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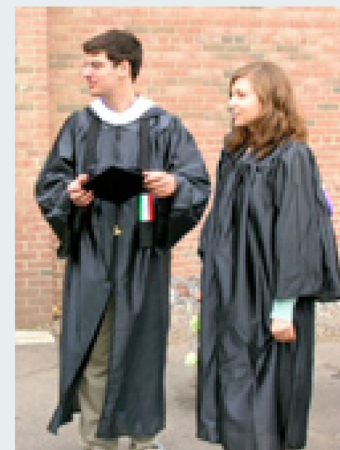
WEAKENING THE ESTATE TAX: PUTTING OUR FUTURE PROSPERITY AT RISK

By Nicole Witherbee, Ph.D.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) reducing the tax contributions of wealthier Americans. These tax cuts included lowering the top income tax and capital gains rates, as well as phasing out the estate tax. The estate tax is of particular importance this year because under EGTRRA it has been phased down each year and will wholly disappear in 2010 unless 2009 levels are extended. In 2011 the estate tax will once again return to pre-2001 levels if Congress does not intervene. For many members of Congress, neither of these scenarios is appealing. The pre-2001 levels affect more estates than some members are comfortable with (roughly 2% of estates) but full repeal of the estate tax would add more than $800 billion to our federal deficit by 2021: $630 billion in direct revenue losses and another $168 billion lost to higher interest payments on our national debt.[1]

Because of the increasing concern about the demand that the recession has placed on the national treasury, President Obama has proposed compromising by extending the current estate tax levels into the future. While there are many in Congress that consider this a generous compromise, there is continuing effort to further weaken the estate tax. Conservatives, led by Senator Kyle from Arizona, have proposed additional increases to the exemption level and lowering of the rate. These proposals give away almost as much revenue as full repeal of the estate tax, which would be counter to both our revenue needs and shared values.

The past two years have been difficult for many Americans. In May of this year, unemployment rose to 9.4% nationally and 8.3% in Maine. American families are increasingly worried about whether they will be able to send their children to college this fall and if retirement is possible in the coming years. In too many cases they worry about how they will put enough food on the table. As American families struggle to make ends meet and policy makers deliberate over tough choices about how to close budget gaps it is unwise to contemplate further tax cuts to the small fraction of the population who are faring well by weakening the estate tax.



“The Estate Tax is a very equitable tax and in keeping with the idea of equality of opportunity in this country.”

Warren Buffett

Basic Question of Fairness

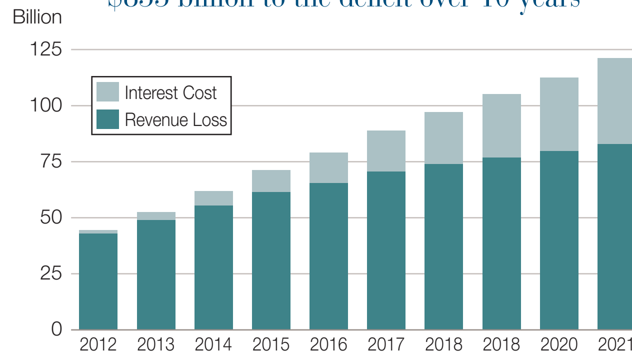
The issue of how and at what level to levy an estate tax strikes at the core principles of fairness in our tax structure. For those who find tax and budget issues dry, think about them as value statements. The estate tax is levied most heavily on those people who have gotten the most return on our collective investments. 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 heavily than others on the government's protection of individual property rights because they have more to protect.

People with the greatest wealth are more likely to use public roads to ship goods, benefit from subsidized gas for that same transportation, and rely on the regulation of a public telecommunications system to advertise goods when they arrive at their destination. Bill Gates, Sr, 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." We built an American infrastructure to serve business because we want to promote economic growth. But we also built a tax structure that recognizes that a small number of people benefit from this infrastructure disproportionate to others. This is why the estate tax was created.

The first $7 million of a couple's estate is tax free

The estate tax is a tax applied to the transfer of a person's property at the time of death. It consists of an accounting of everything a person owns or has a financial interest in at the time of death; the total of which is the "Gross Estate." Estate taxes, however, are not applied to the entire value of the Gross Estate. Instead, through a series of deductions and exclusions, the portion of the estate to which taxes actually are applied (known as the "Taxable Estate") is greatly reduced.

Repealing the estate tax would add more than $833 billion to the deficit over 10 years



Source: CBPP calculations based Joint Committee on Taxation estimates, scaled to reflect the financial crisis.

Allowable deductions include but are not limited to mortgages and other debts, estate administration expenses, and qualified charities. The value of some operating business interests or farms also may be reduced for estates that qualify. Also, the portion of an estate that passes to a surviving spouse is not subject to the estate tax. If the entire estate passes to a surviving spouse, then that estate – regardless of size – is not taxed. Beyond these deductions, a large amount of every estate is excluded from taxation. At present, the first $3.5 million of estate value (or $7 million for a couple)[2] is excluded from the Taxable Estate, and is not subject to estate taxes.

Because the majority of estates are comprised of small amounts of real estate, cash, publicly traded securities, and other easily valued assets, under 2009 estate tax levels, fewer than 3 in 1000 people who die owe any estate tax.[3] In most cases, these small estates do not even need to file an estate tax return. Even for taxable estates, the exemptions and deductions employed by estate planners reduce the average effective – or *real* – estate tax rate to 19%.[4] This rate is well below the rates applied to most regular income, and very close to the rate on capital gains.

The Estate Tax and Capital Gains

According to estimates by economists from the Massachusetts Institute of Technology and the Federal Reserve Board,[5] unrealized capital gains make up about 36 percent of the value of all estates and about 56 percent of estates worth more than $10 million. Further, only the largest estates, those that tend to have the greatest share of untaxed assets, will pay any estate tax. Given the prevalence of untaxed capital gains in large estates, the estate tax serves as a backstop to the income tax, providing a way to tax income that otherwise would avoid taxation altogether.

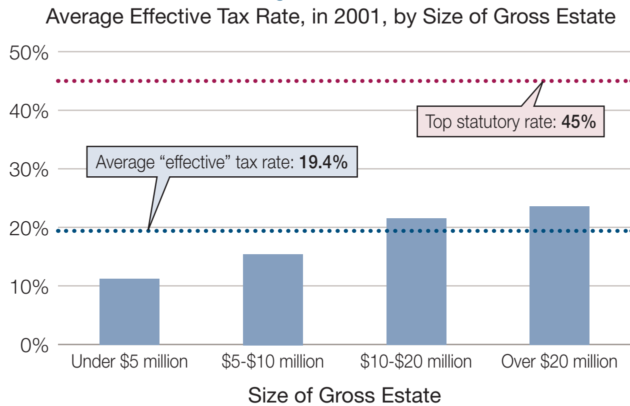
Most Americans who own capital (stocks, bonds, appreciated property) eventually cash out much of their holdings in order to fund their retirement years - and therefore pay capital gains taxes on these "realized" gains. Families who are subject to the estate tax are often able to avoid drawing down reserves during their lifetimes and instead pass their capital gains from one generation to the next entirely untaxed.

Family Farms and the Estate Tax

Several members of Congress have expressed concern about the impact of the estate tax on small businesses and farms; not wanting to place the fiscal health of our nation on the backs of these small family enterprises. Because of this concern, there are several protective measures in place that ensure that small businesses and family farms are either held harmless, or at

most, pay much lower effective estate tax rates. Due to these protections and the large exemption levels, very few small businesses or farms will pay any estate tax and those who do pay far less than the maximum level.

If the 2009 estate tax parameters are made permanent, less than one-fifth of the average taxable estate will be owed in tax



Source: Urban Institute-Brookings Tax Policy Center

Family owned farms and closely held businesses benefit from a number of special estate tax provisions. First, for purposes of the estate tax, farmers and small business owners may value their real estate at its "current-use value" rather than at its fair market value.[6]

The estate must satisfy certain requirements to qualify for this special use valuation: farm or closely-held business assets must make up at least 50 percent of the decedent's gross estate; the decedent or his family must have used the property for farming or another qualified use in the recent past; and the heir(s) must agree to keep the property in a qualified use for 10 years after the decedent's death. According to a United States Department of Agriculture report, special use valuation can reduce the real property value portion of farm estates by 40 to 70 percent of market value.[7]

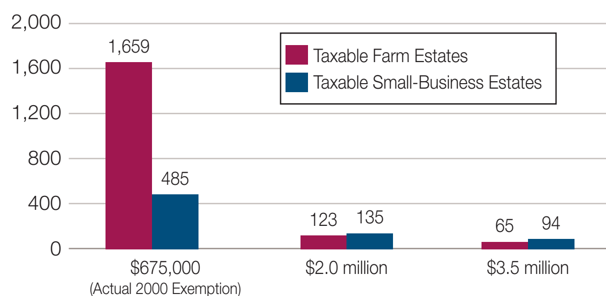
Another special provision allows farm and small business estates (in which closely-held business assets comprise at least 35 percent of the gross estate) to pay the estate tax liability in installments over 15 years, and to do so at preferential interest rates. For the first five years, payments only on the interest portion of the delayed tax bill are due. The family then can spread payment for the actual bill itself over another ten annual installments.

Given these many special provisions, the Urban Institute and Brookings Institutions' Tax Policy Center estimates that *nationwide* only 80 farms and small business estates will owe *any* estate tax in 2009, and that these few dozen estates will be taxed at an effective rate of less than 14%, or a rate lower than that applied to capital gains. Despite concern for family farms, the Federal Farm Bureau Federation was unable to cite a single example of a family farm sold off in order to pay the estate tax.

The Real Cost of the Estate Tax: Foregoing Critical Investments to Benefit a Few

With more than a trillion dollars in revenue on the line over the coming 15 years, the debate surrounding the estate tax goes to the heart of our ability as a nation to pursue core public investments. Congress will have to weigh the value of providing further tax cuts to the top quarter of one percent of the population against a long list of the country's pressing public needs; bearing in mind, that these are the same people who benefit disproportionately from public structures.

Tiny Number of Small Businesses & Farms Owe *Any* Estate Tax



Source: Congressional Budget Office

Among the list of top priorities must be a plan to reduce the federal deficit. The federal deficit has ballooned in part due to skyrocketing health care costs and an aged population that have affected the three large entitlement programs (Medicare, Medicaid, and Social Security). However, the rising cost of these programs is eclipsed by the rising costs of defense and large tax cuts targeted at small numbers of households.

During the period of time between 2001 and 2008, the federal deficit grew to $1.3 trillion. Domestic discretionary spending increases were responsible for seven percent of that, and entitlement increases were responsible for another ten percent. The biggest contributors were defense and security increases (34%) and tax cuts (49%).

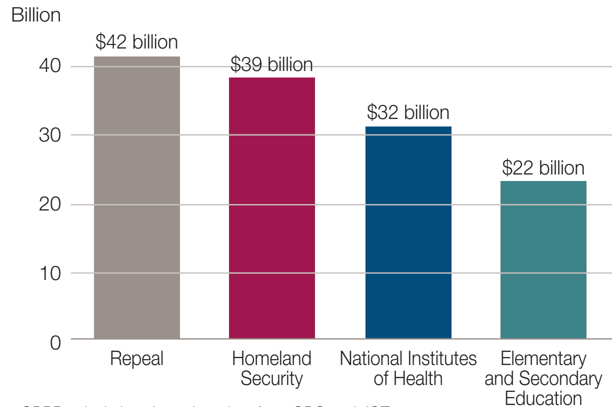
In fact, the tax cuts enacted in 2001 and 2003 are largely responsible for our inability to pay for the things that offer the nation its best opportunity for prosperity, including investments in our educational systems, our energy and transportation systems, and comprehensive health care reform. Further weakening of the estate tax would mean an additional loss of revenue, even as Congress is desperately seeking ways to bring our federal budget back into balance, pay for health care reform, and keep our nation safe.

If Congress allows the estate tax to be repealed, the nation's ability to make important public investments will decline by $42 billion in 2012 alone. That is more than the projected cost of the entire budgets for Homeland Security, the National Institutes of Health, or public education in our country. Low-income Americans would be paying for high-end tax cuts mainly through reduced government services, but it is not only the poor who would lose out. The broad middle class would be paying for them both in the form of reduced public investments, higher consumer interest rates, and higher future taxes to close the deficit and pay down our national debt.

Conclusion

The argument about whether government should be bigger or smaller is irrelevant. What most people really care about is whether it is effective. Does it take only what we can afford to pay and give back that which we could only pay for collectively; roads, bridges, schools, hospitals, public safety, schools, clean water, national security, a judicial system? Does it invest in our children's future? The estate tax is levied on the very people who most benefit from the structures that government provides and so should give back enough to reinvest in the people who make their estates possible.

At a time when so many are struggling in our state and across our nation, we cannot afford to give away sorely need revenue to the people who are least in need of help. As a nation we have a larger agenda to attend to; an agenda that will benefit all Americans whether rich, poor, or somewhere in between. Collectively we can make the nation stronger for all families and businesses but only if we let go of the notion that the only way to prosperity is through giving more to those households who already have wealth while ignoring the needs of the majority of Americans.



About the Author

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Endnotes

1. Joint Committee on Taxation (JCT-1-08)
2. If the estate of a deceased partner is transferred to a surviving spouse, the $3.5 million exclusion available to each partner can be combined, thereby excluding $7million of the estate from taxation whenever the remaining partner also dies.
3. Center on Budget and Policy Priorities, "The Estate Tax: Myths and Realities", 2009
4. Center on Budget and Policy Priorities, June 2009
5. James M. Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," Rethinking Estate and Gift Taxation, William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds. Brookings Institution, 2001.
6. IRS http://www.irs.gov/businesses/small/article/0,,id=164871,00.html
7. Durst, Ron, James Monke, and Douglas Maxwell, 2002. "How Will the Phaseout of Federal Estate Taxes Affect Farmers?" USDA Agriculture Information Bulletin No. 751-02. http://www.ers.usda.gov/publications/aib751/aib751-02/aib751-02.pdf.

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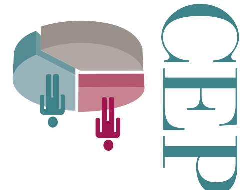

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