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THE ESTATE TAX: MYTHS AND REALITIES

The estate tax has been an important source of federal revenue for nearly a century. It also encourages billions of dollars in charitable donations each year (<http://www.cbpp.org/8-3-04tax.htm>), since donations substantially reduce the tax on large estates. Despite these benefits, a number of misconceptions continue to surround the tax.

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

✓ **Reality: Repealing the estate tax would add trillions of dollars to future deficits.**

Permanently repealing the estate tax would cost roughly \$1 trillion over the first ten years of extension, 2012-2021. This cost includes \$776 billion in lost revenue and \$213 billion in increased interest payments on the national debt. (The official ten-year cost estimate is much lower: \$369 billion. But that estimate is misleading because it covers an earlier ten-year period, 2007-2016, that captures only the cost of five years of extending repeal.)

Given the current fiscal situation — and, more importantly, the looming budgetary challenges posed by the baby boomers' retirement — it would be extremely unwise for the federal government to forgo such large revenues.

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

✓ **Reality: The few estates that pay any estate tax at all generally pay less than 20 percent of the value of their estate in taxes.**

Roughly 99 percent of estates pay no estate tax at all. Among the few estates that do owe taxes, the "effective" tax rate — that is, the percentage of the estate that is paid in taxes — averaged about 19 percent in 2003, according to the IRS, far below the top estate tax rate of 50 percent that these estates faced.

Why is the effective tax rate so much lower than the top tax rate? Estate taxes are due

only on the portion of an estate's value that exceeds the exemption level, not on the entire estate. For example, at today's \$2.0 million exemption level, a \$2.5 million estate would owe estate taxes on \$500,000 at most. In addition, a large portion of the estate's remaining value can be shielded from taxation through available deductions (for charitable bequests and state estate taxes paid, for instance).

It's also worth noting that the effective estate tax rate will fall below 19 percent over the next few years, as the exemption level rises and the top estate tax rate declines.

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

- ✓ **Reality: The number of small, family-owned farms and businesses that owe any estate tax is small — and shrinking rapidly.**

Despite oft-repeated claims that the estate tax has dire consequences for family farms and small businesses, there is in fact very little evidence that it has an outsized impact on these groups. Indeed, 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.

Most recently, an analysis by the Congressional Budget Office confirms that exceedingly few family farms and small businesses face the estate tax (<http://www.cbpp.org/7-11-05tax.htm> and <http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf>). The CBO report found that if the current exemption level of \$2.0 million had been in place in 2000, only 123 farm estates and only 135 family-owned businesses nationwide would have owed any estate tax. The number of taxable farm estates would have dropped to 65 nationwide at a \$3.5 million exemption level, the level that takes effect in 2009. The number of taxable family-owned business estates would have fallen to just 94 under the \$3.5 million exemption.

The CBO report also found that of the few farm and family business estates that would owe any estate tax, the vast majority would have sufficient liquid assets (such as bank accounts, stocks, bonds, and insurance) in the estate to pay the tax without having to touch the farm or business. For instance, of the 65 farm estates that would have owed tax under a \$3.5 million exemption, just 13 would have faced liquidity constraints.

Analyses by the Urban Institute-Brookings Institution Tax Policy Center also find that that few small businesses and farms are subject to the estate tax (<http://www.cbpp.org/3-16-05tax.htm>).

Myth 4: The estate tax is best characterized as the "death tax."

- ✓ **Reality: The estate tax would more appropriately be called an "inheritance tax," as it ultimately affects only the heirs of large estates.**

Today, the estates of only 1 out of every 200 people who die owe any estate tax whatsoever, because the first \$2.0 million of the value of any estate (\$4.0 million for a couple) is totally exempt from the tax. (<http://www.cbpp.org/5-31-06tax2.htm>)

Further, the exemption level is scheduled to rise to \$3.5 million (\$7 million for a couple) in 2009 under current law. At this level, only 3 of every 1,000 people who die will have an estate large enough to owe any tax.

That is why repealing the estate tax, which some people describe as "killing the death tax," has been described more aptly by others as the "Paris Hilton tax cut" after Paris Hilton, the heir to the Hilton hotel fortune.

Myth 5: The estate tax unfairly punishes success.

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

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

Like other Americans, the very wealthy benefit from public investments in areas such as defense, education, health care, scientific research, environmental protection, and infrastructure, and they rely even more than others on the government's protection of individual property rights (since they have so much more to protect). It seems fair that people who have prospered the most in this society help to preserve it for future generations through tax revenues that derive from their estates. Indeed, as President Theodore Roosevelt stated in 1906 that "the man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government."

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

- ✓ **Reality: Eliminating the estate tax wouldn't dramatically affect private saving, and it would greatly increase government dissaving (i.e., deficits).**

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

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

Myth 7: The estate tax constitutes "double taxation" because it applies to assets that already have been taxed once as income.

- ✓ **Reality: Large estates have substantial amounts of "unrealized" capital gains that have never been taxed; the estate tax is the only means of taxing this income.**

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

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

Myth 8: If the estate tax is reformed and retained, the logical top tax rate would be 15 percent, the same as the capital gains rate.

- ✓ **Reality: To match the effective tax rate on capital gains, the top estate tax rate would have to be 35-40 percent, not 15 percent.**

Since the estate tax serves in part to tax capital gains that have not been taxed, some people have proposed taxing estates at the capital gains rate of 15 percent. But the capital gains rate is typically applied to all capital gains income, whereas the estate tax is applied only to part of the estate (see Myth 2 above).

As a result, a 15 percent top estate tax rate would result in an effective tax rate on taxable estates of only 5 or 6 percent — about one-third of the capital gains rate. A top estate tax rate of 35-40 percent would be needed to generate an effective rate of 15 percent.

Moreover, from the standpoint of the effect on the deficit and the national debt, cutting the top estate tax rate to 15 percent rate would differ little from repealing the tax entirely. Tax Policy Center and Joint Committee on Taxation estimates indicate that with a 15 percent top rate and an exemption level of \$2 million, the tax would lose nearly 70 percent of the revenue that would be lost under repeal. With a 15 percent rate and a \$5 million exemption, the loss would grow to nearly 85 percent. (<http://www.cbpp.org/5-31-06tax.htm>)

Myth 9: The cost of complying with the estate tax is nearly equal to the total amount of revenue the tax raises.

- ✓ **Reality: The cost of estate tax compliance is modest, and is not much different than the cost of complying with other taxes.**

Studies find that all of the various public and private costs associated with estate tax compliance (<http://www.cbpp.org/6-14-05tax.htm>) — including the IRS's costs of administering the tax and the cost taxpayers bear in terms of estate planning and administering an estate when a person dies — are about 7 percent of estate tax revenues. These costs are consistent with the compliance costs for other taxes. For instance, administrative and compliance costs represent about 14.5 percent of revenue for the individual and corporate income taxes, 3-5 percent for value added taxes, and 2-5 percent for the sales tax.

Furthermore, the estate tax compliance burden will disappear for a growing number of families each year under current law, as the exemption level rises and fewer estates are subject to the estate tax.

Part of the confusion around the cost of estate tax compliance is that some estimates

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