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Ten Facts You Should Know About the Federal Estate Tax

By Chye-Ching Huang and Brandon DeBot[1]

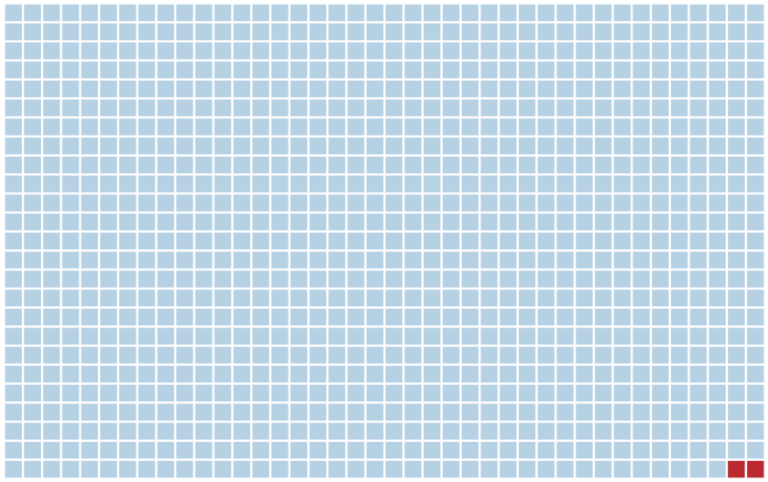
The federal estate tax is a tax on property (cash, real estate, stock, or other assets) transferred from deceased persons to their heirs. Only the wealthiest estates pay the tax because it is levied only on the portion of an estate's value that exceeds a specified exemption level — $5.43 million per person (effectively $10.86 million per married couple) in 2015.[2] The estate tax thus limits, to a modest degree, the large tax breaks that extremely wealthy households get on their wealth as it grows, which can otherwise go untaxed.

The estate tax has been an important source of federal revenue for nearly a century, yet a number of misconceptions continue to surround it. This report briefly describes ten facts about the federal estate tax.

(While this paper focuses on the federal estate tax, taxes on inherited wealth are also a traditional and common revenue source for states.)

FIGURE 1

Only 2 Out of Every 1,000 Estates Will Owe Federal Estate Tax in 2015



Source: Joint Committee on Taxation

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[1] Nathaniel Frentz contributed to a previous version of this report.

[2] The American Taxpayer Relief Act of 2013 set the estate tax exemption at $5.25 million for 2013 (effectively $10.5 million for a couple), and indexed that level for inflation in future years. It set the top rate at 40 percent. See Internal Revenue Bulletin 2013-5, *Revenue Procedure 2013-5*, January 2013, http://www.irs.gov/pub/irs-drop/rp-13-15.pdf.

1. Roughly 2 of Every 1,000 Estates Face the Estate Tax

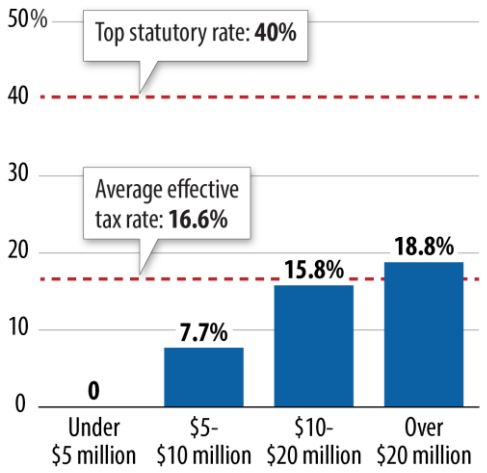
Today, 99.8 percent of estates owe no estate tax at all, according to the Joint Committee on Taxation.[3] Only the estates of the wealthiest 0.2 percent of Americans — roughly 2 out of every 1,000 people who die — owe any estate tax. (See Figure 1.) This is because of the tax's high exemption amount, which has jumped from $650,000 per person in 2001 to $5.43 million per person in 2015.

Thus, the estate tax is best characterized as a tax on very large inheritances by a small group of wealthy heirs; repeal would amount to a massive windfall for those heirs. That's why it is misleading to characterize the tax as the "death tax," as repeal advocates often do. Rather, as other observers such as the columnist E. J. Dionne have said, estate tax repeal could be more appropriately called the "Paris Hilton tax cut."[4]

FIGURE 2

Taxable Estates Owe 16.6 Percent of Their Value in Tax, on Average – Well Below Top Statutory Rate

Average effective estate tax rate in 2013, by size of gross estate



Note: The average effective rate is far below the top statutory rate largely because tax is due only on the part of the estate that exceeds the exemption level.

Source: Tax Policy Center Table T13-0020

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2. Taxable Estates Generally Pay Less Than One-Sixth of Their Value in Tax

Among the few estates nationwide that owed any estate tax in 2013, the effective tax rate — that is, the share of the estate's value paid in taxes — was 16.6 percent, on average, according to the Urban-Brookings Tax Policy Center (TPC).[5] That is far below the top statutory rate of 40 percent. (See Figure 2.) Claims by repeal proponents that the estate tax consumes nearly half of an estate's value are therefore false.

The effective rate is so much lower than the top rate for several reasons. First, estate taxes are due only on the portion of an estate's value that exceeds the exemption level; at the 2015 exemption level of $5.43 million, a $6 million estate would owe estate taxes on $570,000 at most. Second, heirs can often shield a large portion of an estate's remaining value from taxation through generous deductions and other discounts that policymakers have enacted over time.[6] Further, as explained below, estates use large loopholes to avoid considerable amounts of tax.

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[3] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," March 16, 2015, https://www.jct.gov/publications.html?func=startdown&id=4744.

[4] E. J. Dionne Jr., "The Paris Hilton Tax Cut," *Washington Post,* April 12, 2005, http://www.washingtonpost.com/wp-dyn/articles/A45305-2005Apr11.html.

[5] Tax Policy Center Table T13-0020. While the estimates have not been updated after 2013, the average effective estate tax rate should be very similar for 2014 and 2015 because the statutory rate remains the same and the exemption level is indexed to inflation.

[6] See these CBPP reports: Chye-Ching Huang, "Congress Should Not Weaken Estate Tax Beyond 2009 Parameters," March 11, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2356; Aviva Aron-Dine and Joel Friedman, "New Estate Tax Anecdotes Dredge Up Old Myth That the Estate Tax Claims Half of an Estate," June 14, 2006,

3. Large Loopholes Enable Many Estates to Avoid Taxes

Many wealthy estates employ teams of lawyers and accountants to develop and exploit loopholes in the estate tax that allow them to pass on large portions of their estates tax-free. These strategies don't benefit the broader economy; they only allow the wealthiest estates to avoid taxes.

For example, some estates use grantor retained annuity trusts (GRATs) to pass along considerable assets tax-free. The estate owner puts money into a trust designed to repay the estate the initial amount plus interest at a rate set by the Treasury, typically over two years. If the investment — typically stock — rises in value any more than the Treasury rate, the gain goes to an heir tax-free. If the investment doesn't rise in value, the full amount still goes back to the estate. Such techniques have been described as a "heads I win, tails we tie" bet.[7]

The GRAT loophole enables wealthy estates to avoid extraordinary amounts of tax when stock or other assets rise in value quickly, as has happened frequently in recent years. The tax lawyer credited with discovering the loophole estimates that it has allowed wealthy estates to avoid as much as *$100 billion* in estate taxes since 2000, or close to one-third of the amount that the tax raised over the period.[8]

A top estate tax priority for policymakers should be to eliminate loopholes such as these.[9]

4. Only a Handful of Small, Family-Owned Farms and Businesses Owe Any Estate Tax

Only roughly *20* small business and small farm estates nationwide owed any estate tax in 2013, according to TPC.[10] TPC's analysis defined a small-business or small farm estate as one with more than half its value in a farm or business and with the farm or business assets valued at less than $5 million. Furthermore, TPC estimates those roughly 20 estates owed just 4.9 percent of their value in tax, on average.[11]

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Those 20 estates owed just 4.9 percent of their value in tax, on average.

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http://www.cbpp.org/6-14-06tax.htm; Chye-Ching Huang, "Impact of Estate Tax on Small Businesses and Farms Is Minimal," February 23, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2663.

[7] Zachary Mider, "How Wal-Mart's Waltons Maintain Their Billionaire Fortune," Bloomberg, September 12, 2013, http://www.bloomberg.com/news/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes.html.

[8] Estimate by Richard Covey. See Zachary Mider, "Accidental Tax Break Saves Wealthiest Americans $100 Billion," Bloomberg, December 17, 2013, http://www.bloomberg.com/news/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion.html.

[9] For a description of other loopholes and proposals to close them see: the President's fiscal year 2015 budget; S. 2899, introduced by Senator Bernie Sanders (I-VT) on September 18, 2014; and Paul Caron and James Repetti, "Revitalizing the Estate Tax: Five Easy Pieces," Tax Analysts, March 17, 2014.

[10] Tax Policy Center Table T13-0020.

[11] Tax Policy Center estimates.

These findings are consistent with a 2005 Congressional Budget Office (CBO) study finding that of the few farm and family business estates that would owe any estate tax under the rules scheduled for 2009, the overwhelming 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.[12] The current estate tax rules are even more generous.

Furthermore, special estate tax provisions — such as the option to spread payments over a 15-year period and at low interest rates — allow the few taxable estates that would face any liquidity constraints to pay the tax without selling off any farm assets.

5. The Largest Estates Consist Mostly of "Unrealized" Capital Gains That Have Never Been Taxed

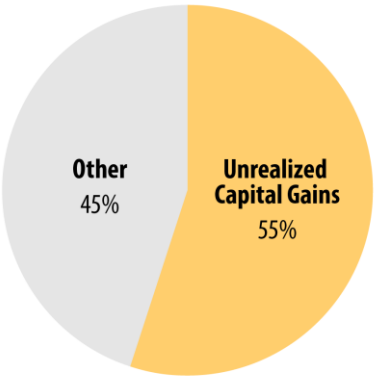
Much of the money that wealthy heirs inherit would never face any taxation were it not for the estate tax. In fact, that's one reason why policymakers created the estate tax in 1916: to serve as a backstop to the income tax, taxing the income of wealthy taxpayers that would otherwise go completely untaxed.

Under the current tax system, capital gains tax is due on the appreciation of assets, such as real estate, stock, or an art collection, only when the owner "realizes" the gain (usually by selling the asset). Therefore, the increase in the value of an asset is never subject to income tax if the owner holds on to the asset until death.[13]

These unrealized capital gains account for a significant proportion of the assets held by estates — ranging from 32 percent for estates worth between $5 million and $10 million to as much as about 55 percent of the value of estates worth more than $100 million. (See Figure 3.)[14]

FIGURE 3

Large Share of Biggest Estates Consists of Unrealized Capital Gains That Have Never Been Taxed



Note: Reflects estates of over $100 million in assets. Estimates assume 2009 estate tax parameters, including exemption of $3.5 million ($7 million per couple) and top rate of 45 percent.

Source: Federal Reserve Board

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[12] Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses*, July 2005, http://www.cbo.gov/publication/16897.

[13] The President's 2016 budget proposes to repeal this favorable treatment, known as "step-up basis," and raise the top tax rate on capital gains to 28 percent. For more on this proposal, see Chuck Marr and Chye-Ching Huang, "President's Capital Gains Tax Proposals Would Make Tax Code More Efficient and Fair," Center on Budget and Policy Priorities, January 18, 2015, http://www.cbpp.org/cms/?fa=view&id=5260.

[14] Robert B. Avery, Daniel Grodzicki, and Kevin B. Moore, "Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death," Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., Finance and Economics Discussion Series, April 2013; and James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains At the Time of Death," NBER, July 2000, p. 19, http://www.nber.org/papers/w7811.

The estate tax also serves as a modest corrective to other tax rules that provide massive tax benefits to income from wealth, such as the fact that capital gains are taxed at lower rates than wages and salaries. The top 0.1 percent of taxpayers — those with incomes above $3.2 million — will receive more than 50 percent of the benefit of the preferential capital gains rates in 2015, worth about $500,000 apiece.[15] Other tax rules allow part of the income of the very wealthiest to go completely untaxed, even with the estate tax.[16]

Since the estate tax serves, in part, to tax capital gains that have not otherwise been taxed, some people have proposed taxing estates at the top capital gains rate, currently 23.8 percent. This argument is flawed: the capital gains tax rates typically apply to nearly all capital gains income, whereas the estate tax applies only to the part of an estate that exceeds the exemption level. The estate tax's *average effective rate* of 16.6 percent in 2013 was below the capital gains rate.)

6. The Estate Tax Is a Significant Revenue Source

The estate tax will generate about $246 billion over 2016-2025 under current law, according to CBO.[17] While this is less than 1 percent of federal revenue over the period, it is significantly more than the federal government will spend on the Food and Drug Administration, the Centers for Disease Control and Prevention, and the Environmental Protection Agency *combined*.

Most budget experts agree that more deficit reduction — on top of the significant measures of recent years — is needed to address our longer-term fiscal problems as the economy strengthens. Even without the loss of estate tax revenues, deficit reduction is difficult. Cuts enacted so far will affect funding for programs ranging from education and medical research to law enforcement and environmental protection, as well as for programs that alleviate hardship and expand opportunity for low- and moderate-income Americans. It would be irresponsible for policymakers to add more than $246 billion to the task of deficit reduction by cutting the taxes of a few wealthy estates while at the same time asking for further sacrifices from less-fortunate Americans.[18]

7. Repeal Would Likely Leave Less Capital for Investment

Claims that eliminating the estate tax would encourage people to save and thereby make more capital available for investment do not take into account the impact on government borrowing. A 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* (private plus public) saving, a critical determinant of the amount of capital available for private investment, is likely positive. "[I]f the only objective [of eliminating the estate tax] were

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[15] Tax Policy Center Table T13-0081.

[16] Chye-Ching Huang and Chuck Marr, "Raising Today's Low Capital Gains Tax Rates Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits," Center on Budget and Policy Priorities, September 19, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3837.

[17] Congressional Budget Office, "Updated Budget Projections: 2015 to 2025," March 9, 2015, https://www.cbo.gov/publication/49973.

[18] The cost of repeal would exceed the $246 billion that the estate tax is expected to raise over the decade because repeal would further encourage taxpayers to hold assets with unrealized capital gains until death to avoid taxation.

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."[19]

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 estate-tax repeal, the added government borrowing would more than outweigh any added private saving, leaving the economy no better off and quite possibly worse off.[20]

8. Compliance Costs Are Modest

The public and private costs associated with estate tax compliance — including IRS costs to administer the tax and taxpayer costs for estate planning and administering an estate when a person dies — equaled about 7 percent of estate tax revenues in 1999.[21] That is within the range of compliance costs for other taxes. For instance, administrative and compliance costs equal about 14.5 percent of the revenue raised by the individual and corporate income taxes and about 2 to 5 percent of the revenue raised by sales taxes.[22] In addition, the number of individuals and estates that bear these costs has fallen markedly as the estate-tax exemption level has risen since 2001.

Exaggerated estimates of estate tax compliance costs often incorrectly include the cost of activities that would be necessary even *without* an estate tax — hiring estate executors and trustees, drafting provisions and documents for the disposition of property, and allocating bequests among family members, for example. These activities account for about half of all costs sometimes associated with estate planning.[23]

9. The United States Taxes Estates More Lightly Than Comparable Countries

Twenty-seven of the 34 members of the Organisation for Economic Co-Operation and Development levied some form of estate tax, inheritance tax, or other wealth or wealth transfer tax in 2012 (the latest year for which full data are available). U.S. estate and gift tax revenues at all levels of government were well below average among these 27 countries as a share of the economy.[24]

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[19] Jane G. Gravelle and Donald J. Marples, "Estate and Gift Taxes: Economic Issues," Congressional Research Service, November 27, 2009.

[20] See Aviva Aron-Dine, "Estate Tax Repeal Would Decrease National Saving," Center on Budget and Policy Priorities, June 8, 2006, http://www.cbpp.org/cms/?fa=view&id=352.

[21] Relative to 1999, estate tax revenues are now lower, but there are also fewer taxable estates, and those that are taxable are also much larger on average due to the higher exemption level. As a result, there is no reason to believe that compliance costs as a share of estate tax revenue are necessarily much higher today.

[22] See Joel Friedman and Ruth Carlitz, "Cost of Estate Tax Compliance Does Not Approach the Total Level of Estate Tax Revenue," Center on Budget and Policy Priorities, June 9, 2006, http://www.cbpp.org/cms/?fa=view&id=389.

[23] See Charles Davenport and Jay A. Soled, "Enlivening the Death-Tax Death-Talk," *Tax Notes,* vol. 84, July 26, 1999; and Richard Schmalbeck, "Avoiding Federal Wealth Transfer Taxes," in William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation,* Brookings Institution, 2001.

[24] Organisation for Economic Co-Operation and Development, "Revenue Statistics – Comparative tables," retrieved January 9, 2015, http://stats.oecd.org/Index.aspx?DataSetCode=REV. Although the United States has a higher top statutory estate tax rate than some other OECD countries, its effective tax rate is lower and the tax reaches relatively few estates. Also, many countries tax accumulated wealth by means of wealth or wealth transfer taxes (such as inheritance taxes) rather than through an estate tax, so international comparisons must take these other taxes into account. Further, some countries levy taxes on a broader tax base than others (that is, they allow fewer exemptions and other special

10. The Estate Tax Is the Most Progressive Part of the U.S. Tax Code

Because it affects only those who are most able to pay, 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.[25] The money it raises helps to fund essential programs, from health care to education to national defense. If the estate tax were further weakened or repealed, other taxpayers 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. Bill Gates, Sr., a prominent advocate of retaining a strong estate tax, has explained that wealthy individuals benefit from the government because it "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."[26]

It is appropriate 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. As President Theodore Roosevelt stated in 1906, "the man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government."

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preferences). For all of these reasons, experts generally agree that the appropriate way to compare taxes across countries is to look at revenues as a share of gross domestic product, not at statutory tax rates.

[25] Jeffrey Rohaly and Katherine Lim, "Wealth Transfer Taxes: Who Pays the Estate Tax?" Tax Policy Center, June 13, 2011, http://www.taxpolicycenter.org/briefing-book/key-elements/estate/who.cfm.

[26] Excerpts from a CBPP conference call, June 1, 2006, http://www.cbpp.org/6-1-06tax-transcript.pdf.