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AN ESTATE TAX WITH A 15 PERCENT TAX RATE DOES NOT REPRESENT A REASONABLE COMPROMISE

By Ruth Carlitz and Joel Friedman

Senate Finance Committee Chairman Charles Grassley recently indicated he believes a viable compromise on the estate tax is within reach. Grassley said on September 7 that he expects a deal that features an estate-tax exemption of between $4 million and $5 million and a top estate tax rate of 15 percent. "I think we can get 60 votes to pass that," he said. "But that's put off now because of Katrina for a few weeks."[1]

Such a proposal, however, would lose more than 80 percent as much revenue as would be lost if the estate tax were repealed. As a result, it does not represent a middle ground that effectively balances the desires of some policymakers for a smaller estate tax with concerns about substantially enlarging mid-term and long-term deficits that already are projected to reach levels dangerous for the economy.

In addition, proposals to sharply cut the top estate tax rate would provide benefits heavily skewed toward the nation's very wealthiest families but provide little or no additional gain for small family businesses and farms. Only a tiny fraction of small businesses and farms face the estate tax at all. Those that do are affected to a vastly greater degree by the level of the estate-tax exemption level than by the top estate tax rate.

At Any Exemption Level, a 15 Percent Estate Tax Rate Would Lead to Huge Revenue Losses

Under current law, by 2009, the first $3.5 million of an estate will be tax-free ($7 million will be tax-free for an estate left by a couple), with the rest of an estate taxed at a 45 percent rate. In 2010, the estate tax will disappear entirely. It is then scheduled to return in 2011, with a $1 million exemption and a top rate of 55 percent.

An estate tax with the parameters slated to be in effect in 2011 is viewed as undesirable by many in Congress. Yet repealing the estate tax would entail massive revenue losses and make long-term deficits worse than they already are projected to be. That, too, is unpalatable to enough members of the Senate to prevent estate-tax repeal from securing the 60 votes it would need for Senate passage.

[1] "Reconciliation Tax Package Hangs in Balance," *Tax Notes*, September 8, 2005.

As a result, a number of compromise proposals have been floated in recent months. In assessing the merits of these proposals, one fact stands out: *any proposal that sets the top rate at 15 percent is not much of a compromise, regardless of where the exemption level is set, because it would lose almost as much revenue as full repeal* (see Table 1).

- An estate tax with a $3.5 million exemption — the level that will be in effect in 2009 — and a 15 percent rate, for example, would lose 78 percent as much revenue as would be lost under full repeal, according to estimates from the Joint Committee on Taxation.

Table 1

Cost of Estate Tax Proposals With A 15 Percent Rate

Exemption level	Cost of proposal as a percentage of the cost of repeal in 2015*
$3.5 million	78%
$4.0 million	81%
$5.0 million	84%
$10.0 million	92%

*Joint Committee on Taxation cost estimates cover the period 2006-2015. While these ten-year estimates may indicate the medium-term fiscal impact of a proposal, the cost in 2015 gives the best sense of its fiscal impact over the long term. JCT estimates that full repeal would cost $72 billion in 2015 relative to current law, when the estate tax is slated to have a $1 million exemption and a top rate of 55 percent.

Source: Joint Committee on Taxation

- The proposal that Senator Grassley outlined, with a $4 million to $5 million exemption and a 15 percent rate, would lose 81 percent to 84 percent as much as repeal, according to Joint Tax Committee estimates. At higher exemption levels, even more revenue would be lost.

- Over the period from fiscal year 2012 through fiscal year 2021 — the first ten-year period in which the proposal would have a full fiscal impact — the proposal outlined by Senator Grassley would increase federal deficits and the national debt by $770 billion to $800 billion. (These figures include the added interest payments on the debt that would result.)

The Wealthiest Estates Benefit the Most from Cutting the Estate Tax Rate to 15 Percent

The wealthiest estates will pay most of the estate tax, regardless of where the exemption level is set. As a result, a substantial reduction in the estate tax *rate* amounts to an extremely large tax cut for the nation's wealthiest individuals and their heirs, at a hefty cost to the federal government and other, less privileged taxpayers.

Simply stated, a reduction in the estate tax rate provides a tax-cut benefit that is directly proportional to the amount of tax that an estate would otherwise owe. If the rate is sharply reduced, the biggest estates will receive massive tax cuts.

To illustrate this point, consider a very large estate that, with a 45 percent estate tax rate, has a tax liability of $30 million.[2] If the tax rate is reduced from 45 percent to 15 percent, the estate's tax

[2] The estate tax liability represents the portion of the estate that is owed in taxes. This example assumes that the taxable portion of the estate is $66.7 million ($30 million is 45 percent of $66.7 million). Given the availability of numerous deductions and exemptions, the taxable portion of an estate is usually much smaller than the total value of the estate. So, even at a top rate of 45 percent, an estate tax liability of $30 million would represent substantially less than 45 percent of the entire estate. For instance, the Tax Policy Center estimates that estates facing an estate tax with a $3.5 million exemption and a 45 percent top rate would pay on average about 17 percent of their total estates in estate taxes.

liability will fall by two-thirds, from $30 million to $10 million, giving the estate a tax cut of $20 million. By contrast, suppose that instead of the tax rate being lowered, the estate-tax exemption is raised substantially, such as by $10 million (above what it otherwise would be). In this case, the very large estate in our example would see its tax liability reduced from $30 million to $25.5 million, for a tax cut of $4.5 million.[3]

This example helps to demonstrate why proposals that rely on a 15 percent estate tax rate are almost as costly as outright repeal of the estate tax. The huge estate in this example would receive more than four times as big a tax cut under a reduction in the estate-tax rate to 15 percent as under an increase of $10 million in the exemption level. Proposals with a 15 percent rate entail massive tax cuts for the largest estates — and entail massive revenue losses as a result.

That the wealthiest estates and their heirs benefit the most from sharp rate reductions is also shown in estimates prepared by the Urban Institute-Brookings Institution Tax Policy Center. Table 2 compares a 45 percent rate to a 15 percent rate (assuming a $3.5 million exemption level). The Tax Policy Center's estimates show that at a $3.5 million exemption level, only 8,450 estates in the entire country would be subject to *any* estate tax in 2011. (These are estates with an average value of $12 million each.) Thus an exemption of $3.5 million would relieve all but the largest three of every 1,000 estates from paying any estate tax whatsoever.

Table 2

Distribution of Tax Cuts When the Exemption is $3.5 Million and the Tax Rate is Lowered from 45 Percent to 15 Percent
(distribution in 2011)

Size of Estate	Number of taxable estates	Percentage of tax-cut benefits	Average tax-cut benefits
Less than $3.5 million	0	0%	n/a
$3.5 million - $5.0 million	2,060	2%	$130,000
$5.0 million - $10 million	4,030	23%	$678,000
$10 million - $20 million	1,660	23%	$1.6 million
Above $20 million	700	52%	$9.0 million
Total	**8,450**	**100%**	**$1.4 million**

Source: Urban-Brookings Tax Policy Center

Among the small number of estates that would be subject to the estate tax with a $3.5 million exemption, the Tax Policy Center data show that a majority of the benefit from cutting the estate-tax rate from 45 percent to 15 percent would flow to the *700 largest estates* nationwide. These estates are worth *more than $20 million each* and have an average value of $56 million. These huge estates would get an average tax cut of about *$9 million apiece* from lowering the estate tax rate from 45 percent to 15 percent.

Finally, it bears noting that extremely few small businesses and family farms are subject to the estate tax. A recent Congressional Budget Office report found that if a $3.5 million exemption had

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For estates worth over $20 million, Tax Policy Center estimates that their tax liability would average less than one-quarter of their value.

[3] Increasing the exemption amount by $10 million allows a large estate to shield $10 million more from the estate tax. Under this example, that $10 million would otherwise have been taxed at a 45 percent rate. Hence, the tax cut that would be provided by raising the exemption amount by $10 million is calculated by taking 45 percent of $10 million.

been applied in 2000, only *65* farm estates in the nation would have owed any estate tax.[4] The number of small family business estates that would have owed any tax would have been similarly low. In addition to being very costly, a large cut in the estate tax rate would primarily benefit a very small number of extremely large estates, while having almost no effect on small family businesses and farms.

[4] Matt Fiedler and Joel Friedman, "CBO Finds Tiny Number of Farms Face Estate Tax," Center on Budget and Policy Priorities, July 11, 2005