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PERMANENT REPEAL OF THE ESTATE TAX WOULD BE COSTLY, YET WOULD BENEFIT ONLY A FEW, VERY LARGE ESTATES

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Overview

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Estate Tax & Family Businesses & Farms
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The House of Representatives is scheduled to continue its tax-cutting spree this week when it considers legislation to make permanent the repeal of the estate tax. According to Joint Committee on Taxation estimates, this measure would cost $162 billion through 2013. These revenue losses would be on top of the $350 billion tax cut that the President signed on May 28 and the $82 billion expansion of the Child Tax Credit that the House passed last week. If the House adopts estate tax repeal, it will have passed tax cuts officially totaling nearly $600 billion in less than one month. These tax cuts should be seen in the context of the House Republican leadership's desire to enact the full $1.3 trillion in tax cuts allowed under this year's Congressional budget plan. House Majority Leader Tom DeLay, noting the tax-cut allocation in the budget resolution, stated, "We intend to use every dollar of it."[1]

The debate surrounding the estate tax can be seen as a choice between eliminating the tax altogether and reforming it by increasing the exemption level and lowering the top rate. The 2001 tax-cut legislation lowers the top estate tax rate to 45 percent by 2007, increases the estate tax exemption to $3.5 million — $7 million for a couple — by 2009 and then repeals the estate tax altogether in 2010. The repeal expires at the end of 2010, as part of the general expiration of all provisions of the 2001 tax law at that time. Following the 2010 sunset, the estate tax reverts to prior law, with an exemption of $1 million and a top rate of 55 percent.

- Permanent repeal would lose $64 billion of revenue in 2013 alone, according to Joint Committee on Taxation estimates. In contrast, retaining the estate tax with a $3.5 million exemption and a top rate of 45 percent — the policy in effect in 2009, just prior to repeal — would lose *less than half* of the revenue in 2013 that full repeal would lose.

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[1] Mark Wegner and April Fulton, "Two Sides Keep Firing Shots In Battle Over Child Tax Credit," CongressDaily, June 4, 2003.

- Over the subsequent decade, 2014 through 2023, permanent repeal would lose approximately $820 billion in revenues. More than $460 billion of this revenue loss could be averted by retaining the estate tax with a $3.5 million exemption and a top rate of 45 percent.

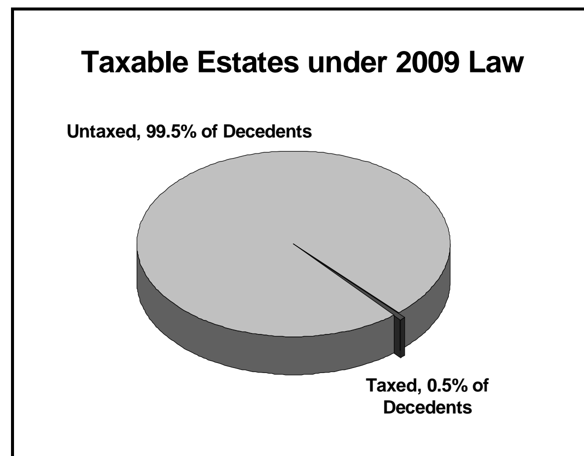
The sharply higher cost of permanent repeal, compared to retaining and reforming the estate tax with an increased exemption level and a lower top rate, would worsen the long-term budget outlook, which has deteriorated markedly since the 2001 tax-cut package was enacted. The principal impact of eliminating rather than reforming the estate tax would come in the years beyond the current ten-year budget window, when the baby boom generation begins to retire and the Social Security and Medicare systems come under increasing pressure.

Moreover, permanent repeal of the estate tax cannot be viewed as an isolated proposal. As a result of the 2001 tax-cut legislation and the new tax-cut measure that just became law, the tax code is now filled with provisions that expire or "sunset" artificially. The supporters of these tax cuts have made it clear they intend to push not only for making repeal of the estate tax permanent but for continuing most or all of these tax cuts past their sunset dates. Brookings Institution economists William Gale and Peter Orszag have found that if all of the provisions in the tax code that are scheduled to expire in the coming years are extended, the cost of extending these measures will total *$430 billion a year* by 2013. Unless these tax-cut extensions are "paid for," their cost will equal 2.4 percent of Gross Domestic Product, which is three times the average size of the projected shortfall in the Social Security Trust Fund over the next 75 years.[2]

Only A Small Number of Large Estates Would Benefit From Repeal

The higher exemption level envisioned as part of reform proposals would exempt all but a small number of very large estates from taxation. It is only this very small number of extremely wealthy estates that would benefit from permanent estate tax repeal rather than the estate tax reform proposals.

- If the $3.5 million exemption and the lower 45 percent rate that will be in effect in 2009 were extended, only about 10,000 estates in 2010 — or less than one half of one percent of the projected 2.6 million deaths in that year — would be subject to taxation. That is, for every 1,000 deaths, 995 people would be exempt from estate taxes



[2] William Gale and Peter Orszag, "Sunsets in the Tax Code," *Tax Notes*, June 9, 2003.

altogether. Only the largest five of every 1,000 estates would be taxed, and even these estates would pay significantly less in tax because of the lower rates and higher exemption.

- With a $3.5 million exemption, the burden on family-owned farms and businesses — which already are eligible for special estate tax rules — would be negligible. For example, a Treasury Department analysis found that raising the exemption for these family-owned enterprises to $4 million ($8 million for couples), as then-Senator Daniel Patrick Moynihan proposed in 2000, would have exempted *almost all* family-owned farms and reduced the already small number of family businesses subject to the tax by nearly three-quarters.[3]

Reforming the Estate Tax Preserves Options to Address the Social Security Shortfall

In 2010, there will be an estimated 53 million Social Security beneficiaries. This figure contrasts with the 10,000 or so estates that year that would remain subject to the estate tax if the tax is retained with a $3.5 million exemption rather than eliminated altogether. Cutting but not eliminating the estate tax on the 10,000 wealthiest estates each year would leave resources available that could be used to narrow Social Security's long-term financing deficit, which ultimately will affect millions of elderly people, many of whom have low or moderate incomes. Compared to permanent repeal, the amount saved by keeping the estate tax at the higher exemption level and lower top rate in effect in 2009 is equivalent to nearly one-quarter of the entire shortfall in the Social Security Trust Fund over the next 75 years, the period used by the Social Security actuaries to gauge the long-term financial health of Social Security. Thus, one option would be to reform rather than repeal the estate tax and to dedicate the estate tax revenues that remain to the Social Security Trust Fund.

Reform Addresses Estate Planning Problems Better Than Repeal

Proponents of permanent repeal argue that long-range estate planning is virtually impossible under current law, which calls for the estate tax to be repealed in 2010 and then reinstated in 2011, with reversion to the estate-tax parameters in place prior to enactment of the 2001 law. They argue that repeal is the only approach to address this problem. Retaining the estate tax with a high exemption level and lower top rate, however, would likely be a more effective way to stabilize long-term planning, both because it is a more affordable policy in the long run — and thus is less likely to be altered in subsequent years — and because repeal raises serious administrative issues itself.

Despite sounding straightforward, repeal will be very complicated to implement, largely because it will be accompanied by a new requirement regarding the capital gains tax that heirs

[3] Treasury Department's Office of Tax Policy, "Estate Taxes: Impact of Senate Democratic Alternative," July 11, 2000.

Repealing the Estate Tax Would Reduce Charitable Giving

In addition to depriving the Treasury of needed revenues, permanent estate tax repeal would have a negative impact on charitable donations. Research has shown that the estate tax increases the amount of charitable contributions, particularly among the largest estates, because these donations are fully deductible and consequently reduce estate taxes. In 2001, the latest year for which these data are available, estates contributed $16.2 billion to charities. Taxable estates of more than $20 million gave $6.8 billion of this total, averaging $23 million in donations per estate.

Retaining the estate tax at a high exemption level would maintain a tax incentive for these large estates to make charitable contributions. In contrast, eliminating the estate tax would entirely remove this significant incentive. A new study by Brookings Institution economists Jon Bakija and William Gale finds that if the estate tax had been eliminated in 2001, charitable bequests at death would have been 22 percent to 37 percent — or $3.6 billion to $6.0 billion — lower in that year.*

Moreover, because charitable contributions made during life have a comparable effect to charitable bequests made at death in terms of reducing the size of taxable estates, Bakija and Gale find that repeal of the estate tax also would reduce incentives for wealthy people to make charitable gifts during their lifetimes. They estimate that if the estate tax had been repealed in 2001, charitable donations made by people still alive would have declined about $5 billion.

The combined effect of estate tax repeal — in terms of reduced charitable bequests at death and reduced charitable donations during life — would have been about $10 billion in 2001, or an amount "equivalent to the total grants currently made by the largest 110 foundations in the United States."

*Jon Bakija and William Gale, "Effects of Estate Tax Reform on Charitable Giving," Brookings Institution, June 2003.

will have to pay on certain inherited assets when these assets are sold. Under the new requirement, when heirs sell an asset, they will owe capital gains tax in certain cases on the increase in the value of an asset since the time the *decedent* purchased the asset; under current law, they only pay capital gains tax on the increase in the value of asset from the time it was inherited. This new requirement regarding capital gains taxation — which is known as "carry-over basis" (because the original "basis," or purchase price of an asset, is carried over to the heirs) — would be exceedingly difficult, if not impossible, to administer. Past experience with carry-over basis rules exposed serious problems: A similar carry-over basis provision was enacted in the 1970s, but was found to be so complicated as to be unworkable, and it was repealed before it took effect.

A key problem with the carry-over provision is that it will require individuals to maintain records of assets for very long periods of time — in some case for generations — to determine the original price of an asset paid by a person who has died. This problem is avoided under

current law. Today, when heirs sell an inherited asset, they owe no capital gains tax on the increase in the asset's value that occurred during the life of the decedent. Heirs need keep track only of the appreciation of the asset that occurs *after* they inherited it. When they choose to sell the asset, they owe capital gains tax only on this post-inheritance appreciation.

The difficulty of implementing the carry-over basis rules — without which repeal of the estate tax would cause major problems and inequities in the taxation of capital gains — adds another dimension to the uncertainty as to whether estate tax repeal could be sustained over time. Retaining the estate tax with a high exemption avoids this problem, since carry-over basis would not be necessary.

Still another example of why permanent repeal is not straightforward is that some estates and their heirs will find they may face *higher taxes after the estate tax has been repealed* than they would owe if the tax were retained with a high exemption level. Due to the carry-over basis provision, some estates will face additional capital gains taxes that could make them worse off under repeal than reform.[4] This is true of some farms, for example. As the Agriculture Department's Economic Research Service has found, "...a small number of farm estates may actually experience a tax increase or owe capital gains taxes even though they would not have been subject to Federal estate or capital gains taxes under prior law."[5]

Estate Tax Reform Offers a More Sustainable Approach Than Repeal

The fiscal outlook is far more constrained than it appeared two years ago when the 2001 tax cut was enacted. Calls to make the repeal of the estate tax permanent, as well as to make permanent the other provisions of the tax-cut package that expire in 2010, fail to take these new circumstances into account. Permanent repeal would deprive the Treasury of needed revenues just as the baby boomers begin to retire and the rising costs of Social Security and Medicare strain the budget. Compared to full repeal, reforming the estate tax by increasing the exemption

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[4] Donald Kiefer, Robert Carroll, Janet Holtzblatt, Allen Lerman, Janet McCubbin, David Richardson, and Jerry Tempalski, "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers," National Tax Journal, March 2002. For instance, some estates with large amounts of debt may face higher taxes after repeal of the estate tax. Consider the following example: A single person has assets worth $6 million; these assets are the result of an investment of $2 million that has appreciated by $4 million during the person's life. In addition, the person has debts (such as a mortgage) of $3 million. If the person were to pass away in 2009, this person's estate would be exempt from estate tax under the law in effect that year. The estate would be valued at $3 million ($6 million of assets minus $3 million of debt), or $500,000 less than the $3.5 million exemption in effect that year. If the person were instead to die in 2010 after the estate tax has been repealed, the heirs of this estate would have to pay capital gains tax on a portion of the appreciation of the inherited assets that occurred during the decedent's life. Under the carry-over basis rules that accompany estate tax repeal, $1.3 million of the appreciated value of the inherited assets would be exempt from capital gains tax. But because the appreciated value of the assets is $4 million, the heirs would owe capital gains tax on the remaining $2.7 million when they sell the assets.

[5] Ron Durst, James Monke, and Douglas Maxwell, "How Will the Phaseout of Federal Estate Taxes Affect Farmers," USDA Economic Research Service, Agriculture Information Bulletin No. 751-02, February 2002.

level and lowering the rates would cut the revenue loss by more than half. Overall, reform based on a higher exemption and lower rates offers a more sustainable approach to the estate tax and should create a more stable tax policy environment for estate planning.

The following sections of this report examine the long-term costs of repealing the estate tax, the small number of estates that would benefit from full repeal, the impact of the estate tax on small businesses and family farms, and the implications of the carry-over basis rules that accompany estate-tax repeal.

Long-Term Cost of Estate Tax Repeal Exacerbates Worsening Budget Outlook

The budget outlook has deteriorated sharply since the tax-cut package was signed into law in June 2001. The Congressional Budget Office estimates that the $5.6 trillion budget surplus that was projected at that time for the years 2002 to 2011 has completed disappeared. CBO projects that the budget outside Social Security will be in deficit each year through 2011.

Moreover, these CBO estimates are likely to be too optimistic. Since it made those projections in March, Congress has enacted funding for the war in Iraq and a $350 billion tax-cut package. Further, revenue collections are below expectations for 2003, and CBO estimates that revenues may finish the year $50 billion to $80 billion below the level CBO anticipated. But the largest distortion results from the way that CBO is required to calculate its projections, following prescribed rules. Under these rules, CBO does not take into account a number of expected costs. A number of studies, including a forthcoming Center analysis, conclude that the outlook is far bleaker when more realistic assumptions are employed.[6]

For instance, the CBO projections do not include the cost of extending the provisions of the 2001 and 2003 tax-cut bills that expire artificially and a number of popular tax breaks — such as the research and experimentation tax credit — that are routinely extended before they expire. Nor do the CBO projections include the cost of ensuring that the number of taxpayers subject to the individual Alternative Minimum Tax does not skyrocket from fewer than 3 million today to over 40 million by 2013 (assuming the 2001 tax cut is extended). On the spending side, the CBO figures do not include the cost of a Medicare prescription drug benefit or the full cost of the Administration's plans for defense, Iraq reconstruction and homeland security. Altogether, using more realistic assumptions adds more than $4 trillion to the deficit between 2004 and 2013, leaving the budget mired in deficit throughout the next decade and beyond.

New York Federal Reserve Bank Chairman and former Nixon Administration Commerce Secretary Peter Peterson wrote recently in the *New York Times Magazine* that in 2001 "the 10-

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[6] Richard Kogan, forthcoming analysis of the budget outlook through 2013, Center on Budget and Policy Priorities. Also see Alan Auerbach, William Gale, Peter Orszag, and Samara Potter, "The Budget Blues: The Fiscal Outlook and Options for Reform," Tax Policy Center Discussion Paper No. 10, May 2003. Robert Reischauer, "Statement before the Senate Finance Committee," January 29, 2002.

year budget balance was officially projected to be a surplus of $5.6 trillion — a vast boon to future generations....By midyear [2003], prudent forecasters pegged the 10-year fiscal projection at a deficit of over $4 trillion."[7]

Although long-range fiscal and economic forecasts are inherently uncertain, there are things we know with some certainty about the decade that commences after 2013, when the cost of permanently repealing the estate tax would be very large. Specifically, we know that the baby boom generation will begin to retire in large numbers during the second decade of this century and that the cost of Social Security, Medicare, and Medicaid long-term care will rise substantially as a result.

- Former CBO Director Dan Crippen observed in testimony before the Senate Budget Committee in January 2002, "long-term pressures on spending loom just over the horizon. Those pressures result from the aging of the U.S. population (large numbers of baby boomers will start becoming eligible for Social Security retirement benefits in 2008 and for Medicare in 2011), from increased life spans, and from rising costs for federal health care programs."[8]

- The current CBO director, Douglas Holtz-Eakin, apparently concurs with the conclusions of his predecessor. In a recent forum, Holtz-Eakin observed that "the current budget battles that we've seen the last few years are really small potatoes compared to what's coming down the road."[9]

- The Administration's 2004 budget finds that: "In 2008, the first members of the huge baby-boom generation born after World War II will reach age 62 and become eligible for early retirement under Social Security.

The Joint Committee on Taxation estimates that removing the 2010 sunset and making permanent the repeal of the estate tax would cost $162 billion between 2004 and 2013. Three-quarters of this cost — or $121 billion — would occur in *the last two years* of this period. The long-term costs of permanent repeal thus are much larger than the costs that would occur in the budget window.

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[7] Peter G. Peterson, "Deficits and Dysfunction," *The New York Times Magazine*, June 8, 2003.

[8] Dan L. Crippen, "The Budget and Economic Outlook: Fiscal Years 2003-2012," Testimony before the Senate Budget Committee, January 23, 2002. For more details, see the series of CBO "long-range fiscal policy briefs;" they can be found at http://www.cbo.gov/byclasscat.cfm?class=0&cat=3.

[9] "CBO Director Says Severe Budget Trade-Offs Needed to Fund Long-Term Federal Liabilities," BNA Daily Tax Report, June 9, 2003.

Widespread Concern Over Long-Term Budget Outlook

Recent budget projections show a dramatic deterioration in the ten-year budget outlook, and a broad range of analysts have expressed growing alarm over the nation's fiscal condition.

- The investment firm Goldman Sachs recently concluded: "The long-term budget outlook is also terrible, far worse than the official projections suggest. The CBO currently projects that the ten-year budget balance for fiscal 2004-2013 will be a surplus of $0.9 trillion. In contrast, our estimate is for a deficit of $4.2 trillion." ("Budget Blues: Play It Again, Uncle Sam," March 14, 2003)

- Peter Peterson, who is chairman of the Federal Reserve Bank of New York and president of the Concord Coalition and was Commerce Secretary under President Nixon, described in Congressional testimony the "grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations." (Testimony before the House Financial Services Committee, April 30, 2003)

- In a recent report, the Committee for Economic Development, a distinguished organization of 250 current and former corporate CEOs and university presidents, stated, "All told, the new [Administration] budget proposals, if enacted, would raise the ten-year deficit by about $2.7 trillion and annual deficits ten years from now by about $500 billion. ... A decade of these growing deficits will leave America ill-prepared for the arrival of the baby-boomers' retirement." The report later warned, "If we do not change our current fiscal course, we are inviting a low-growth economy. Such a steep and protracted rise in federal deficits and fall in economic growth rates would be unprecedented. Perhaps for the first time in this country's history, most Americans could no longer expect their children and grandchildren to have higher living standards than their own." ("Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America," March 2003)

- The Office of Management and Budget has expressed similar concerns. The *President's Budget of the U.S. Government for Fiscal Year 2004* states, "These long-run budget projections show clearly that the budget is on an unsustainable path, although the rise in the deficit unfolds gradually. As the baby-boomers reach retirement age in large numbers, the deficit is projected to rise steadily as a share of GDP. Under most scenarios, well before the end of the projection period for this chapter [about 2080] rising deficits would drive debt to levels several times the size of GDP."

- In the decade after 2013, permanent repeal would result in a revenue loss of $820 billion. Assuming that the cost of a tax cut will stay constant as a share of GDP

once the cut is fully in effect is the standard estimating method that CBO and the General Accounting Office use when making long-term fiscal forecasts.[10]

- Looking out over the next 75 years, the cost of permanently repealing the estate tax would be equal to an amount that is *about 40 percent of the entire shortfall in the Social Security Trust Fund.* (This estimate, as well, uses the standard assumption that the cost of tax cuts — in this case, estate tax repeal — will remain constant as a share of GDP. It uses the Social Security Trustees' estimate of the size of the Social Security shortfall.)

- The cost of permanent estate tax repeal will be even higher if it ultimately is accompanied by repeal of the gift tax. The two taxes have historically been closely linked, and it may be difficult over the long term to sustain the gift tax in the absence of the estate tax. According to the Joint Committee on Taxation, elimination of both the estate and gift taxes would result in significant income tax avoidance and sharply increase the revenue loss (see box on page 10).

Retaining the estate tax at the policy that will be in place in 2009 — with a $3.5 million exemption and a top rate of 45 percent — would result in less than half of the revenue loss associated with full repeal. Relative to permanent repeal of the estate tax, the amount saved by maintaining the estate tax at the 2009 level, with the much higher exemption and lower rates, would total more than $460 billion between 2014 and 2023. Over the next 75 years, the savings would be equivalent to nearly one-quarter of the long-term Social Security shortfall.

Ironically, calls to make the estate tax repeal permanent come after the President's Social Security Commission issued a report showing it was unable to come up with options to restore long-term Social Security solvency that do not involve shifting very large amounts of funding from the rest of the budget to Social Security. The President's hand-picked Commission presented three options, one of which failed to restore solvency to the Trust Fund. The other two options were able to eliminate the shortfall in the Trust Fund and restore long-term solvency only by relying both on substantial cuts in traditional Social Security benefits (cuts likely to be too large to be acceptable politically) *and* the transfer of several trillion dollars in revenue from the est of the budget.

Permanent extension of estate tax repeal would eliminate essential resources that likely will be needed if long-term Social Security solvency is to be restored without deep Social

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[10] As noted, the $820 billion figure assumes that the cost of estate tax repeal will remain constant at its 2013 level, measured as a share of the economy. This is a conservative estimate that is likely to understate the cost of estate tax repeal in the decade after 2013. The estate tax exemption that is slated to be in place in 2011 under existing law is not indexed for inflation. As a result, under current law, estate tax revenues would grow faster than GDP after 2011 and represent an increasing (rather than a constant) share of the economy. It thus is likely that the actual revenue loss from permanent repeal of the estate tax would be more than $820 billion over the second decade.

Long-Term Costs Could Be Even Higher If Gift Tax Is Also Repealed

Although the estate and gift taxes have historically been closely linked, the 2001 tax-cut measure repealed the estate tax and left the gift tax in place. The long-term cost of estate tax repeal will be considerably higher if the gift tax also is repealed. According to a Joint Committee on Taxation analysis, repeal of both the estate and gift tax would lead to substantial *income tax* avoidance and thus to a much higher cost than just the loss of estate and gift tax revenues.

These higher revenue losses are of concern, because in the long run it is unlikely that the gift tax can be maintained in the absence of the estate tax. Supporters of estate tax repeal originally proposed to eliminate both the estate tax and the gift tax and only shied away from this approach at the last minute to avoid the costly Joint Tax Committee estimate of the revenue loss from repeal of both taxes. The estate tax and the gift tax both address the issue of transfers of wealth. Under current law, both taxes rely on a single (unified) exemption and apply the same tax rates to amounts that are taxable.

If the estate tax is repealed and the gift tax remains, people will be taxed on large gifts given during their lifetime, but not on bequests at death. A significant number of wealthy people will want to give gifts to their children during their lifetime, however, and will inevitably view the gift tax as discriminatory. For example, people with a family business may have a reason to transfer control to their children before death. People with disabled children may want to transfer assets to assure themselves that the children will be taken care of during the parents' declining years. As a result, there almost surely will be strong calls to repeal the gift tax on the grounds that the differential treatment of gifts given during one's lifetime and at death is highly inequitable.

The Joint Tax Committee projects that if the gift tax and estate tax are both repealed, massive income tax evasion will occur. Without the gift tax, wealthy taxpayers could easily manipulate the system by temporarily transferring assets to taxpayers with lower incomes to take advantage of lower tax rates. For example, a wealthy person could transfer appreciated stocks to a relative or friend in a lower tax bracket. The recipient of this "gift" could sell the stock, facing a lower tax rate than the original owner would have, and later transfer the after-tax gains back to the original owner (and perhaps retain a fee for these services). In 2001, the Joint Tax Committee estimated that repeal of both the estate and gift tax would result in a revenue loss of $97 billion in 2011, *of which $44 billion reflected a reduction in income tax revenues due to income tax evasion*. With the repeal of both the estate and gift taxes, the already-large revenue loss in the second decade could increase by more than 50 percent.

Security benefit cuts or sizeable payroll tax increases. The long-term financing gaps in Social Security and Medicare are much too large to close with benefit cuts or payroll tax increases alone; the benefit cuts and tax increases that would be required go well beyond what policymakers from either party will accept. This is true whether or not a privatization approach is used. Some revenues from the rest of the budget will be essential as part of larger reform efforts that restore long-term solvency to these programs. Retaining the estate tax, and possibly dedicating the revenues to the Social Security Trust Fund, could help to address these financing

problems and thus to make feasible the development of a Social Security solvency package that might be enacted.

Few Would Benefit from Permanent Repeal of the Estate Tax

The estate tax is a progressive tax paid by only the highest income and wealthiest people in the country. This will be even more true as the exemption level rises under current law from $1 million in 2002 ($2 million for a couple) to $3.5 million ($7 million for a couple) in 2009.

IRS data for 2001, the latest year available, show that only two percent of the estates of people who died in that year — when the exemption was $675,000 — were subject to the tax. Of the two percent of estates subject to tax, the largest estates paid by far the most in estate tax.[11]

- More than half of all estate taxes paid in 2001 were paid by the 3,500 largest estates, all of which were valued at over $5 million. Stated another way, more than half of the estate tax was paid by the estates of the wealthiest one of every 700 people who died. (See Appendix 1 for a state-by-state breakdown of estates valued at over $5 million in1999, the most recent year for which such data are available.)
- The 469 estates valued at over $20 million — representing fewer than one percent of taxable estates, or one out of every 5,000 people who died — paid over one-fifth of all estate taxes in 2001.

These figures reflect the effects of the estate tax when the estate tax exemption was $675,000. As the exemption level rises over the decade, even fewer estates will be subject to the estate tax, with only the very largest estates paying any tax.

[11] Distributional analyses typically show the impact of a tax at different income levels. The Treasury Department assumes that the estate tax is borne by the decedent and assigns the tax based on the decedent's income. Under these assumptions, the Treasury Department estimates that 91 percent of the estate tax is paid by the five percent of taxpayers with the highest incomes. Some object to this approach, claiming that the incomes of the heirs are not as high as those as the decedents. A Brookings Institution analysis concludes, however, that it makes little difference whether a distributional analysis is based on the incomes of the decedents or the heirs because "the recipients of large inheritances tend to have very high income and (non-inheritance) wealth themselves." See William Gale and Joel Slemrod, "Overview" in William Gale, James Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Brookings Institution Press: Washington, 2001).

- In the year before repeal takes effect, only estates valued in excess of $3.5 million will be taxable at all. These large estates are estimated to represent less than *one-half of one percent* of all estates.[12]

- In addition, the amount of tax paid by these few taxable estates will be substantially less than today, both because the first $3.5 million of an estate ($7 million for a couple) will be exempt from the tax and because the tax law enacted in 2001 reduces the top estate tax rate that will apply to the taxable portion of an estate from 55 percent to 45 percent. A married couple with a $10 million estate, for instance, will face an effective tax rate of only 13.5 percent under the rates and exemptions that will be in effect in 2009, as compared to an effective rate of 38.1 percent today. (Note that if the couple makes charitable contributions, these effective rates would be even lower.)

- Yet maintaining the exemption at $3.5 million and the top rate at 45 percent would lose only about half of the revenue that would be lost under full repeal of the estate tax.

- The revenue loss that would be avoided totals more than $460 billion between 2014 and 2023 and could prove important to helping restore Social Security solvency, reducing budget deficits, or meeting some other crucial need.

Family Farms and Businesses

Despite the rhetoric around the impact of the estate tax on family farms and businesses, only a very small fraction of family farms or small businesses are ever subject to the estate tax. Current estate tax law already provides sizable special tax breaks for family farms and businesses. Furthermore, raising the exemption to $3.5 million would sharply reduce to tiny proportions the already small number of family-owned enterprises subject to the tax.

- IRS data show that more than 93 percent of taxable estates in 2001 were valued at less than $5 million. Farm and family-owned business assets — including closely-held stocks, limited partnerships, and non-corporate businesses —

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[12] There are no official estimates of the number of taxable estates assuming a $3.5 million exemption. Using IRS Statistics of Income data on estate tax returns from 1998 to 2001 and Joint Committee on Taxation projections of the number of taxable estates over the decade under the estate tax laws that were in effect prior to the 2001 tax cut, we estimate that with a $3.5 million exemption, the number of taxable estates in 2010 would be between about 8,000 and 12,000, or fewer than one-half of one percent of the projected 2.6 million deaths in that year. In the text, we have used a point estimate of 10,000 taxable estates, which falls in the middle of this range.

accounted for *less than three percent* of the total value of these taxable estates in 2001.[13]

- The Agriculture Department's Economic Research Service projects that, when the estate tax exemption rises to $3.5 million, fewer than one percent of all farm estates will be subject to the estate tax.

It often is claimed that repeal of the estate tax is necessary to save family businesses and farms — that is, to assure they do not have to be liquidated to pay estate taxes. This claim makes a good sound bite, but there is little evidence to support it. The vast bulk of estates that include a farm or family-owned business are not taxable even at the current exemption levels. Furthermore, in most estates that *are* taxable and include a business or farm, the business or farm does *not* constitute the majority of the estate. The American Farm Bureau Federation acknowledged to the *New York Times* that it could not cite a single example of a farm having to be sold to pay estate taxes.[14]

- A Treasury Department tabulation of 1998 data show that family-owned businesses or farms formed the majority of the estate in just 1,418 taxable estates out of the approximately 2.3 million people who died that year — or six out of every 10,000 people who died.

- The Treasury study found that in only 776 of the 47,482 taxable estates in 1998 (or 1.6 percent of such estates) did family-owned business assets equal at least half of the gross estate. In only 642 taxable estates (or 1.4 percent of them) did farm real estate and other farm assets equal at least half the gross estate.

Family-owned businesses and farms already are eligible for special treatment under current law (see box on page 11 for the definition of "family-owned").[15] For instance, family-owned businesses and farms may use special valuation rules to reduce or eliminate estate tax liability and, when the enterprise accounts for at least 35 percent of an estate, tax payments can

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[13] In large estates, such as those valued at over $20 million, family-owned business assets accounted for more than 20 percent of the value of all taxable estates. These figures imply that in some large estates, family-owned businesses are not necessarily "small" businesses. Some of the country's largest businesses are family owned. Examples of large family-owned businesses include Mars Candy, Levi Strauss, Hallmark Cards, Enterprise Rent-a-Car, and Gallo Winery.

[14] David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *The New York Times*, April 8, 2001.

[15] When a family-owned businesses or farm constitutes more than half of the estate, the exemption is $1.3 million, higher than the current $1 million exemption for other estates. This special treatment sunsets in 2004, when the general exemption from the estate tax rises to $1.5 million.

be deferred for up to 14 years. To the extent that any problems may remain in the taxation of small family-owned businesses and farms under the estate tax once the estate-tax exemption has risen to $3.5 million, those problems could be specifically identified and addressed at a modest cost to Treasury. Wholesale repeal of the estate tax is not needed for this purpose.

Double Taxation and Carry-Over Basis

During the upcoming debate on estate tax repeal, proponents of repeal can be expected to level some of the same charges against the estate tax that have been leveled during previous debates. In particular, advocates of estate tax repeal will claim that the estate tax is unfair because the assets in an estate have already been taxed once as income under the income tax and should not be taxed again. Yet the premise on which this "double taxation" claim is based is not accurate. A significant portion of the value of estates — and the majority of the value of the largest estates — has never been taxed as income because the value is in the form of unrealized capital gains. In this respect, the estate tax serves as a backstop to the income tax, providing a way to tax income that otherwise would avoid taxation altogether.

Without the estate tax, capital gains included in an estate would never be taxed. Under current law, the gain from the appreciation of an asset is subject to income tax only when the asset is sold. When an individual sells an asset, the capital gains tax calculation is based on the profit from the sale — the difference between the amount received when the individual sells the asset and the amount the individual paid to acquire the asset, which is known as the "basis." In many cases, the basis is simply the original purchase price. When heirs inherit an asset, the basis of the asset is increased — or "stepped up" — to equal the value of the asset at the time the decedent passed away. Under these "step-up basis" rules, if an individual holds an asset until he dies, the gain in the asset's value from the time the individual purchased the asset to the time the individual dies is never taxed under the income tax. The appreciated value of the asset is included in the decedent's estate, however, and if the estate is large enough, it will be subject to estate tax.

A substantial proportion of assets subject to the estate tax appear to be capital gains that have never been taxed. Estimates made by economists James Poterba and Scott Weisbenner, based on data from the Survey of Consumer Finances, suggest that these untaxed capital gains make up about 37 percent of the value of estates worth more than $1 million and about 56 percent of the value of estates worth more than $10 million.[16] Repeal of the estate tax would eliminate this backstop to the income tax code.

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[16] James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," *Rethinking Estate and Gift Taxation*, Brookings Institution, 2001.

The Concept of "Double Taxation"

The charge of "double taxation" is used by some to imply that the estate tax is unfair and can distort economic decisions about work, savings, and investment. However, economists William Gale and Joel Slemrod point out that the double taxation argument is "an exercise in *rhetoric*, and has no economic significance"; they use the following example to explain their point: "[I]n a value-added tax, goods are taxed at each stage of production; in a retail sales tax, they are only taxed once, at the retail level. Yet economists understand that — aside from administrative features — the two systems are economically equivalent, and the difference in the number of times the item is taxed is economically meaningless." See "Rhetoric and Economics in the Estate Tax Debate," paper presented at the National Tax Association spring symposium, May 22, 2001.

Implementation of "Carry-Over Basis" Requirements

To avoid being accused of allowing significant amounts of capital gains to go untaxed, supporters of estate tax repeal included a provision in the 2001 tax-cut legislation that imposes a new requirement that heirs pay capital gains tax on certain inherited assets when they are sold. The new system is slated to take effect at the same time that the estate tax is repealed.

Under current law, when heirs sell inherited assets, they only pay capital gains tax on the appreciation of the assets from the time they were inherited to the time they were sold. The increase in the value of the asset that occurred when the decedent owned the asset is disregarded (because the basis of the asset is "stepped up" when it is inherited, as discussed above). When the estate tax is repealed in 2010, however, a new approach — known as "carry-over basis" — goes into effect. Under this approach, the original basis of assets that are inherited would be "carried over" to the heirs. In other words, when the heirs sold the assets, they would be responsible for paying capital gains tax on all of the gains that had accrued since the decedent originally acquired the assets, rather than (as under current law) only on the gains since the heirs inherited the assets.

Not all heirs would have to pay capital gains tax on the increase in the value of an inherited asset that occurred during the life of a decedent. Under the carry-over basis rules enacted as part of the 2001 tax-cut legislation, the "basis" assigned to the assets in an estate could be increased by $1.3 million. For example, an estate that includes an asset valued at $10 million that was initially purchased for $5 million would be eligible for the $1.3 million basis adjustment. As a result, an heir who inherits this asset and immediately sells it would have to pay capital gains tax on $3.7 million — the difference between the $10 million current value and the $6.3 million adjusted basis amount. For assets bequeathed to the decedent's spouse, an additional $3 million upward adjustment would be allowed, for a total possible basis adjustment

Is It Difficult to Qualify as a "Family-Owned" Business?

Despite the assertions of some who advocate repeal of the estate tax, few family-owned businesses face the estate tax at all. Current law grants special treatment to family-owned businesses to minimize the impact of the tax. Proponents of estate tax repeal sometimes assert that these targeted provisions are ineffective because the rules make it difficult to qualify as a family-owned business; in fact, businesses easily qualify for this special status as long as the family owns and operates the business and intends to continue doing so.

If a business is wholly owned and operated by the person who died, it readily qualifies for treatment as a family-owned business under current estate tax law. It will also qualify if other family members participate in the business. For estate tax purposes, the definition of "family" is quite broad — it includes not only the decedent's spouse, but also his or her children, grandchildren, and great-grandchildren and their spouses, as well as their nieces and nephews and their spouses.

In general, the family must own at least 50 percent of the business — or as little as 30 percent if more than one family owns the business — and the family must have worked at the business and taken part in management decisions for at least five of the previous eight years. In the decade after the person's death, the heirs or one of the members of their families must continue to operate the business for at least five of any eight consecutive years. If three siblings inherit a business, for example, the test is met if any one of them participates in operating the business or even if one of the siblings' children participates in operating the business.

Businesses that manufacture or sell a product, provide a service, or engage in farming qualify for the special treatment. A business that is a holding company for managing other investments would not qualify. Nor can a company be publicly traded. If stock in the business has been publicly traded within three years of the person's death, the business does not qualify as family-owned.

of $4.3 million.[17] For large estates in which the amount by which the decedent's assets had appreciated during the decedent's life exceeded the basis adjustments that could be made, the estate's executor would be responsible for deciding how to allocate the basis adjustments among the various assets in the estate. The executor could raise the basis for some assets while leaving the basis for other assets unchanged.

These basis adjustments would relieve heirs of some capital gains tax. But, as explained below, executors and heirs would face immense administrative complexities in trying to apply these carry-over basis rules. A similar carry-over basis provision was enacted as part of the Tax Reform Act of 1976; due to its inordinate complexity and administrative difficulty, it was repealed four years later, before ever taking effect. In testimony before the Senate Finance Committee, the former chair of the American Bar Association Section of Taxation, Stefan

[17] In general, basis adjustments cannot increase the basis for an asset to a level that exceeds the asset's value at the time of the decedent's death.

Tucker, stated that the carry-over basis provision would "add incredible layers of complexity" to the tax code, a view that other practitioners have echoed.[18]

The record-keeping requirements that the carry-over basis provision would entail would be formidable. In some cases, heirs would have to determine the price that a decedent paid to acquire an asset many decades earlier. Estate executors also would face substantial complexity in figuring out how best to allocate the $1.3 million and $3 million in basis adjustments among the assets in an estate in order to minimize subsequent capital gains taxes, as well as how to deal with missing or inadequate records for establishing the basis for various assets.

The burden of distinguishing between those assets, or portions of assets, that were revalued at death as a result of these basis adjustments and those assets that were *not* revalued at death and thus retain their original basis would be substantial. These problems would multiply over time, as each generation's estate administrators would have to keep track not only of assets entirely exempted from the carry-over basis by a basis adjustment made when a decedent died, but also of the amounts by which other assets may have had their bases adjusted upward when previous decedents died, before the assets were passed on to the current decedent. As assets are held by each succeeding generation, it could eventually become necessary to track changes in the value of some assets that have occurred over a century or more.

That supporters of eliminating the estate tax felt it necessary to include the carry-over basis provision in the 2001 law as an accompaniment to estate tax repeal highlights the misleading nature of claims that the estate tax represents unfair double taxation. By including a carry-over basis provision in the legislation, supporters of repeal acknowledged that significant amounts of capital gains would escape taxation altogether in the absence of an estate tax.

The carry-over basis rules, however, are unlikely to provide a viable solution to this problem. If history is a guide, they are likely to prove so complicated and cumbersome to administer that intense pressure is generated for their repeal.

Yet some means of taxing these capital gains is necessary to ensure equity in the income tax system and deter income tax avoidance schemes. Retaining the estate tax, even with higher exemption levels, would address these problems. It would eliminate the need for unworkable carry-over basis rules and allow the continuation of the current practice of a "step-up basis" for inherited assets.

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[18] Stefan Tucker, "Testimony before the Senate Committee on Finance," March 15, 2001. Also see, Joseph Dodge, "What's Wrong With Carryover Basis Under H.R. 8," Tax Notes, May 4, 2001. Lee Sheppard, "Debt in Contemplation of Death," Tax Notes, June 1, 2001. Frank S. Berall, Ellen K. Harrison, Jonathan G. Blattmachr, and Lauren Y. Detzel, "Planning for Carryover Basis That Can Be/ Should Be/ Must Be Done Now," Estate Planning, Volume 29, March 2002.

Conclusion

The context of the upcoming debate in the Congress over making estate-tax repeal permanent is much different than it was in 2001 when the current estate tax changes were enacted as part of that year's large tax-cut package. Since then, the budget outlook has worsened dramatically, due in part to the enactment of extensive tax cuts, and projected surpluses have turned into hefty deficits. Furthermore, while the situation created by the 2010 sunset of estate-tax repeal may complicate estate planning, permanent repeal of the estate tax is not a viable solution over the long run. The full fiscal effects of estate tax repeal will be felt most strongly after the end of the decade, at a time when the budget will be struggling mightily to cope with the high cost of the baby-boomers' retirement.

Given the pressures on the budget, policymakers should reject calls for making the repeal of the estate tax permanent. If they feel that action is necessary to address the current uncertainty surrounding estate planning, they can adopt a more prudent approach than full repeal. Simply making permanent the $3.5 million estate-tax exemption and the 45 percent top-estate-tax rate that are slated to be in effect in 2009 would preserve more than $460 billion in revenues between 2014 and 2023, compared to the revenue that would be foregone under permanent repeal. With this high exemption level, fewer than one-half of one percent of estates would face any estate tax whatsoever. Adopting a somewhat lower exemption such as $2 million (or $4 million per couple) — the policy that is scheduled to be in effect in 2008 — would save even more revenue and still exempt all but the largest estates.

Stopping short of full repeal — and retaining the estate tax with an increased exemption level — represents a far more sustainable solution to the estate tax. Such an approach carries a substantially lower cost, while also eliminating the need for the complex, unworkable carry-over basis provision.

Appendix 1

Taxable Estate Tax Returns Filed in 1999 By State of Residence

(Money amounts are in thousands of dollars)

State of Residence	Gross Estate For Tax Purposes		Gross Estate For Tax Purposes Estates of $5 Million or More	
	Number	Amount	Number	Amount
Total	**49,870**	**119,176,309**	**3,283**	**52,383,542**
Alabama	416	1,016,970	41	420,667
Alaska	48	90,361	0	0
Arizona	958	1,842,355	46	538,326
Arkansas	183	501,057	17	243,158
California	7,445	16,262,673	491	6,339,829
Colorado	591	1,192,530	26	429,250
Connecticut	980	2,340,424	73	972,675
Delaware	214	383,435	11	87,597
District of Columbia	198	638,740	18	367,719
Florida	4,859	13,521,011	412	6,974,470
Georgia	831	3,621,398	63	2,473,912
Hawaii	160	598,391	12	353,239
Idaho	148	245,502	6	64,569
Illinois	2,722	5,618,817	158	2,000,431
Indiana	793	1,484,582	42	463,643
Iowa	643	1,216,753	23	433,342
Kansas	491	819,134	23	218,143
Kentucky	384	836,567	27	317,891
Louisiana	454	873,109	23	319,047
Maine	203	420,496	11	153,791
Maryland	1,030	2,226,972	59	817,271
Massachusetts	1,478	3,116,850	86	1,129,377
Michigan	1,299	3,036,676	83	1,410,854
Minnesota	636	1,377,055	36	586,112
Mississippi	173	399,658	13	160,699
Missouri	1,090	2,146,331	54	656,953
Montana	208	259,841	4	27,352
Nebraska	481	1,291,617	13	717,217
Nevada	223	988,715	21	666,684
New Hampshire	188	544,914	18	240,315
New Jersey	1,963	4,583,623	152	2,087,171
New Mexico	184	360,418	14	133,249
New York	3,571	11,803,345	331	6,682,967
North Carolina	1,322	2,734,552	76	1,015,954
North Dakota	116	186,580	5	53,199
Ohio	2,175	6,117,946	127	3,254,656
Oklahoma	382	884,171	28	339,239
Oregon	553	963,015	21	283,204
Pennsylvania	2,184	5,289,598	144	2,150,024
Rhode Island	134	440,215	15	260,103
South Carolina	403	1,163,087	34	612,123
South Dakota	149	222,032	5	37,797
Tennessee	686	1,581,215	38	667,986
Texas	2,571	5,953,974	152	2,410,080
Utah	146	237,632	6	54,014
Vermont	174	346,031	9	130,624
Virginia	1,504	3,142,191	74	1,064,442
Washington	850	1,589,678	51	458,928
West Virginia	262	523,763	20	218,310
Wisconsin	790	1,594,486	50	649,930
Wyoming	101	227,169	6	70,502
Other areas	122	318,654	11	164,506

Source: IRS Statistics of Income; figures are estimates based on samples of estate tax returns.