50,000 while still alive, the taxable capital gains is $40,000. But if that asset is part of one's estate at death, its value is stepped-up to $50,000. The capital gains are taxed as part of the estate; they are not taxed a second time when the heir sells the asset.

In 1976, Congress adopted the "carryover" method for determining the capital gains basis of inherited assets. In this case, the basis of the asset in the hands of one's heirs does not change – it continues to be the original purchase price. The carryover method, however, was never actually used because Congress retroactively repealed the 1976 changes in 1980.**[4]**

An estate is taxable if its total value – after transfers to a surviving spouse, charitable gifts, debts, funeral expenses and administrative fees have been deducted – exceeds an exempt amount.**[5]** In 2001, only the value of estates over $675,000(after deductions) was taxed. Family-owned farms and businesses were allowed an additional deduction of up to $675,000 for business assets, if the heirs kept the business going. The heirs could pay the estate tax over 14 years at below-market interest rates.**[6]**

Under the old law, the tax rate on assets over $675,000 in value began at 37 percent and increased in one-percentage point increments to a maximum of 55 percent for amounts above $3 million. A 5-percent surtax was imposed for amounts between $10 million and just under $18 million, thereby raising the marginal tax rate to 60 percent. For amounts over $18 million the tax rate fell back to 55 percent. Under the old law, state estate taxes were subtracted dollar for dollar from federal estate tax liability.**[7]**

In 2001, Congress passed a law that phases out and ultimately eliminates estate taxes.**[8]** The new law reduces the top marginal rate to 50 percent in 2002, and decreases the tax by one point annually to 45 percent by 2007. It also eliminates the 5 percent surtax. The amount of an estate that is exempt from taxation rises from $1 million in 2002, to $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. In 2010, the estate tax is completely repealed. To partially offset the loss in income from these changes, Congress required that in 2010, the basis for calculating capital gains on inherited assets change from stepped-up to carryover. **[9]**

A quirk in the law, done in part so that the loss of revenue after 2010 would not have to be taken into account in the 2001 evaluation of 10 year budgetary impact of the original tax change, the law expires on December 31, 2010. In 2011 the situation returns to that in 2000 with an exemption of $1 million, and a top marginal rate of 55 percent.

From 1935 through 1998, the percentage of estates in a given year that pay estate tax has generally been less than two percent.**[10]** The Congressional Budget Office estimates that 16,700 estates will be subject to the tax in 2005, compared with 30,400 that would have been subject to the tax without the 2001 changes.**[11]**

Since 2001, the House has twice passed legislation that would make permanent the estate tax repeal after 2010. Similar bills have been voted down in the Senate, with the exception of a bill that was passed but not implemented in 2003.

The problem

Should we abolish the estate tax?

The conservative perspective

Conservatives maintain that the estate tax is unfair. They note that the estate tax exemption has not kept up with inflation and thus increasingly affects the middle class.

In 1916 the estate tax exemption was $50,000 – the equivalent of $11 million in 2003. In 1931 the exemption was worth $14 million in today's wealth. The exemption of $675,000 in 2001 did not prevent the estate tax from affecting average Americans. A middle class family with a home and retirement savings accounts could easily have assets exceeding the old exemption.**[12]**

"The dirty little secret of the death tax is that the people clobbered by it are not billionaires. More often they are ordinary Americans with medium-sized estates", according to Stephen Moore of the Cato Institute.**[13]** In 1997, the average tax rate for estates valued at over $20 million was actually lower than the average rate for estates in the $2.5 million to $5 million range.**[14]**

Conservatives maintain that estate taxes are bad for family-owned businesses, a critical component of the American economy. Survey data indicate that estate taxes are a primary reason that family businesses do not survive beyond one generation.**[15]** Small businesses and farms are often property-rich but cash-poor. They are unable to pay estate taxes without liquidating business assets.

Conservatives maintain that planning for estate taxes diverts money and efforts that could otherwise be invested in business growth and thus negatively affects the economy. They point to a survey of 400 business owners in New York that found that businesses in which the owner would be subject to the estate tax if he died had less employment growth over the previous five years than other firms.**[16]**

Conservatives argue that inheritance itself is good for business by fostering entrepreneurship. Receipt of an inheritance increases the likelihood that a household starts a business, and increases the probability that the recipient's existing business will survive and expand.**[17]** Thus estate taxes not only reduce incentives for wealthy individuals to invest; they lead to reduced investments by the beneficiaries of estates.

Conservatives maintain that the estate tax reduces savings and investment. "Being able to pass on wealth to one's children is a strong incentive. By reducing that incentive, the estate tax reduces savings and investment", argues National Review editorialist Ramesh Ponnuru.**[18]**

Studies show that individuals who retire wealthy make conscious decisions to save rather than spend.**[19]** But wealthy parents facing the prospect of having to give the government as much of their savings as they can give to their children could decide to spend the money instead and thereby realize more of the benefits of each dollar themselves.**[20]**

Estate taxes discourage investments for a second reason. Wealthy individuals take into account the fact that their current investments will produce future tax liabilities. Therefore they require a greater return on their investment to compensate for future taxes.**[21]** Thus an investor willing to invest $2 million in a company with an expected 8 percent return on investment might require a 9 percent return to offset future tax liabilities resulting from an inheritance tax. This increases the company's cost of capital by $20,000 annually. If all investors expect higher rates of return to compensate for taxes, the increased cost of capital will slow economic growth. One economist estimates that federal estate taxes add at least 1.3 percent to the cost of capital in the U.S.**[22]**

Conservatives maintain that eliminating estate taxes will spur savings and improve the U.S. economy. The Heritage Center for Data Analysis estimates that an immediate repeal of estate taxes would increase the gross domestic product by $10.6 billion on average each year from 2003 to 2012.**[23]**

Some conservatives maintain that by stimulating the economy an estate tax repeal could actually increase federal revenues by increasing capital gains revenues. Even with a $1 million exemption for capital gains on inherited assets, the Heritage Center for Data Analysis estimates that increases in capital gains tax revenues would more than compensate for an immediate repeal of the estate tax by 2007, assuming the carryover method of calculating capital gains were in place.**[24]**

Many conservatives, on the other hand, oppose the change to a carryover method of capital gains taxation when the estate tax is eliminated under the new law. They argue it is "not an acceptable trade-off for elimination of the death tax; it is simply a new death tax in a different form."**[25]** If Congress will not repeal the estate tax unless the stepped-up basis for capital gains is changed, they recommend the estate tax be retained with a $5 million exemption and a top rate no higher than the capital gains tax rate.**[26]**

Conservatives say the estate tax is a form of double taxation. Income is taxed as it is earned. And then it is taxed again at death.**[27]**

Conservatives argue that the estate tax does nothing to reduce inequality. They cite numerous studies by liberal as well as conservative economists. Economist Alan Blinder found that only about 2 percent of inequality was attributable to unequal distribution of inherited wealth.**[28]** Another study found that just 14 percent of millionaires cite inheritance as the source of their wealth.**[29]**

A 1996 analysis found that differences in annual earnings are far more important in accounting for inequality than differences in inheritance.**[30]** Nobel Prize-winning economist Joseph Stiglitz, who served as Chairman of President Clinton's Council of Economic Advisers, argued that the estate tax might actually increase inequality in the distribution of consumption, because it encourages wealthy families to spend rather than save.**[31]**

Conservatives reject the argument made by liberals that if the estate tax were abolished, charitable giving will decline. They note that between 1992 and 1995, four out of five estates did not make any charitable bequests. Even among estates worth more than $20 million, half did not take advantage of the charitable deduction.**[32]** In the five years after the 1981 <u>reduction</u> in estate tax marginal rates, charitable bequests actually <u>increased</u> by 22 percent over the five years before the reduction.**[33]**

Conservatives point out that the estate tax generates surprisingly little federal revenue, just 1.4 percent of federal revenues in 1998. That level has remained relatively stable over the last five decades. In fact, the income tax in 1998 alone raised more money than was raised by the estate tax during the entire 20th century.**[34]**

The liberal perspective

Liberals say the hereditary transfer of concentrated wealth is incompatible with American values and democracy. The estate tax reduces the concentration of political power that accompanies concentration of wealth. Moreover, an estate tax enables genuine equality of opportunity.**[35]**

Liberals cite the writings and actions of Andrew Carnegie who warned that leaving wealth to one's family is the "most injudicious" way an estate can be disposed of. It often undermines the entrepreneurial spirit of the next generation while reducing societal revenue. "Wise men will soon conclude that, for the best interests of the members of their families, and of the State, such bequests are an improper use of their means.**[36]**

When President Theodore Roosevelt proposed an inheritance tax in 1906, he recognized that wealthy citizens derive "special advantages from the mere existence of government", which protects wealth and property rights.**[37]** Bill Gates Sr. has noted that public goods provided by the U.S. government are essential to wealth creation. These include secure borders, stable markets for the sale of goods, public schools to educate workers, and publicly funded research that has led to economically productive technology such as integrated circuits, the Internet and the map of the human genome.**[38]** Thus he argues, the wealthy should be willing to pay to the public sector a portion of their estates.

Liberals point out that the U.S. income gap has grown dramatically since 1980. From 1979 to 2000 the after-tax income of the top one percent grew by 200 percent, while the after-tax income of the middle twenty percent grew by only 15 percent.**[39]** In 2001 the top five percent of Americans owned more than the combined wealth of all other Americans.**[40]** Wealth is now more concentrated than at any time since the 1920s.**[41]** The U.S. now holds the dubious distinction of being the most unequal society in the industrialized world.

In the liberal view, the amount of revenue generated from the estate tax is not relevant to the question of whether or not there should be an estate tax. "The essential issue is not the magnitude of revenue raised, but whether the benefits associated with the estate tax – in terms of revenue, distributional and behavioral effects, and other issues – are worth the costs."**[42]**

Nevertheless, liberals maintain that the estate tax is an important source of funds for government. It generated $20 billion in 2003. The departments of State, Energy, Labor, Commerce, Agriculture and Interior each have discretionary budgets of $20 billion or less.

According to the Center for Budget and Policy Priorities, permanent repeal of the estate tax would lead to lost federal revenue of $64 billion in 2013 alone, and an additional $840 billion from 2014 through 2023.**[43]** This is the time when the costs associated with the retirement of the baby boom generation will begin to adversely affect the federal budget. If the estate tax is repealed, the burden of paying for public services will be shifted from the wealthy to low- and middle-income taxpayers.

Liberals point out that using the carryover basis to calculate capital gains on inherited assets will only replace a small fraction of the tax revenues lost by repealing the estate tax. They note that the Joint Committee on Taxation estimated that if the estate tax were abolished in 2002 and the carryover method adopted the same year, the federal government would lose more than $400 billion in estate tax revenue between 2002 and 2011, while the increase in capital gains revenue would be only about $50 billion.**[44]** Moreover, liberals note that even this estimate was very conservative since it assumed there would be no exemption from capital gains on inherited assets. But the 2001 law allows an exemption of $1.3 million in assets, and an additional $3 million for transfers to spouses.**[45]** Thus the loss to the federal treasury would be even greater.

Liberals point out that the estate tax affects a very small number of people. Only 2 percent of the people who died in 2001 left taxable estates.**[46]** The 3,500 largest estates, all of which were valued at over $5 million, paid more than half of all estate taxes. The 469 estates valued at over $20 million paid over one-fifth of all estate taxes.**[47]** In 2004 an estimated 18,800 estates will pay estate taxes –one out of every 15,587 taxpayers, equivalent to one household in every mid sized city.**[48]**

Clearly the estate tax is collected from those who are most able to pay. This is true even when one takes the view that the heirs rather than the donor bear the burden of the estate tax, because the heirs are very wealthy as well.**[49]**

Liberals point out that the amount collected per dollar of wealth in an estate is much lower than the tax rate suggests, because exemptions and deductions lower the effective tax rate. The effective tax rate is the amount of tax paid relative to the total size of the estate. The tax rate for a $10 million estate in 2004 is 48 percent. But that doesn't mean the estate will be paying $4.8 million in taxes. After excluding from taxation the exempt amount of $1.5 million, the effective tax rate is 40.8 percent(33.6 percent for a couple).**[50]** The effective rates is further lowered by any deductions for charitable gifts, funeral expenses, or administrative fees.

Thus in 1999, when the top estate tax rate was 55 percent, the average effective estate tax rate was 12.4 percent. The effective rate was 2.2 percent for estates worth $600,000 to $1 million, and 9.4 percent for estates worth $1 million to $2.5 million.**[51]** In other words, an estate of $900,000 actually paid less than $20,000 in estate taxes.

Liberals reject the conservative argument that the estate tax burdens ordinary Americans with medium-sized estates. They note that estates valued at over $20 million sometimes pay a lower effective tax rate than smaller estates because they give much more to charity– 28.4 percent of gross versus 5.7 percent for estates valued at $2.5 million to $5 million. The estate tax is still a highly progressive tax paid only by the wealthiest 2 percent of American families.**[52]**

Liberals point out that some estates will be negatively affected if the estate tax is eliminated and the capital gains basis is changed from stepped-up to carryover. The change will result in a capital gains tax liability for estates between $1.3 million and $3.5 million that would not have had any tax liability under an estate tax with an increased exemption. "If more people really understood what eliminating the estate tax meant, they wouldn't be for it," says Jeffrey Condon, author of an estate-planning guide.**[53]**

Liberals maintain that the estate tax does not burden the vast majority of family farms and businesses. Only one out of every 1,500 people who die leaves a taxable estate in which a family farm or business constitutes the majority of the estate's value. And a study by the Federal Reserve found that the average small business is worth just over $700,000 – well below the level at which the estate tax kicks in.**[54]** A 1999 study found that 77 percent of business owners in their fifties would either face no estate tax liability or could pay the tax out of insurance and liquid assets without having to use any non-liquid assets or the business itself, and without any estate tax planning or avoidance.**[55]** Moreover, estate tax law includes special provisions to accommodate family-owned businesses – including the right to pay estate tax liabilities over a 14-year period at below-market interest rates.

Liberals maintain that the estate tax is not an additional layer of taxation. Much of the wealth in estates is unrealized capital gains that have never been taxed. Indeed, capital gains represented 36 percent of all wealth held by those who died in 1998, and 56.4 percent of estates over $10 million.**[56]**

Liberals maintain that the effect of the estate tax on behavior is ambiguous. Scholars at the Brookings Institution found the impact of estate taxes on saving significantly dependent on the motives for wealth transfers.**[57]** When bequests are altruistic, estate taxes lead to higher savings among parents. When bequests are accidental, estate taxes do not negatively affect saving by parents and lead to higher savings by their children, perhaps because they do not expect a large inheritance. There is evidence that people who anticipate receiving an inheritance save four to 10 percent less of their own earnings than those who do not, after controlling for other factors that affect savings.**[58]**

Liberals also point out that it is inconsistent for conservatives to argue that estate taxes affect one set of behaviors (work, saving and investment) but not another (philanthropy).**[59]** They maintain that a large body of empirical evidence shows that subsidies, like the estate tax deduction for charitable contributions, encourage philanthropy. Thus abolishing the estate tax will reduce charitable giving.**[60]**

In 2001 estates gave $16.2 billion to charities, with estates of more than $20 million accounting for $6.8 billion of the total. Brookings Institution economists estimate that had the estate tax been eliminated in 2001, this amount would have been $3.6 billion to $6 billion lower.**[61]** Since charitable gifts while living have the same effect as estate gifts (decreasing the size of the taxable estate), repealing the estate tax would also reduce incentives for wealthy people to make charitable contributions during their lifetime.**[62]**

Liberals say that the estate tax should be reformed, not repealed. By making permanent the 2009 provisions – an exemption of $3.5 million and a top rate of 45 percent – 88 percent of the households that currently pay the estate tax would be exempt. In 2009 fewer than 6,000 estates, each boasting an average wealth of $17 million, would have to pay any taxes.**[63]** Yet maintaining this tax would generate $460 billion more in revenue just between 2014 and 2023, than would be the case if the estate tax were fully repealed.**[64]**

Notes and Sources

- **A note on internet sources**

[1] Joint Committee on Taxation, ***Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation***, March 15, 2001. In this paper we use the term "estate tax" and "inheritance tax" interchangeably. However, they operate differently. An estate tax is imposed on the value of an estate before it is transferred to heirs. An inheritance tax is imposed on the heirs. To understand the difference and is implications, consider the following example. An estate valued at $10 million is divided equally between two heirs. Under an estate tax of 10 percent on the first $2 million and 15 percent on anything above that, the estate tax would be $1.4 million ($200,000 on the first $2 million and $1.2 million on the remaining $8 million). The heirs would each receive $4.3 million($10 million less $1.4 million divided by two). Under an inheritance tax each heir would receive $5 million and each would pay $650,000 in taxes ($200,000 for the first $2 million and $450,000 for the remaining $3 million). The federal tax collected via the estate tax is $1.4 million while under the inheritance tax it drops to $1.3 million. The reason is that under an inheritance tax both heirs can benefit from the lower 10 percent tax on amounts under $2 million. The more heirs there are, the greater is the share of the estate that goes to them.

The U.S. and the U.K. are the only countries in the Organization for Economic Cooperation and Development (OECD) that level a pure estate tax. Among OECD countries, only Australia and Canada impose neither an inheritance tax nor an estate tax. The others have an inheritance tax, or a mixture of inheritance and estate taxes. But many of these countries also have wealth taxes (an annual tax on total assets, including property and financial assets) while the U.S. does not. In most countries the tax is between .5 percent and 1.5 percent of total assets over an exempt amount. OECD countries that have a wealth tax include Austria, Denmark, Finland, France, Germany, Hungary, Iceland, Luxembourg, the Netherlands, New Zealand, Norway, Spain, Sweden, and Switzerland. For more extensive examples see Dennis E. Logue Sr. and Dennis E. Logue Jr., "**For Fairness, Choose a Wealth Tax**," Josiah Bartlett Center for Public Policy, February 2001.

[2] The income tax was instituted in 1913 after passage of the 16th Amendment to the Constitution made such a tax constitutional.

[3] Ibid. The gift tax requires that the total of monetary gifts made during the life of the deceased be included in the estate calculations if they exceed an exempt amount. Individuals are allowed to give $10,000 tax-free each year to any number of recipients ($20,000 for a couple). If they give more than that away, the additional money must be added to the value of their estate at death. Generation-skipping transfers are bequests to grandchildren or great-grandchildren that, before 1976, allowed families to avoid one or two layers of estate tax. The 1976 changes introduced a separate tax of up to 55 percent on generation-skipping transfers in excess of a $1 million exemption.

[4] One reason Congress abolished the change was that it led in many cases to double taxation. After the increase in the value of the stock was taxed as part of the estate it was taxed again when the stock was transferred to the heirs and sold.

[5] Life insurance policies owned by the deceased are included in the value of the estate. Life insurance policies owned by someone other than the deceased are not included in the value of the estate, nor are they subject to federal income taxes.

[6] The exemption under the 2001 law was scheduled to increase to $1 million by 2006. Joint Committee on Taxation, 2001, Op. Cit. Estate tax attributable to assets in a family-owned business can be paid in up to ten installments over a 14 year period. Interest is charged only for the first five years. A special 2 percent interest rate is applied to the first $1 million in taxable value of a family business. Interest on the remaining amount is equal to 45 percent of the federal short-term rate plus 3 percentage points.

[7] Ibid.

[8] Congress passed similar legislation in 1999 and 2000, but President Clinton vetoed both bills.

[9] Economic Growth and Tax Relief Reconciliation Act of 2001.

[10] Joint Committee on Taxation, 2001, Op. Cit.

[11] U.S. Congressional Budget Office, ***Budget Options: Options that Affect Revenues***, March 2003.

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[13] Stephen Moore, "**Repeal the Grave Robber Tax**", Cato Institute, February 22, 2001.

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[23] By 2012 the economy would support 118,000 more jobs than under the current law, and personal disposable income would be $11 billion higher. Alfredo B. Goyburu, "The Economic and Fiscal Effects of Repealing Federal Estate, Gift and Generation-Skipping Taxes", Heritage Center for Data Analysis, Heritage Foundation, November 15, 2002.

[24] Ibid.

[25] Phyllis Schlafly, **Letter to President George W. Bush**, Eagle Forum, February 28, 2001.

[26] Ibid. See also Bruce Bartlett, "**Taxing Debate**," National Review, July 3, 2002.

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The bedrock of good government is an informed citizenry. We strive to get behind the sound bites and sloganeering to identify the real differences.