



TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

Do Estate and Inheritance Taxes Affect Entrepreneurship?

March 7, 2018

Leonard E. Burman
Robert McClelland
Chenxi Lu

Overview

- We examine how changes to wealth transfer taxation affect the likelihood of self-employment among those of retirement age
- We examine how receipt of an inheritance affects the likelihood of owning and managing a business

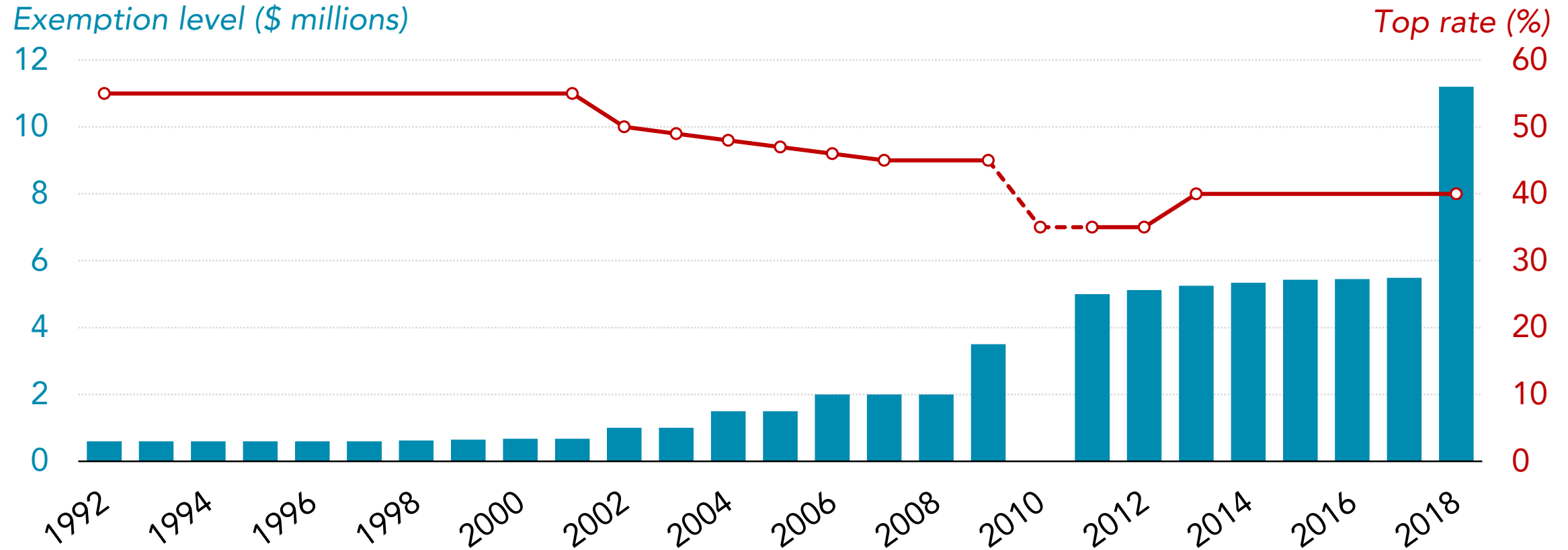
Caveats

- Entrepreneurship involves innovating and taking risks, which are difficult to measure
- It is unclear whether taxation has larger or smaller effects on entrepreneurs than other business owners
- Receipt of an inheritance might be correlated with factors such as having parents who are successful entrepreneurs

Who is an Entrepreneur?

- Schumpeter (1947) “...an innovator who brings together ‘existing productive resources in new ways or for new purposes’ ”
- Because of data limitations, we use two definitions:
 - self-employment
 - owning and managing a business

Federal Estate Tax Exemption and Top Tax Rate



Source: Jacobson, Raub, and Johnson (2007); “Exemption Level, 1999-2015.” Tax Policy Center Statistics, May 31, 2017; and the Form 706 Changes, from [“What’s New – Estate and Gift Tax,”](#) Internal Revenue Service, last revised January 12, 2018.

Note: In 2010, estate executors could opt out of the estate tax in exchange for taxing some capital gains of heirs. Exemption level for married couples is double that for singles after 2001.

Less Than 0.1% of Decedents are Subject to Federal Tax

- We estimate 3,700 estate tax returns for those who die in 2018
- Taxable estates may avoid or reduce tax liability via various deductions
- Special provisions allow valuation discounts for family-owned businesses and farms

Effect of Expected Taxable Estate on Self-Employment

- Entrepreneurs may respond to the estate tax by retiring earlier, or retiring later
- This only occurs with bequest motive, but evidence is scant
 - Most bequests are accidental
 - *Inter vivos* transfers are compensatory
 - Bequests tend to be equal, despite different needs
 - Almost 40 percent of decedents die intestate

Effect of Expected Taxable Estate on Self-Employment

- Business owners are more likely to purchase life insurance
- Wealthy people are the most likely to have a bequest motive
- People likely to be affected by estate tax do relatively little *inter vivos* giving

Effect of Expected Taxable Estate on Self-Employment

Dependent Variables: Self-employment status of respondent

Key Independent Variable: Expected taxable estate (including state taxes)

Data: Health and Retirement Study, 1994-2014

Method: Fixed Effects, Instrumental Variable

Sample size: 26,405 respondents

Demographic variables: age, age squared, indicators for wave number

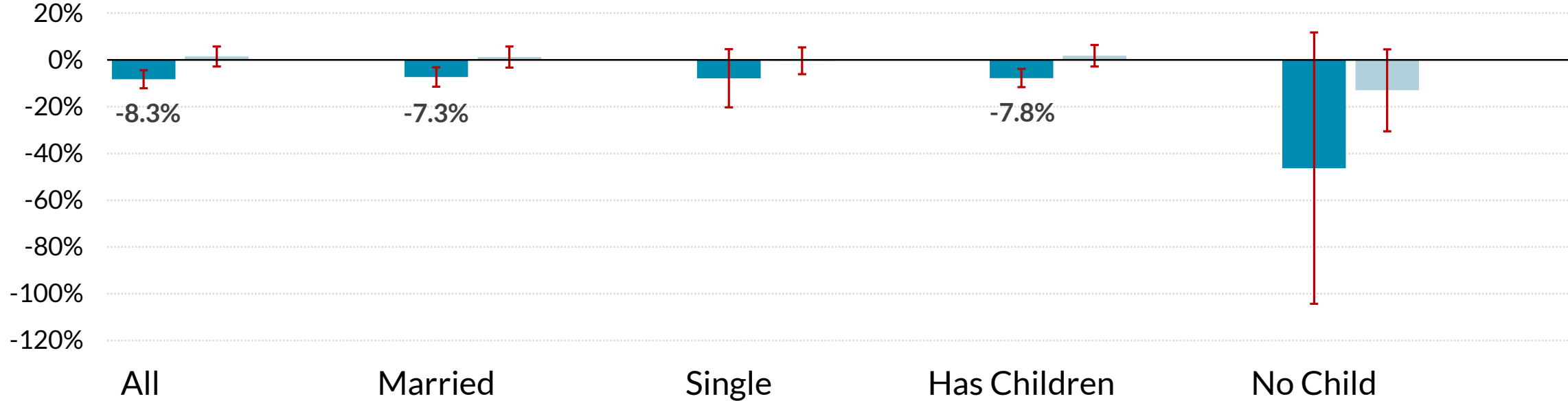
Wealth variables: Spline for lagged net worth excluding business wealth

Additional control variables: Lagged income

Effect of Expected Taxable Estate on Self-Employment

■ Self-employment (versus non-self-emp) ■ Self-employment (versus wage emp)

Per million dollars of expected taxable estate



Source: Health and Retirement Study, 1994–2014.

Note: Results based on our full fixed-effect model with nonbusiness wealth spline control. The vertical bars represent 95 percent confidence intervals of corresponding effects.

Effects of Inheritance on Business Formation

- The “Carnegie conjecture”: “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.”
 - Families who receive a large inheritance are more likely to exit the labor force and report less labor income
- Liquidity constraints are an important factor in starting businesses
 - Inheritances can be used as seed money for new businesses
 - The size of an inheritance substantially affects the likelihood of starting a business

Effects of Inheritance on Business Formation

Dependent Variable: Head of household owns and actively manages a business

Key Independent Variables: Receipt of an inheritance in the past 20 years and all inheritances received in the prior 20 years

Data: Survey of Consumer Finances, 1992-2010

Method: Weighted Probit

Sample size: 30,510 households

Demographic Variables: age, age squared, indicator variables for sex, marital status, educational level

Wealth Variables: Spline for net worth, spline for net worth excluding business wealth

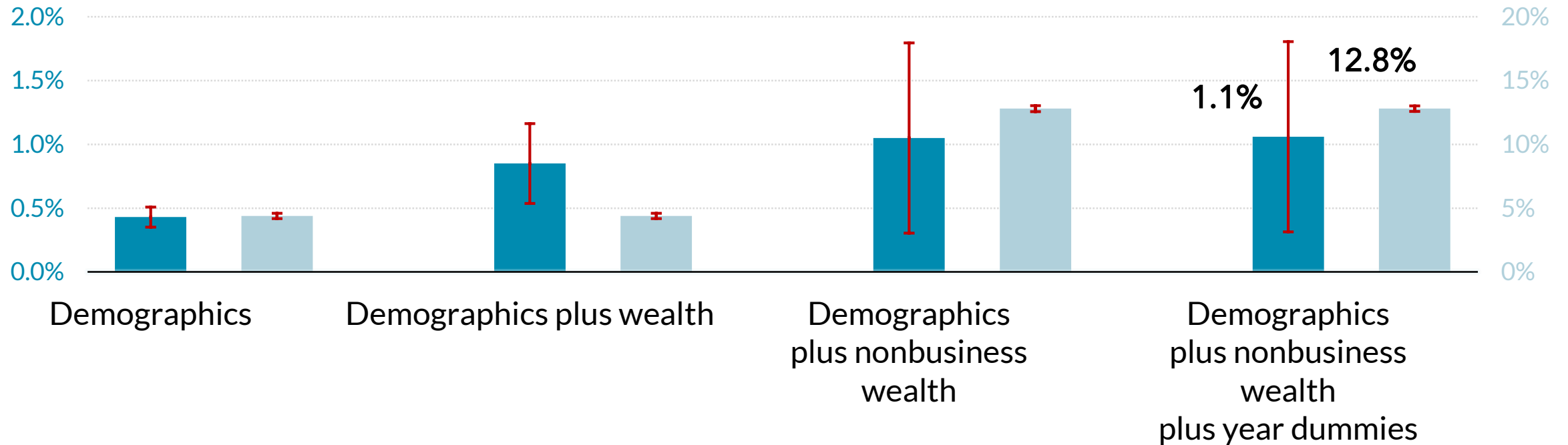
Year: Indicator variable for year

Effects of Inheritance on Business Formation

■ Size of inheritance (\$ millions) ■ Receiving inheritance

Per million dollars of inheritance

From receiving an inheritance



Source: Survey of Consumer Finances, 1992–2010.

Note: The vertical bars represent 95 percent confidence intervals of corresponding effects.

Conclusions

- The likelihood of self-employment falls by about eight percentage points for every million dollars of taxable estate
- Self-employed choose between working and retiring rather than between self-employment and wage employment
- Beneficiaries of bequests are almost 13 percentage points more likely to own and manage a business. Every \$1 million of inheritance raises the probability by about one percentage point