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The Estate Tax Is Down, But Not Out

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The combination of significant loopholes and high tax rates makes the estate tax fair game for reform, but the new tax law creates as many problems as it solves.

The estate tax became a red-hot political issue in the late 1990s. Opponents called it the "death tax," describing it as a complex, unfair, and inefficient levy that violated every norm of good tax policy. Supporters saw it as an essential component of a progressive tax system, one with the added virtues of plugging income tax loopholes and encouraging charitable contributions. Paying heed to these divergent views, politicians debated whether they should live with the estate tax, reform it, or throw it out. Remarkably, they chose all three options. Under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the estate tax will be modified and reduced between 2002 and 2009. It will be repealed in 2010, although the gift tax will be retained and capital gains on inherited assets will be taxed for the first time. In 2011, all of those changes will be eliminated, and the tax will revert to its current form.

It is difficult to believe that this crazy-quilt treatment of estate taxes will be allowed to occur. Between 2002 and 2009, the numerous, significant changes will vastly complicate tax planning. Several features of the legislated repeal in 2010 would create additional problems. Once repealed, the tax could not be fully reinstated without significant political opposition, so lawmakers are likely to revisit the whole issue in the next few years. Rumors of the death of the estate tax are greatly exaggerated.

Presumably, such a tumultuous change in tax policy would be based on compelling evidence and analysis. In fact, what was astonishing about the recent estate tax debate was the almost complete lack of hard evidence about any of the alleged effects of the estate tax or its alternatives. Ironically, perhaps, the new law will provide some evidence, by generating new information about the real distributional burden and economic effects of the estate tax. Ideally, that evidence will inform policymakers' reexamination of the estate tax.

This policy brief reviews current estate tax rules and the changes introduced in the new tax law. It also evaluates the distribution of estate tax burdens and the impact of the tax on saving, entrepreneurship, and family farms, and it discusses alternative policy options.

Estate Tax Rules before EGTRRA

Estates have been subject to taxation since 1916, shortly after the modern income tax was enacted. Since 1976, federal law has imposed a linked set of taxes on estates, gifts, and generation-skipping transfers.[1] In 2001, the executor of an estate must file a federal estate tax return within nine months of the owner's death if the gross estate exceeds $675,000. (The gross estate generally includes all of the decedent's assets, his or her share of jointly owned assets, life insurance proceeds from policies owned by the decedent, and some gifts and gift tax paid within three years of death.) Through careful tax planning, however, the valuation of assets can often be discounted for purposes of the estate tax, so the effective exemption far exceeds the statutory amount for many estates.

The estate tax allows deductions for transfers to a surviving spouse, charitable gifts, debts, funeral expenses, and administrative fees. A unified credit currently

exempts taxes on the first $675,000 of taxable transfers (including both gifts made during life and transfers at death), a figure that, under pre-EGTRRA law, was scheduled to rise to $1 million by 2006. Family-owned farms and businesses also benefit from a special additional deduction of up to $675,000 for those assets (plus other special tax provisions) so long as the heirs keep the business going.[2]

For estates above the exempt amounts, the tax rate begins at 37 percent, and it rises to 55 percent on taxable transfers above $3 million. A 5 percent surtax applies to estates with taxable wealth between $10 million and $17.184 million, eliminating the benefit of a graduated rate structure for very large estates and raising the effective marginal rate to 60 percent. Estate tax rates represent combined federal and state tax rates, since the federal estate tax includes a credit for state death taxes. Basically, the credit refunds the state taxes at rates up to 16 percent of the taxable estate. Almost all states levy death taxes large enough to qualify for the maximum federal credit.

Federal transfer taxes raised about $29 billion in 1999—less than 2 percent of total federal tax receipts. Under pre-EGTRRA law, the Congressional Budget Office projected that transfer taxes would have raised about $400 billion between 2001 and 2010. Nearly all OECD countries levy some kind of wealth-transfer tax. But the United Kingdom is the only such country besides the United States that levies a "pure" estate tax; the others have an inheritance tax or a mixture of inheritance and estate taxes. In 1997, the United States ranked third highest among OECD countries in terms of transfer taxes as a share of total revenues. But many OECD countries have annual wealth taxes, which the United States does not.

Although not an estate tax, the capital gains tax is a critical part of estate planning. Under pre-EGTRRA law, capital gains on appreciated assets were not subject to income tax at death, and heirs that sold inherited assests paid taxes only on gains earned after the date of inheritance. This loophole (called "step-up in basis") gives people a strong incentive to convert income from taxable forms into capital gains and to hold capital gains assets until death. The estate tax dampens that incentive somewhat, since assets held at death are subject to the estate tax. The new legislation would take a different approach to limiting this loophole, as described below.

Transfer Tax Changes under EGTRRA

Table 1 summarizes changes in transfer taxes under the new law. The effective estate tax exemption rises from $675,000 in 2001 to $1 million in 2002, and then rises in stages to $3.5 million by 2009. The highest effective marginal tax rate falls from 60 percent in 2001 to 50 percent in 2002 and then drops gradually to 45 percent by 2007.[3] The credit for state-level estate taxes is phased out between 2002 and 2005, when it is replaced by a deduction for state taxes.[4] In 2004, the special deduction for family-owned businesses and farms is repealed. In 2010, the estate and generation-skipping transfer taxes are repealed, and the gift tax rate is set equal to the top individual income tax rate. The step-up in basis for inherited assets that have capital gains is repealed, subject to a very large exemption.[5] As noted, the law reverts to its current form in 2011.

Progressivity in the Estate and Gift Tax

A crucial question is who ultimately pays the estate tax. Many observers view estate taxes as a burden primarily on those whose estate pays the tax. That perspective is logical if the tax is viewed as a tax on savings, like taxes on interest, dividends, and capital gains. An alternative view is that heirs shoulder the burden via reduced inheritances. Although it is also possible that the estate tax undermines capital accumulation in the economy as a whole, retarding the growth of both productivity and wages and forcing workers whose wages fall to bear part of the brunt, there is little evidence of such an effect. More likely, decedents or heirs take all or most of the hit. Although it is difficult to know how the burden is distributed between those two, the estate tax is clearly progressive because both the people

TABLE 1. Changes in Transfer Tax Exemptions and Rates Due to EGTRRA, 2002–11

Calendar Year	Value of Estate and GST Tax Transfer Exemption ($)	Highest Estate and Gift Tax Rates (%)
2001*	675,000	60
2002	1,000,000	50
2003	1,000,000	49
2004	1,500,000	48
2005	1,500,000	47
2006	2,000,000	46
2007	2,000,000	45
2008	2,000,000	45
2009	3,500,000	45
2010	N/A (taxes repealed)	35 (gift tax only)

* Pre-EGTRRA law

who have taxable estates and their heirs tend to be well off.

About 96 percent of those who die in a given year do not have to file estate tax returns, and half of those who file owe no taxes once credits and deductions are claimed. Thus, only about 2 percent of deaths result in estate tax liability, and payments are highly concentrated within that group. For example, although 83 percent of estate taxpayers in 1999 had assets between $600,000 and $2.5 million, those returns accounted for only about one-quarter of transfer tax revenue (see table 2).[6] The 10 percent of taxable estates worth between $2.5 million and $5 million accounted for 20 percent of tax payments. The wealthiest 6.5 percent of taxable returns (0.13 percent of decedents)—those with estates larger than $5 million—paid 55 percent of all transfer taxes.

The Treasury Department estimates how estate taxes relate to the income of taxpayers.[7] By that measure, too, the estate tax is highly progressive (table 3). More than 99 percent of the tax falls on the fifth of all households with the highest incomes, and 96 percent is paid by the top tenth. Indeed, nearly two-thirds of the tax (64 percent) is paid by the richest 1 percent of taxpayers. The estate tax is much more progressive than the individual income tax or any other major tax in the United States. Recipients of inheritances from estates subject to estate taxation are also very well off; their average income is typically almost double that of the population's mean income (Joulfaian 1998).

Like other taxes on saving, transfer taxes have been criticized because they do not treat people in similar circumstances the same way: The taxes favor those who spend rather than save their wealth. But these taxes seem more equitable if the issue is who benefits from windfalls. If inheritances are considered to be like other sources of good financial fortune—such as winning the lottery—then taxes on inheritances can be seen as balancing out the advantage those who have rich relatives possess over those who do not.

Effects on Saving, Entrepreneurship, and Farms

Some analysts argue that the estate tax significantly reduces the saving and entrepreneurship essential to economic prosperity, and claim that the impact on family farms and small businesses is particularly onerous. But little evidence substantiates these claims.

As for saving in general, some evidence suggests that estate taxes reduce saving by the donor of the transfer. But, on balance, economic theory is ambivalent about whether the estate tax either encourages or discourages such saving. The tax discourages saving by reducing the after-tax value of an estate, but it encourages those who want to leave large bequests to save more so they can pay the tax for their children. The evidence to date suggests that the disincentive is stronger, but the overall effect on national savings appears to be small.

The evidence about the effect on heirs, however, is unambiguous. Recipients of large inheritances consume more and work less than they otherwise would (Weil 1994; Holtz-Eakin, Joulfaian, and Rosen 1994; and Brown and Weisbenner 2001). As Andrew Carnegie noted in 1891, "The parent who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would." By extension, if estate taxes reduce net-of-tax inheritances, they should raise saving and work effort by the recipient.

The estate tax's impact on family-held businesses and farms has taken on a hugely disproportionate role in public policy debates, fueled by anecdotal evidence on the tax's adverse effect on particular families or businesses, but there is little hard evidence that the estate tax burdens these entities.

Holtz-Eakin (1999) uses a survey of about 400 business owners in New York state and concludes that businesses whose owner would be subject to the estate tax if he or she died immediately had significantly less employment growth over the previous five years than other firms. That study is problematic for several reasons. For example, the business owners who expected to be subject to the estate tax were almost surely older

TABLE 2. Allocation of Returns, Gross Estate, and Tax Payments by Estate Size among Taxable Returns, 1999

		Percent of Total, by Size of Gross Estate (in millions)					
	Total	$0.6–$1.0	$1.0–$2.5	$2.5–$5.0	$5.0–$10.0	$10.0–$20.0	Over $20.0
All Taxable Returns	49,870	38.4	44.6	10.5	4.1	1.5	0.9
Total Gross Estate among Taxable Returns	$119,176,309,000	13.3	27.8	14.9	11.8	8.8	23.3
Total Estate Taxes Paid	$22,920,156,000	3.5	23.3	19.9	17.0	12.5	23.9
Total Transfer Taxes Paid	$30,093,180,000	4.2	22.1	18.6	16.2	12.6	26.2

Source: Internal Revenue Service (2001).

TABLE 3. Distribution of Estate Tax Liability (2000 Income Levels)

Income Category	Percent of Income	Percent of Estate and Gift Tax Liability
Bottom Quintile	2.7	0.0
Second Quintile	7.2	0.0
Third Quintile	12.6	0.0
Fourth Quintile	21.3	0.8
Top Quintile	56.7	99.2
Total	100.0	100.0
Top 10 percent	40.5	96.2
Top 5 percent	29.4	91.0
Top 1 percent	14.8	64.2

Source: Department of the Treasury, Office of Tax Analysis, July 21, 1999 (unpublished release).
Note: Treasury's tables are based on "family economic income," a broad-based income concept developed by the Treasury Department and used since the 1980s. Treasury has experimented with alternative income measures; the qualitative conclusions generally do not depend on the income measure.

than those who did not, because wealth tends to increase with age. Thus, the data may simply show that older owners are less aggressive than younger ones—a factor that would likely persist even without an estate tax. Moreover, the data are based on responses to a mail survey and so may not be representative of other owners' attitudes. Nor does it appear that many business owners would have difficulties paying estate taxes without liquidating the business (Holtz-Eakin et al. 1994). Other survey evidence cited by estate tax opponents is similarly suspect.

For example, Astrachan and Tutterow (1996) report that in a survey of 983 family-owned businesses, more than 60 percent reported that paying estate taxes will limit business growth, 13 percent said it would make growth impossible, more than 60 percent said paying would threaten business survival, 8 percent said it would make survival impossible, and 33 percent said that paying estate taxes will require selling all or part of the business. Estate taxes were also thought to affect current business behavior: 36 percent said the tax shortens the time owners wait for an investment to pay off, and 68 percent said it reduces the acceptable risk associated with investment. Finally, 60 percent of respondents said that if estate taxes were eliminated, they would immediately hire more workers and revenues would grow at least 5 percent faster than otherwise anticipated. But several important caveats apply to these figures. First, somewhat contradictorily, 45 percent of respondents said they had no knowledge of their likely estate tax liability. Second, the effects appear to be hugely out of proportion with the actual impact of estate taxes. The vast majority of family businesses undoubtedly do not ever face estate tax because they fail well before the death of the owner or because their value is well below the estate tax exemption.

Beyond the heartrending anecdotes and questionable surveys, however, little hard evidence suggests that the impact of estate taxes on family farms and businesses is a major concern. We offer several reasons for this conclusion.

First, family farms and businesses already receive special treatment under the estate tax. Taxpayers are entitled to calculate the taxable value of the real estate used in a farm or closely held business on the basis of its current-use value, rather than market value. Because such assets do not trade in liquid markets, there is often substantial discretion (and hence substantial discounts) used in determining value. Furthermore, legislation enacted in 1997 permits a special deduction for family-owned farms and businesses when they constitute at least 50 percent of an estate and in which heirs materially participate. Taken together, these effects can be sizable.

Second, empirical evidence also suggests that valuation discounts, or other avoidance measures, are substantial. Poterba and Weisbenner (2001) apply mortality probabilities to household wealth data in the 1998 Survey of Consumer Finance and project that about 49 percent of the wealth in estates worth more than $10 million was due to active businesses and farms. In contrast, the corresponding figure in actual estate tax returns, reported in table 3, is between 13 percent and 22 percent. This suggests that businesses are able to evade or avoid the estate tax quite successfully.

Third, any estate tax liability that is due to family farms and businesses can be paid in installments over a 14-year period, with only interest charged for the first 4 years. The applicable interest rate is 2 percent on estate tax liability stemming from the first $1 million of taxable assets, with higher—but still below-market—rates on larger amounts. This not only reduces the cash flow needs for the business, it significantly reduces the present value of estate tax liabilities.

Fourth, the vast majority of the value of family-owned businesses consists of unrealized capital gains (Kenickell and Wilcox 1992; Poterba and Weisbenner 2001). This income has never been taxed under the income tax and would never be taxed

at all if exempted from the estate tax. Moreover, small businesses already receive numerous investment tax subsidies under the income tax.

Finally, there is an issue of fairness: Why, between two families with the same size estate, should the one whose assets are in business form have a smaller tax liability? The answer is presumably that in some sense the family owning the business is less well off, or has assets that are less diversified or less liquid than those of the other family. If so, the same tax represents a larger burden to the business-owning family. Nevertheless, the current adjustments in the estate tax for small businesses already address these concerns, as noted above.

The analysis above suggests that claims for additional special treatment on behalf of family businesses and farms should be treated with great skepticism. In practice, the claims made by opponents of the tax actually go well beyond special treatment; many argue that the problems of family businesses and farms are sufficient to merit the abolition of the estate tax. This seems extreme, however. Policymakers concerned with the tax should also bear in mind that farms and other small businesses represent a small fraction of estate tax liabilities. Farm assets were reported on 6 percent of taxable returns filed in 1998; farm real estate was reported on 12 percent. Together, these items constituted just 1.7 percent of taxable estate value. About 8.7 percent of taxable returns in 1998 listed closely held stock, which accounted for 6.6 percent of taxable estate value. Limited partnerships and "other noncorporate business assets" accounted for an additional 2.6 percent of taxable estate. Even under a very expansive definition, farms and small businesses account for at most 11 percent of assets in taxable estates (Internal Revenue Service 2000). Clearly, people who own neither farms nor small businesses pay the vast majority of estate taxes, and the effects on farms and small businesses provide insufficient justification for abolishing the estate tax.

Serious empirical analysis of the role of the estate tax in the demise of family-run businesses would be enlightening. That information could permit estimates of the efficiency cost of "breaking up" small businesses. Such analysis should start with the presumption that the tax system should be neutral with respect to whether a family member continues to run the business, but could also incorporate the role other factors (e.g., of life insurance, business and estate planning in the absence of estate taxes, market imperfections due to credit constraints, and the incentives that other aspects of the tax system, such as basis step-up on appreciated assets) have on the outcome.[8]

Should People Be Taxed at Death?

Wrestling with the estate tax as well as dealing with the trauma of a loved one's death is unpleasant. Few people actually owe estate tax at death, but it is sensible to ask whether the estate tax's advantages—making taxes more progressive, stemming tax avoidance, and encouraging charitable giving—might be better realized through income taxes or other means.

Unfortunately, creating a comprehensive income tax without loopholes would be difficult for administrative reasons. As the debate about taxing capital gains at death shows, eliminating loopholes in exchange for estate tax repeal is also difficult politically. The step-up in basis for capital gains is a substantial loophole in the individual income tax, but the new tax law would retain this mechanism for all but the wealthest families. Moreover, administering the new carryover basis regime, with its large individual and spousal exemptions, means retaining much of the complexity of the estate tax, as well as adding provisions to allow the tax authorities to monitor taxable capital gains from generation to generation. Thus, there is no simple substitute for the estate tax.

Finally, the estate tax has at least one indirect benefit: It stimulates charitable contributions. Gifts at death are stimulated because they are deductible against the estate tax. The estate tax may also stimulate gifts during life because such gifts both benefit from an income tax deduction and are removed for the estate, and so avoid estate taxation, too. Studies suggest that eliminating the estate tax would reduce total charitable contributions by about 12 percent, or by about $12 billion per year (Auten and Joulfaian 1996; Joulfaian 2000).

Reform Options

Given the changes EGTRRA made to the tax system, why not simply let the tax act run its course? The short answer is that the new tax law creates numerous complexities and uncertainties. First, though few people believe the tax cut will simply be allowed to evaporate in 2011, the sunset provisions create unnecessary uncertainty about how, whether, and when the tax change will be extended. Second, the long transition period before the estate tax is abolished will complicate estate planning, since different planning techniques, asset allocations, or investments may be most appropriate, depending on when a person dies.

The third problem stems from the repeal of basis step-up at death. Under pre-EGTRRA law, when an heir receives an asset from an estate, the basis price is stepped up. Under the new bill, heirs inherit an asset's original basis price. Transfers below $1.3 million and interspousal transfers of up to $3 million are exempt, effectively allowing $5.6 million of capital gains per couple to escape the tax. This new carryover basis scheme would raise vexing administrative

issues without raising much revenue. Some families would have to keep track of asset purchase prices and improvements for generations to accurately measure capital gains on inherited assets. Those with large estates (who also have most of the capital gains) would have particularly nettlesome paperwork burdens. A carryover basis provision enacted in the late 1970s was repealed before it took effect, because of concerns about its administrability. Why would an even more complicated provision be any easier to deal with now?

If the estate tax were abolished, and basis carry-over proved unworkable or undesirable, capital gains at death must receive some other tax treatment. If the current treatment of gains—basis step-up—were coupled with a repeal of the estate tax, the enormous loophole in the income tax would drain revenues, bestow huge tax cuts on the wealthiest households, and increase incentives to convert other income into capital gains and hold appreciated assets until death.

An alternative would be to abolish the estate tax and extend the capital gains tax to the gains accrued but unrealized at death. But that proposal would raise only about a quarter of the revenue of the estate tax. It would also be much less progressive and almost as complex as the current estate tax.

Another approach to reform would be to replace the estate tax with an inheritance tax, as several U.S. states and many foreign countries have already done. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden, encouraging the division of estates into smaller shares—an effective defense against accumulations of extraordinary wealth over many generations. The simplest option would be to treat inheritances and gifts above some lifetime exemption as heirs' taxable income, subject to progressive income tax rates. Very wealthy heirs, or those receiving a very large inheritance, would pay the highest effective tax rates. Placing the statutory burden of the tax on recipients rather than donors may reduce some of the moral outrage generated by taxing decedents (although it would not eliminate the record-keeping and reporting requirements for estates).

The best option for reforming the estate tax would be to follow the principles of the Tax Reform Act of 1986: Close loopholes, lower tax rates, and significantly raise the exempt amount. Raising the exemption would reduce the number of people paying the tax—while still taxing the wealthiest—and would chip away at the concentration of wealth. It would also help smaller family-owned businesses, while avoiding the complications and inequities associated with preferential treatment for business assets. Lowering estate tax rates would dampen the incentive to invest in estate tax shelters and reduce the penalty on saving and work. Indeed, EGTRRA will raise the exemption and lower tax rates between 2002 and 2009, but the loopholes will remain intact.

Closing loopholes by treating different assets more consistently would make the tax simpler and fairer by making it harder for owners to shelter funds from the tax. An additional step, indexing the exemption and the tax brackets for inflation, would automatically keep the tax burden at any particular real wealth level constant over time.

Conclusion

The combination of significant loopholes and high tax rates makes the estate tax fair game for reform. Unfortunately, the path taken in the new tax law would create as many problems as it solves. The estate tax plays a small but important role in the government's portfolio of tax instruments, making the tax system more progressive, encouraging charitable contributions, and reducing the concentration of wealth. Despite the claims of its detractors, the estate tax does not appear to have serious negative impacts on saving, small businesses, and farms. Thus, though the appropriate role and effects of transfer taxes are still open to debate, the confusion created by the recent tax legislation invites further reform of the estate tax to mitigate its problems but retain its advantages.

Endnotes

1. The generation-skipping transfer (GST) tax was designed to close a loophole. Without a GST tax, a family could avoid one or two layers of estate tax by making gifts or bequests directly to a grandchild or great-grandchild, rather than making the bequest to the child first, who would later bequeath the remainder to the grandchild. To close this loophole, the tax code mandates a separate tax, at rates up to 55 percent, for generation-skipping transfers in excess of $1 million per donor (before the recent tax act), above and beyond any applicable estate and gift tax. The GST tax raises virtually no revenue directly because it discourages generation-skipping transfers so effectively, but it indirectly raises revenue by closing what would otherwise be an easily exploitable loophole in transfer taxation.
2. The total amount of assets exempted from the estate tax by the "qualified family-owned business interest" provision is limited to $1.3 million.
3. As under current law, the marginal tax rate for the GST tax is the highest statutory transfer tax rate prevailing in each year.
4. At this point, some taxpayers could actually face higher combined federal and state taxes if state death taxes are not eliminated (Kaufman 2001).
5. An estate can erase $1.3 million of capital gains on bequeathed assets. In addition, there is a $3 million exemption for capital gains on transfers to a spouse. Thus, with careful planning, a couple could eliminate capital gains tax liability

on $5.6 million of gains ($1.3 million for each spouse, plus $3 million for the transfer from the first decedent to the second).
6. Estate tax returns filed in 1999 generally applied to deaths in 1998.
7. The Treasury assumes the decedent bears the burden of the tax and imputes estate tax liability to living taxpayers based on their actuarial probability of death (an increasing function of their age) and an estimate of the size of their estate given their income. The methodology is described in Cronin (1999).
8. For further information on the estate tax's impact on small businesses and family farms, see Gale and Slemrod (2001) and Gravelle and Maguire (2001).

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