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THE ESTATE TAX: MYTHS AND REALITIES

The estate tax has been an important source of federal revenue for nearly a century. It also encourages billions of dollars in charitable donations each year (http://www.cbpp.org/6-7-06tax.htm), since donations substantially reduce the tax on large estates. Despite these benefits, a number of misconceptions continue to surround the tax.

Myth 1: Weakening the estate tax wouldn't significantly worsen the deficit because the tax doesn't raise much revenue.

✓ **Reality: Repealing the estate tax, or weakening it well beyond its 2009 parameters, would add trillions of dollars to future deficits and be fiscally irresponsible.**

Permanent repeal of the estate tax would cost almost $1.3 trillion over the first ten years in which its cost would be fully felt, 2012-2021. This includes $1 trillion in lost revenue and $277 billion in increased interest payments on the national debt.[1]

Making the 2009 estate tax parameters permanent itself would cost $609 billion over this period, or about half as much as repeal — $485 billion in revenue losses and $124 billion in added interest costs. Making the 2009 parameters permanent thus would be quite expensive, although it would cost $667 billion less than repeal.

Acting to make the 2009 rules permanent would be more fiscally responsible than various other proposed estate-tax changes. For example, one proposal, advanced by Senator Jon Kyl (R-AZ), would set the estate-tax exemption level at $5 million ($10 million for a couple) and the top tax rate at 15 percent. Senator Kyl, an advocate of complete repeal of the tax, has commented that an estate tax along these lines "would be almost as good as full repeal." That is an apt description of its budgetary effects; the proposal would cost 84 percent as much as repeal, adding nearly $1 trillion to deficits over the 2002-2021 period.

[1] The official ten-year cost estimate is much lower: $670 billion, but that estimate is misleading because it covers a ten-year period, 2009-2018, that captures the full cost of only *six* years of making repeal permanent. (http://www.cbpp.org/6-5-06tax.htm)

The Kyl proposal would cost $380 billion more over this period than making the 2009 parameters permanent. Yet the added costs would benefit the estates of only the wealthiest three of every 1,000 Americans who die.

Given the nation's serious long-term fiscal problems, repealing or further weakening the estate tax would not be fiscally responsible.

Myth 2: The estate tax forces estates to turn over half of their assets to the government.

✓ **Reality: The few estates that pay any estate tax generally pay less than one-fifth of the value of the estate.**

Today, more than 99.7 percent of estates owe no estate tax at all, according to the Urban Institute-Brookings Tax Policy Center. Among the few estates that owe any tax, the "effective" tax rate — that is, the percentage of the estate's value that is paid in taxes — is less than 20 percent on average. That is far below the top estate tax rate of 45 percent.

Why is the effective tax rate so much lower than the 45 percent top tax rate? For several reasons. First, estate taxes are due only on the portion of an estate's value that exceeds the exemption level for the tax, not on the entire estate. At today's exemption level of $3.5 million, a $4 million estate would owe estate taxes on $500,000 at most. Second, a large portion of an estate's remaining value often can be shielded from taxation through various deductions. (http://www.cbpp.org/6-14-06tax.htm)

Myth 3: Many small, family-owned farms and businesses must be liquidated to pay estate taxes.

✓ **Reality: The number of small, family-owned farms and businesses that owe any estate tax at all is tiny, and virtually no such farms and businesses have to be liquidated to pay the tax.**

The estate of only 0.24 percent of all people who die in 2009 (i.e., the estates of between two and three of every 1,000 people who die) are expected to owe *any* estate tax, according to the Tax Policy Center.[2] And only about 1.3 percent of the few estates that still are taxable are small business or farm estates.[3]

TPC estimates that only *80 small business and farm estates nationwide* will owe *any* estate tax in 2009. This figure represents only 0.003 percent of all estates — that is, the estates

[2] Leonard E. Burman, Katherine Lim, and Jeffrey Rohaly, "Back from the Grave: Revenue and Distributional Effects of Reforming the Federal Estate Tax," Urban Brookings Tax Policy Center, October 20, 2008.

[3] A small-business estate is one with more than half its value in a farm or business and with the farm or business assets valued at less than $5 million.

of three out of every *100,000* people who die this year.

Furthermore, the minuscule number of small business and farm estates that do owe estate tax generally owe only a modest percentage of the estate's value in tax. The 80 small farm and business estates left by people who die in 2009 that will owe any estate tax will owe the tax at an average rate of just 14 percent.[4]

Despite the oft-repeated claim that the estate tax has dire consequences for family farms and small businesses, no evidence supports that charge. Indeed, the American Farm Bureau Federation acknowledged to the *New York Times* several years ago, when the estate tax was more expansive than it is today, that even then it could not cite a single example of a farm having to be sold to pay the estate tax.

A Congressional Budget Office study, as well, exploded the myth that small businesses and farms have to be liquidated to pay the estate tax. CBO found that of the few farm and family business estates that would owe any estate tax under the 2009 parameters, the overwhelming majority would have sufficient liquid assets (such as bank accounts, stocks, bonds, and insurance) in the estate to pay the tax without having to touch the farm or business. For instance, of the 65 *farm* estates that would owe any tax after the $3.5 million exemption, just *13* could *potentially* face liquidity constraints, and CBO explained that even this figure likely overestimates the number of farm estates with liquidity constraints, because CBO was unable to take into account certain assets held in trusts (such as life insurance trusts) when calculating the liquid assets available to estates to pay the tax. Furthermore, the few, if any, farm estates that would face any liquidity constraints would have other important options available to them — such as spreading their estate tax payments over a 14-year period — that would allow them to pay the tax without having to sell off any of the farm assets.

Myth 4: The estate tax constitutes "double taxation" because it applies to assets that already have been taxed once as income.

- ✓ **Reality: Large estates are comprised to a large degree of "unrealized" capital gains that have never been taxed; the estate tax is the only means of taxing this income.**

Income taxes on the appreciation of assets, such as real estate or an art collection, are paid only when the asset is sold. Therefore, the increase in the value of an asset is never subject to income tax if the asset is held until a person dies. These "unrealized" capital gains can make up a significant share of an estate's total value (http://www.cbpp.org/6-17-05tax.htm), especially among large estates — the ones likely to owe estate tax.

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[4] Urban Institute and Brookings Institution Tax Policy Center estimates. The average rate falls far below the 45 percent top marginal estate tax rate primarily because of the tax's $3.5 million exemption (effectively $7 million for a couple).

One reason the estate tax was created was to serve as a backstop to the income tax, taxing income that was never taxed under the income tax. The taxation of this income is essentially deferred and ultimately taxed for the first time through the estate tax.

Myth 5: If the estate tax is reformed and retained, the logical top tax rate would be 15 percent, the same as the capital gains rate.

✓ **Reality: To match the effective tax rate on capital gains, the top estate tax rate needs to be about 45 percent.**

Since the estate tax serves, in part, to tax capital gains that have *not* otherwise been taxed, some people have proposed taxing estates at the current capital gains rate of 15 percent. There are two problems with this argument. First, the 15 percent top capital gains rate is temporary; it expires at the end of 2010. President Obama has indicated that he plans to propose setting the capital gains rate for high-income individuals no lower than 20 percent after that. Second, the capital gains rate is typically applied to *all* capital gains income, whereas the estate tax is applied only to the part of an estate that is not subject to the tax's large exemption or to available deductions (see Myth 2 above).

For the effective estate tax rate to equal about 20 percent, the likely capital gains rate on high-income people after 2010, it needs to be set no lower than 45 percent — precisely where the estate-tax rate stands in 2009.

- Tax Policy Center estimates show that because the estate tax applies to only a portion of an estate, a 15 percent top estate tax rate would result in an *effective* rate on taxable estates of *only 5 or 6 percent.*

- Tax Policy Center estimates also show that under the 2009 estate-tax parameters, which include an estate 45 percent tax rate, the average effective estate tax rate will be 19.4 percent.

It should be noted that lowering the estate tax rate below 45 percent would be quite costly. Joint Committee on Taxation and Tax Policy Center estimates indicate, for example, that setting the estate tax rate at 15 rate would, in combination with the current exemption level of $3.5 million, lose 78 percent as much revenue as would be forgone under full repeal. (http://www.cbpp.org/5-31-06tax.htm)

Myth 6: Eliminating the estate tax would encourage people to save and thereby make more capital available for investment.

✓ **Reality: Eliminating the estate tax would not substantially affect private saving, and it would greatly increase government dissaving (i.e., deficits); as a result, it would be more likely to *reduce* the capital available for investment than to increase it.**

A Congressional Research Service report found that the estate tax's net impact on *private* saving is unclear — it causes some people to save more and others to save less — and that its overall impact on *national* saving (a critical determinant of the amount of capital available for private investment) is likely negative. "[I]f the only objective [of eliminating the estate tax] were increased savings," the report concluded, "it would probably be more effective to simply keep the estate and gift tax and use the proceeds to reduce the national debt."

The reason is simple: while repealing the estate tax might lead some people to save more, it also would lead the government to borrow more to offset the lost revenue. Government borrowing "soaks up" capital that would otherwise be available for investment in the economy. In the case of estate-tax repeal, the added government borrowing would more than outweigh any added private saving, leaving the economy no better off and quite possibly worse off. (http://www.cbpp.org/6-8-06tax.htm)

Myth 7: The estate tax unfairly punishes success.

✓ **Reality: The estate tax affects only those most able to pay, and the funds it raises are used to support a range of programs that benefit the nation.**

The estate tax is the most progressive component of a tax code that overall is only modestly progressive, particularly when regressive state and local taxes are taken into account. The money it raises helps to fund essential programs, from health care to education to defending the nation. If the estate tax were repealed, then other taxpayers — presumably a more numerous and less well-off group than the taxpayers paying the estate tax — would have to foot the bill for these programs, face cuts in the benefits and services provided, or bear the burden of a higher national debt.

Like other Americans, the very wealthy benefit from public investments in areas such as defense, education, health care, scientific research, environmental protection, and infrastructure, and they rely even more than others on the government's protection of individual property rights (since they have so much more to protect). Bill Gates, Senior, a prominent advocate of retaining a strong estate tax, has explained, "The reason the estate tax makes so much sense is that there is a direct relationship between the net worth people have when they pass on and where they live. The government that protects their business activities, the traditions that enable them to rely on certain things happening, that's what creates capital and enables net worth to increase." (http://www.cbpp.org/6-1-06tax-transcript.pdf)

It seems fair that people who have prospered the most in this society help to preserve it for future generations through tax revenues that derive from their estates. President Theodore Roosevelt stated in 1906 that "the man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government."

Myth 8: The cost of complying with the estate tax is nearly equal to the total amount of revenue the tax raises.

- **Reality: The costs of estate tax compliance are relatively modest and are consistent with the costs of complying with other taxes.**

Studies find that all of the various public and private costs associated with estate tax compliance (http://www.cbpp.org/6-14-05tax.htm) — including the IRS's costs of administering the tax and the cost that taxpayers bear in terms of estate planning and administering an estate when a person dies — equal about 7 percent of estate tax revenues. These costs are consistent with the compliance costs for other taxes. For instance, administrative and compliance costs equal about 14.5 percent of the revenue raised by the individual and corporate income taxes and about 2 percent to 5 percent of the revenue raised by sales taxes.

In addition, the number of individuals and estates that bear these costs has diminished markedly as the estate-tax exemption level has risen.

Part of the confusion around the cost of estate tax compliance is that some estimates incorrectly include the cost of activities that would be necessary even in the absence of an estate tax — hiring estate executors and trustees, drafting provisions and documents for the disposition of property, and allocating bequests among family members, for example. These activities account for about half of all costs sometimes associated with estate planning.

Myth 9: The estate tax is best characterized as the "death tax."

- **Reality: The estates of nearly all people who die are tax free.**

As noted, the estates of fewer than 3 out of every 1,000 people who die now owe any estate tax whatsoever because the first $3.5 million of the value of any estate (effectively the first $7 million of an estate for a married couple) is exempt from the tax. (http://www.cbpp.org/1-27-09tax.htm)

Some advocates of estate-tax repeal have tried to portray repeal as "killing the death tax." But other observers, such as the columnist E. J. Dionne, have characterized estate-tax repeal as the "Paris Hilton tax cut."

Myth 10: The United States taxes estates highly compared to other countries

- **Reality: U.S. estate tax revenues as a share of GDP are below the international average for taxes on wealth**

Some have claimed that the United States taxes estates highly relative to other countries. This claim, however, is based on a misleading comparison of the top

statutory estate tax rates across countries. As explained in Myth 2 above, the top statutory estate tax rate is a highly misleading indicator of how much estates in the United States actually pay in estate tax, due to the $3.5 million per person exemption and other deductions and valuation preferences. Because some countries levy taxes on a broader tax base than others (i.e. allow fewer exemptions, exemptions, and special preferences), experts agree that the right way to compare revenue levels across countries is to look at revenues *as a share of GDP, not at statutory tax rates*.

Outside the United States, many countries tax accumulated wealth by means of wealth or wealth transfer taxes (such as inheritance taxes) rather than through an estate tax, so one must account for these various types of taxes when making international comparisons.

- Of 25 other countries for which data are available from the Organisation for Economic Co-Operation and Development (OECD), 22 levied some form of estate tax, inheritance tax, or other wealth or wealth transfer tax in 2007 (or in the latest year for which data are available).

- U.S. estate tax revenues as a share of GDP were *below* the OECD average for wealth and wealth transfer taxes (including inheritance taxes). Moreover, these data are for 2007 when the U.S. estate tax had an exemption of $2 million for individual — only a little more than half of today's $3.5 million exemption — so estate taxes today are still lower as a share of GDP.