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ESTATE TAX REPEAL: A COSTLY WINDFALL FOR THE WEALTHIEST AMERICANS

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Summary

A key component of President Bush's tax package would repeal the federal estate, gift, and generation-skipping transfer tax by 2009. Repealing the estate tax is costly, reducing revenues for both the federal government and states, and would provide a massive windfall for some of the country's wealthiest families.

- In 1997, the estates of fewer than 43,000 people — fewer than 1.9 percent of the 2.3 million people who died that year — had to pay any estate tax. The Joint Committee on Taxation projects that the percentage of people who die whose estates will be subject to estate tax will remain at about two percent for the foreseeable future. In other words, *98 of every 100 people who die face no estate tax whatsoever.*

- To be subject to tax, the size of an estate must exceed $675,000 in 2001. The estate tax exemption is rising to $1 million by 2006. Note that an estate of *any* size may be bequeathed to a spouse free of estate tax.

- Each member of a married couple is entitled to the basic $675,000 exemption. Thus, a couple can effectively exempt $1.35 million from the estate tax in 2001, rising to $2 million by 2006.

- The vast bulk of estate taxes are paid on very large estates. In 1997, some 2,400 estates — the largest five percent of estates that were of sufficient size to be taxable — paid nearly *half* of all estate taxes. These were estates with assets exceeding $5 million. This means about half of the estate tax was paid by the estates of the wealthiest one of every 1,000 people who died.

- If the estate tax had been repealed, each of these 2,400 estates with assets exceeding $5 million would have received a tax-cut windfall in 1997 that averaged about $3.5 million.

As these statistics make clear, the estates of a tiny fraction of the people who die each year — those with very large amounts of wealth — pay the bulk of all estate taxes.

Moreover, a recent Treasury Department study shows that almost no estate tax is paid by middle-income people. Most of the estate taxes are paid on the estates of people who, in addition

to having very substantial wealth, still had high incomes around the time they died. The study found that 91 percent of all estate taxes are paid by the estates of people whose annual incomes exceeded $190,000 around the time of their death. Less than one percent of estate taxes are paid by the lowest-income 80 percent of the population, those with incomes below $100,000.

Small Businesses and Family Farms

Very few people leave a taxable estate that includes a family business or farm. Only six of every 10,000 people who die leave a taxable estate in which a family business or farm forms the majority of the estate.

Nevertheless, 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. In reality, only a small fraction of the estate tax is paid on small family businesses and farms. Current estate tax law already includes sizable special tax breaks for family businesses and farms.

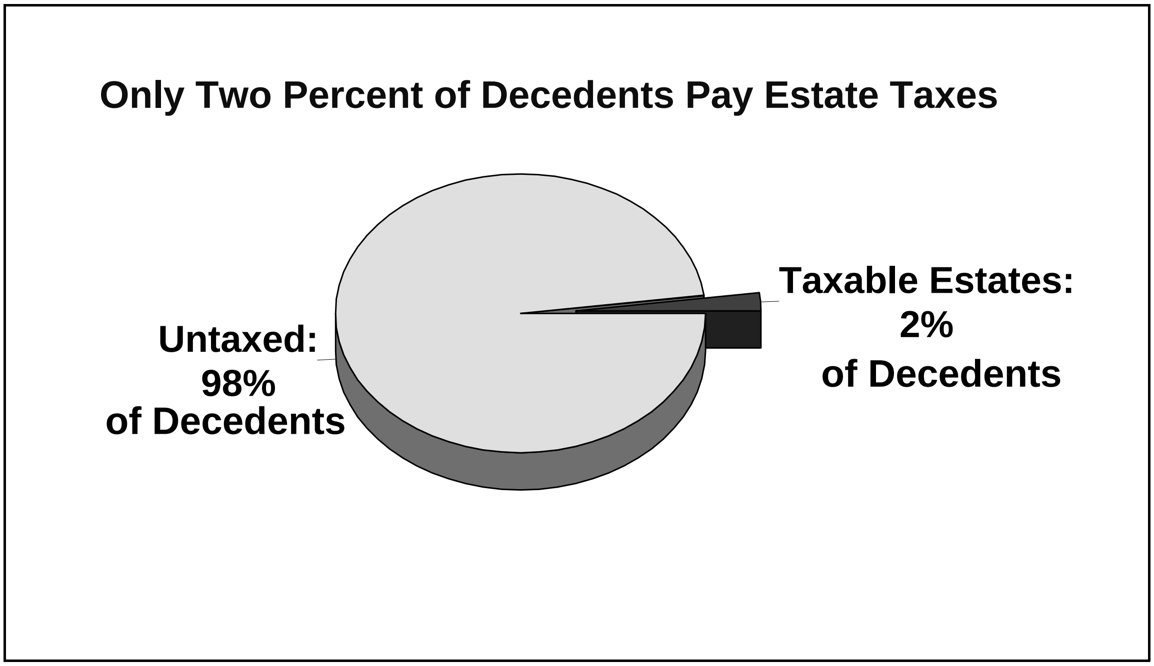
To the extent that problems may remain in the taxation of small family-owned businesses and farms under the estate tax, those problems could be specifically identified and addressed at a modest cost to Treasury. Wholesale repeal of the estate tax is not needed for this purpose.

- Farms and family-owned business assets account for *less than four percent* of all assets in taxable estates valued at less than $5 million. Only a small fraction of the estate tax is paid on the value of farms and small family businesses.

- Family-owned businesses and farms are eligible for special treatment under current law, including a higher exemption. The total exemption for most estates that include a family-owned business is $1.3 million in 2001, rather than $675,000. A couple can exempt up to $2.6 million of an estate that includes a family-owned business or farm.

- Still another feature of current law allows deferral of estate tax payments for up to 14 years when the value of a family-owned business or farm accounts for at least 35 percent of an estate, with interest charged at rates substantially below market rates.

- Claims that family-owned businesses have to be liquidated to pay estate taxes imply that most of the value of the estate is tied up in the businesses. But businesses or farms constitute the majority of the assets in very few estates that include family-owned businesses or farms. A Treasury Department analysis of data for 1998 shows that in only 776 of the 47,482 estates that were taxable that year — or just 1.6 percent of taxable estates — did family-owned businesses assets (such as closely held stock, non-corporate businesses, or partnerships) equal at least half of the gross estate. In only 642 estates — 1.4 percent of the taxable



estates — did farm assets, or farm assets and farm real estate, equal at least half of the gross estate.

- Furthermore, the law can easily be changed to exempt from the estate tax a substantially larger amount of assets, including those related to family-owned farms or businesses, and this can be done without repealing or making other sweeping changes in the estate tax. When the Senate considered the estate tax last year, the Democrats offered a substitute that would have raised the exemption for a family-owned business to $8 million for a couple, effectively exempting almost all family-owned farms and three-quarters of family-owned businesses from the estate tax.

Effective Estate Tax Rates Much Lower than Marginal Rates

The estate tax is levied at graduated rates depending on the size of the estate; the highest tax rate is 55 percent. This sometimes leads people to conclude that when someone dies, half of their estate will go to the government.

It normally is not the case, however, that half of an estate is taxed away. Effective tax rates for estates of all sizes are much lower than the marginal tax rate of 55 percent. On average

The Estate Tax is Not "Double Taxation"

Proponents of estate tax repeal claim the estate tax is unfair because the assets in an estate already have been taxed once as income under the income tax. Therefore, they argue, the value of the estate should not be taxed again. The premise on which this claim is based, however, is not accurate. A significant portion of the value of all estates — and a majority of the value of the largest estates — have *never* been subject to taxation as income. In our overall tax system, the estate tax completes the income tax; it taxes income that otherwise would avoid taxation entirely.

Without the estate tax, capital gains included in an estate would never be taxed. Under current law, the gain from appreciation of an asset is subject to the income tax only when the asset is sold. Upon the sale of an asset, the difference between the purchase price and the sale price is taxed as a capital gain. If a person holds on to an asset until he or she dies, however, the heirs inherit the asset at its value at the time of the decedent's death. The gain on the asset from the time of purchase to the time of death is never taxed under the income tax.

Some of the capital gains income that escapes taxation under the income tax may be taxed under the estate tax. The appreciated value of the asset is included in the estate and, if the estate is large enough, subject to taxation.

A substantial proportion of assets subject to the estate tax appear to be untaxed capital gains. Estimates recently made by economists James Poterba and Scott Weisbenner, based on data from the Survey of Consumer Finances, suggest that unrealized capital gains make up about 37 percent of the value of estates worth more than $1 million and about *56 percent of estates worth more than $10 million*.

for all taxable estates in 1997, estate taxes represented 17 percent of the gross value of the estate. A combination of permitted exemptions, deductions, and credits, together with estate planning strategies, reduced the effective tax rate to less than one-third of the 55 percent top marginal tax rate.

Repeal of the Estate Tax Carries a High Cost

Repealing the estate tax would be very costly. The estate tax repeal proposed by President Bush would cost $294 billion over the 10 years, 2002 through 2011.[1] But this proposal phases in slowly. The estate tax is only fully repealed in calendar year 2009, and the full revenue effects would not be felt for at least another two years because of the time it takes to settle an

[1]The Joint Committee on Taxation estimated the cost the Bush estate tax repeal to be $236 billion, but this only covered the 9-year period from 2002 - 2010. The Center projected the 2011 cost by increasing the JCT estimate for 2010 ($55.3 billion) by the rate of growth in the economy.

estate and pay any taxes. Once the repeal is fully in effect, it would cost over $60 billion a year. Thus the cost of the proposal in the second 10 years — from 2012 to 2021 — would likely be about *three-quarters of a trillion dollars*, more than twice as expensive as in the first 10 years.

The very high cost of repeal would be felt fully in the second decade of this century. That is the period when the baby boomers begin to retire in large numbers, substantially increasing the costs of programs such as Social Security, Medicare, and Medicaid. Repealing the estate tax would subsequently reduce the funds available to help meet these costs and to facilitate reforms of Social Security and Medicare that would extend the solvency of those programs, as well as to meet other priority needs such as improving educational opportunities, expanding health insurance coverage, and reducing child poverty. It also would leave fewer funds for tax cuts targeted on average working families.

Repeal of the Federal Estate Tax Would Cost State Governments Billions in Revenue

State governments also receive revenue through the federal estate tax. Under the current provisions of the federal estate tax, estate taxes levied by states generally do not impose any additional burden on estates; taxpayers receive a dollar credit for state estate taxes (up to a specified maximum) on their federal estate tax return. In other words, states effectively receive a portion of the federal estate tax. In a substantial majority of states, the repeal of the federal tax would result in a complete, automatic repeal of the state estate tax as well.

- Currently, every state has a tax on estates equal to at least the value of the credit that can be taken against federal liability. Some 35 states would face the total loss of their estate tax revenue as a result of the federal repeal; most others would experience a partial loss of revenue.

- The amount of revenue lost to states would be substantial. Information gathered from state budgets and state revenue officials suggests that states together would have lost approximately $5.5 billion in revenue in fiscal year 2000 if estate tax repeal had already been in effect. By 2010, when the estate tax repeal would be fully effective under the proposed legislation, the state revenue loss would approach $9 billion.

Most Estate Taxes Are Paid by Large Estates

Most estate taxes are paid by large estates rather than by small family-owned farms and businesses. As noted above, the first $675,000 of an estate is exempt from taxation in 2001, with the exemption scheduled to rise to $1 million by 2006. In addition, an unlimited amount of property can be bequeathed to a spouse free of estate tax.

Moreover, each member of a married couple is entitled to the basic $675,000 exemption. A number of simple estate planning devices are available under the law, the net effect of which is to double the amount a couple can exempt from estate taxation. Thus, a couple can effectively exempt $1.35 million from estate tax in 2000, rising to $2 million by 2006.

As a result of these exemptions and other provisions, such as unlimited deductions for charitable giving, only about two percent of all deaths result in estate tax liability. Of the 2.3 million people who died in 1997, for example, fewer than 43,000 had to pay any estate tax.[2]

Of those estates that are taxable, the largest pay most of the estate tax. An analysis by IRS of the 42,901 taxable estates filing in 1997 showed that the 5.4 percent of taxable estates with gross value exceeding $5 million paid 49 percent of total estate taxes. In other words, about half the estate tax was paid by the estates of just 2,400 people — about one out of every 1,000 people who died. The 15 percent of taxable estates with gross value exceeding $2.5 million paid nearly 70 percent of total estate taxes.[3]

The average estate tax payment for the 2,400 taxable estates with assets exceeding $5 million in 1997 was about $3.5 million. If the estate tax had been fully repealed for 1997 filers, the 2,400 wealthiest people who died thus would have received a tax-cut windfall averaging about $3.5 million each. A few hundred of the very wealthiest people who left estates exceeding $20 million would have received a tax-cut windfall of more than $10 million each.

Estate Tax Payers Also are High-Income

A recent analysis by the Treasury Department looks at the annual *income* of decedents who pay estate taxes. The Treasury analysis finds that virtually all estate taxes — 99 percent — are paid on the estates of people who were in the highest 20 percent of the income distribution at the time of their death. Some 91 percent of all estate taxes are paid on the estates of individuals who had annual incomes of more than $190,000 around the time of their death.[4]

Effective Tax Rate on Estates Is Far Lower than Marginal Rates

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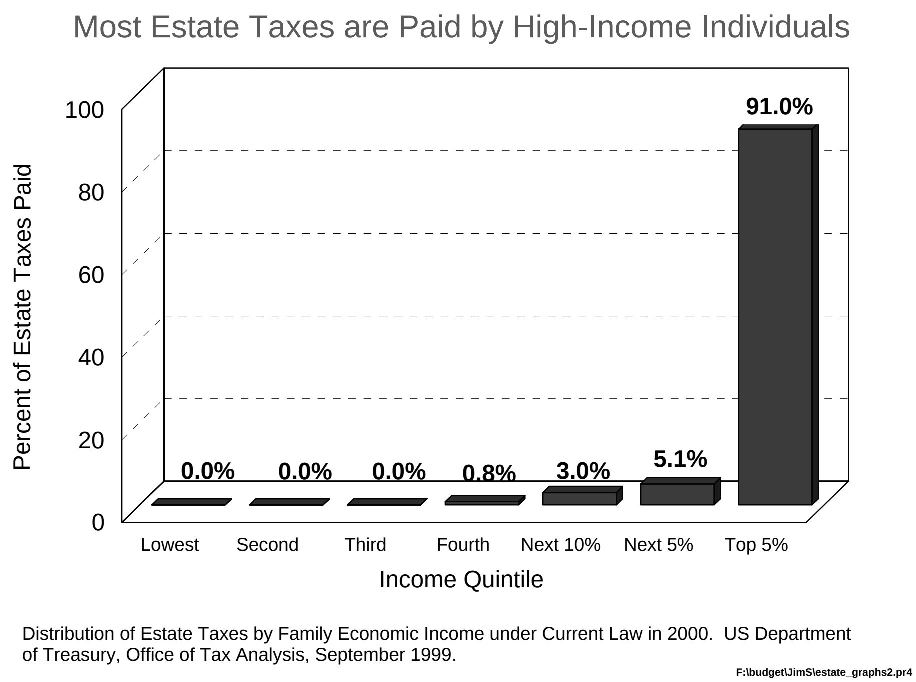
[2] Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes* (JCX-29-99), June 15, 1999. As noted in the JCT report, the number of taxable estates filing tax estate tax returns in 1997 is compared to the number of decedents in 1997. In fact, tax returns are not necessarily filed in the year of death.

[3] Internal Revenue Service, *SOI Bulletin,* Summer 1999.

[4] Julie-Anne Cronin, *U.S. Treasury Distributional Analysis Methodology*, OTA Paper 85, September 1999. For most decedents, this income is measured after retirement, when income may be lower than earlier in life.



Distribution of Estate Taxes by Family Economic Income under Current Law in 2000. US Department of Treasury, Office of Tax Analysis, September 1999.

It often is claimed that estate tax rates are too high and that the government should not be taking as much as half of a person's lifetime savings when he or she dies. The assertion that the government takes half of a person's estate stems from the fact that the estate tax is levied at graduated rates, with the highest marginal rate of 55 percent applying to estates with a value exceeding $3 million.[5]

Data on estate taxes actually paid, however, show that estate taxes represent one-sixth the value of the average estate, not one-half. As shown in Table 1, estate taxes paid equaled 17 percent of the gross value of taxable estates for which estate tax returns were filed in 1997. The smallest and the largest estates had the lowest effective tax rates.[6] In estates valued between $2.5 million and $20 million, the effective tax rate was approximately one-quarter of the amount of the gross estate.

Small Businesses and Farms Make up Only a Small Fraction of Taxable Estates

[5]For estates valued between $10 million and approximately $17 million there is a surcharge that phases out the value of the lower marginal rates, which brings the marginal tax rate to 60 percent for estates in that value range. Estates valued at more than approximately $17 million are taxed at a flat rate of 55 percent.

[6]The fact that the largest estates have an *effective* tax rate below all size estates except the smallest may suggest that the largest estates make greater use of estate tax planning and estate tax avoidance techniques. This suggests that efforts should be explored to curb tax avoidance by large estates and use the additional revenues to lower estate tax rates for all estates.

Table 1

Estate Tax Returns Filed in 1997

Size of Estate	Number of Taxable Estates	Total Value of Estates by Category (in millions of dollars)	Estate Tax After Credits (in millions of dollars)	Effective Tax Rate
$600,000 - $1 million	19,006	$15,315	$835	5.45%
$1 million - $2.5 million	17,606	26,066	4,294	16.47%
$2.5 million - $5 million	3,954	13,567	3,409	25.13%
$5 million - $10 million	1,414	9,954	2,669	26.81%
$10 million - $20 million	592	8,097	1,966	24.28%
$20 million or more	329	24,649	3,465	14.06%
Total	42,901	97,650	16,637	17.04%

Source: Internal Revenue Service, *SOI Bulletin*, Summer 1999.

Note: The table shows, for example, that the 19,006 taxable states with assets between $600,000 and $1 million had a total value of $15.3 billion. These 19,006 estates paid a total of $835 million in estate taxes. The effective tax rate on these estates — the taxes paid as a percentage of the value of the estates — was 5.45 percent.

IRS data show that farms and small, family-owned businesses make up only a small proportion of taxable estates. Farm property, regardless of size, accounted for *about one-quarter of one percent* of all assets included in taxable estates in 1997. Family-owned business assets, such as closely-held stocks, limited partnerships, and non-corporate businesses, accounted for *less than four percent* of the value of all taxable estates of less than $5 million. (Farm and family-owned business assets together accounted for about 10 percent of all assets in all estates and less than four percent of the value of taxable estates of less than $5 million.)

Of particular significance is a Treasury Department tabulation of 1998 data. It shows that in only 776 out of the 47,482 taxable estates that year did family-owned business assets (closely held stock, non-corporate businesses, or partnerships) equal at least half of the gross estate. Similarly, in only 642 out of these 47,482 taxable estates did farm assets or farm assets and farm real estate equal at least half the gross estate. Thus, family-owned businesses or farms form the majority of the estate in just 1,418 estates of the approximately 2.3 million people who died that year — or six out of every 10,000 people who died.

Most farms have relatively modest value. The Agriculture Department estimates that in 1998, fewer than six percent of all farms had a net worth in excess of $1.3 million, the amount of an estate that is completely exempt if the estate includes a family-owned farm. Only 1.5 percent of farms have net worth over $3 million.[7]

Smaller, Family-Owned Business Already Eligible for Favorable Treatment

Family-owned businesses and farms already are eligible for special treatment under current law.

- Under current law, family-owned businesses and farms may be valued in a special way that reflects the current use to which that property is put, rather than its market value. This provision generally reduces the value that is counted for purposes of estate tax; the reduction in value can be as much as $800,000 in 2001. This amount is indexed annually for inflation.

  To use the special valuation, the decedent or other family members must have participated in the business for a number of years before the decedent's death, and family members must continue to operate the business or farm for the following 10 years. This assures that the benefit of this special valuation goes to relatively smaller businesses and farms that are family owned and operated.

- The amount of an estate that is exempt from taxation is higher for family-owned businesses and farms than for other types of estates. Instead of the $675,000 exemption (which rises to $1 million in 2006), the 1997 tax law increased the total exemption for most estates that include family-owned businesses to $1.3 million.

- In addition, when the value of a family-owned business or farm accounts for at least 35 percent of an estate, current law allows deferral of taxation. The tax payable on such an estate may be stretched over up to 14 years, including deferral of annual interest payments for five years, followed by up to 10 annual installments of principal and interest.[8]

  If payments are deferred and paid over time in installments, a below-market interest rate of just two percent applies to the tax attributable to the first $1,060,000 in value of a closely held (family) farm or business. There also is a

[7]Tabulations from the Agriculture Department, Economic Research Service, from Agricultural Resources and Management Study annual survey data.

[8]The executor of an estate can elect to defer paying the estate tax liability for five years and then pay the deferred taxes in 10 installments. The first installment and the last year of the deferral period coincide, meaning that the maximum extension is 14 years.

Is it Difficult to Qualify as a "Family-owned" Business?

Proponents of estate tax repeal often claim that increasing the exemption for family-owned businesses is not a sufficient remedy, because the law makes it too hard to qualify for treatment as a family-owned business. In fact, the definition of a family-owned business is very expansive so 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 easily qualifies for treatment as a family-owned business under current estate tax law. Otherwise, there are two key factors that determine whether the business or farm qualifies as a family-owned business.

The first factor is the relationship of the person who died to others who own a share in the business or help run it. For purposes of the estate tax, the term "family" is quite broad; it includes, for example, grandchildren and great-grandchildren and their spouses as well as nieces and nephews and their spouses.

The second consideration is whether the family actually owns and operates the business.

- The family must own at least 50 percent of the business. However, if more than one family owns the business, the family of the person who died may own as little as 30 percent of the business.*
- Either the person who died or any family member (as family member is broadly defined) must have owned and materially participated in the business for at least five of the previous eight years. In general, material participation means working at the business and taking part in management decisions.
- Businesses that manufacture or sell a product, provide a service, or engage in farming qualify for the special treatment. A business that is solely a holding company for managing other investments would not qualify.
- The company cannot 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.

The heirs also must continue to operate the business for a period of time. In the decade after the person's death, each qualified heir *or* a member of his or her family must materially participate in the business for at least five of any eight consecutive years. If three siblings inherit a business, for example, the test would be met if any one of them participated. It also would be met if one sibling's daughter were the only participant.

*If two different families own shares in the business, their combined holding must be 70 percent or more. If three families hold shares in the business, their combined holding must be at least 90 percent, and the family of the person who died must own at least 30 percent of the business.

preferential rate on the tax attributed to the remaining value of the family farm or business.

- As described below, there are a number of ways to give additional relief to family farms and small businesses other than simply repealing the entire estate and gift tax laws.

Repealing the Estate Tax Carries a High Cost

The Joint Committee on Taxation estimates that President Bush's proposal to repeal the estate and gift tax would cost $236 billion over the 9-year period 2002 - 2010, with a cost of $55 billion in 2010 alone. Extending these estimates to 2011, in order to be consistent with the 10-year budget window under discussion, would add another approximately $58 billion to the total, yielding a 10-year cost of $294 billion.

Full repeal of the estate tax would be effective for people who die in calendar year 2009 and years after that. The full revenue effect from repealing the estate tax would not be felt until two to three years later, because estate taxes are rarely paid in the year of death; it takes two to three years to settle an estate and file the estate-tax return. As a result, the cost of repealing the estate tax will not be fully felt until after the 10-year period covered by the revenue estimate for the bill. It is likely that the cost of repealing the estate tax, when fully phased in and effective, would be a revenue loss of three-quarters of a trillion dollars over the 10-year period from 2012 through 2021.

Repeal of the estate and gift tax law opens opportunities for as high-income taxpayers to structure their finances in a way to shelter more income from taxation. This could result in even higher revenue losses than reflected in current estimates (see box).

Substituting Carry-Over Basis Does Not Solve the Problem

Some have recognized that large amounts of wealth that would escape taxation if the estate and gift taxes were repealed, and have suggested a solution that involves changing the way capital gains are taxed. The proposed change — which was included in bills last year but which apparently is not included in the Bush plan — would require that for purposes of capital gains tax, heirs of estates would value assets at the original purchase price of the asset. In other words, the original "basis" would "carry over" to the new owner. If the heirs of such estates later sold the assets, capital gains taxes would be due on the difference between the sale price and the original price the individual who died paid for the asset. Changing to a "carry-over" basis seems like it could be a partial substitute for the estate tax, particularly with respect to previously untaxed income. In reality, a number of problems and issues would prevent carry-over basis from working in this manner.

Repeal of Estate and Gift Taxes Creates Giant Loophole for the Wealthy

President Bush's proposed repeal of the estate tax also includes repealing the gift tax and the generation-skipping transfer tax. Eliminating these three taxes will create an enormous loophole in the income tax law, allowing wealthy individuals to give "gifts" to trusted relatives or friends that are designed purely to avoid paying taxes. This could drive up the cost of estate tax repeal beyond the current estimate of revenue loss.

The estate, gift, and generation-skipping taxes together help protect the integrity of the income tax code. As a stand-alone tax, any one of the three taxes could easily be defeated by changing the timing of a transfer. For instance, without the gift tax, individuals could avoid estate taxes simply by making gifts during their lifetime. Similarly, a gift tax without an estate tax would favor using one's estate as the vehicle for transferring wealth.

In a recent article in the journal *Tax Notes*, estate tax attorney Jonathan Blattmachr and Hofstra University law professor Mitchell Gans highlight the type of tax-avoidance schemes that would materialize if the estate and gift taxes were repealed. They state that "without the gift tax, high-bracket taxpayers would be well advised to transfer their investments to relatives and trusted friends in a lower income tax bracket." For instance, if a parent owned a stock that appreciated in value by $100 million, that person would face a capital gains tax of $20 million when the stock is sold. But with the gift tax repealed, the parent could transfer the stock to a child who has a lower income. At lower incomes, the capital gains tax rate is only 10 percent. Paying this rate rather than 20 percent would cut the tax bill in half.

Blattmachr and Gans also present other "planning opportunities," through which taxpayers could transfer portfolio assets to trusted friends or relatives that live overseas to take advantage of their favorable tax treatment. For instance, foreigners do not pay capital gains tax on the sale of U.S. stocks. Blattmachr and Gans observe that repeal of the gift tax would also make it easier for taxpayers to create trusts as a way to reduce or eliminate income tax.

In a *New York Times* article, David Cay Johnston interviewed other estate tax attorneys who generally concurred that repeal of the estate and gift tax would spawn new tax-avoidance strategies. Johnston reported, for instance, that capital gains tax could be avoided through such means as the following:

- A wealthy investor could transfer stock that has appreciated in value by $100 million to an elderly relative, such as an uncle who is expected to live at least another year. The uncle would simply hold the stock. After the uncle passed away, the stock would be returned to his niece or nephew as directed in his will. The niece or nephew would inherit the stock at its new (higher) value — the so-called "stepped up" basis — and no capital gains tax would be owed on the $100 million appreciation in value.

- Alternatively, a wealthy investor could transfer stock that has risen in value to a friend who reports a negative income and thus owes no taxes. In 1998, there were 995,000 tax filers who together reported negative income of $53 billion. These tax filers can be wealthy real estate developers or landlords, for instance, who are able to use deductions such as depreciation on their buildings to offset their incomes. After receiving the "gift," the friend would sell the stock, paying no capital gains tax, and return the proceeds to the original owner ("presumably keeping a part of the proceeds for his trouble").

The carry-over basis provision included in the bills last year contained large exemptions that would have allowed a couple to avoid capital gains taxes on up to $5.6 million in inherited assets. Some large level of exemption is inevitable in any carry-over provision that substitutes for an estate tax, since the intention would be, at a minimum, to protect inheritances that are too small to have been subject to the estate tax.

There are major difficulties inherent in administering a carry-over basis provision, which are well known. These include ways to attribute the general exemption to the specific assets that are inherited by different heirs and the need to trace original purchase prices of assets through at least two and perhaps several generations. A carry-over basis provision was enacted a little over 20 years ago, but it was repealed before it took effect. According to a Congressional Research Service report, the primary rationale for repeal was the concern that the carryover basis resulted in great administrative burdens for estates, heirs, and the Treasury Department.

Even if the carry-over basis provision ultimately were implemented, it would replace only a fraction of the revenue lost as a result of estate tax repeal. A Congressional Budget Office analysis of a carry-over basis proposal that does *not* include the type of large exemptions included in last year's bills finds this proposal would replace only 12 percent of estate tax revenues.

Estate Tax Relief for Family Farms and Small Businesses Can Have Modest Costs

There are a number of ways the estate tax burden could be substantially relieved without repealing or making fundamental changes in the rest of the estate tax. A proposal that Rep. Charles Rangel, ranking minority member of the Ways and Means Committee, offered during debate in the House last year is one such alternative.

- A provision in the Rangel proposal would raise the exclusion for family-owned farms and small businesses from $1.3 million to $2 million. It also would allow the transfer of any unused portion of the exclusion between spouses. As a result, a married couple with a farm or small business interest would receive a $4 million exclusion. (Under current law, a couple can receive a $2.6 million exclusion for a farm or small business interest if they engage in some estate tax planning. The Rangel provision would have provided the $4 million exclusion *without* the need for estate tax planning.)

- In addition to this substantial additional tax relief for family owned farms, the proposal would reduce estate tax rates across the board by about 20 percent, bringing the top rate down from 55 percent to 44 percent. In total, the Rangel proposal would cost about $7 billion a year when fully in effect, a large amount but a modest fraction of the cost of full repeal.

Another example is the proposal the Senate Democrats offered during Senate debate on the estate tax last year.

- That proposal would raise the exemption to $2 million for individuals and $4 million for couples. The current exemption is $1.35 million per couple, which is scheduled to rise to $2 million by 2006, so the proposal would effectively double these exemption levels. The Treasury Department estimated this change would relieve from estate tax about two-thirds of estates that are currently subject to the tax.

- This proposal would have provided additional estate-tax relief to family-owned businesses, raising the exemption to $4 million for individuals and $8 million for couples. Compared to a current law maximum of $1.3 million for individuals and $2.6 million for couples, the substitute would have more than tripled the exemption. According to Treasury Department estimates, the proposal would exempt almost all family-owned farms and three-quarters of family-owned businesses from estate taxes.

- This type of substantial estate-tax relief would have cost only about $20 billion a year when fully effective, or about one-third the cost of President Bush's proposed repeal of the estate and gift tax.

States Share in the Federal Estate Tax

Under the current provisions of the federal estate tax, taxpayers receive a dollar-for-dollar credit against their federal estate tax liability for state estate and inheritance tax payments, up to a maximum amount. These state estate taxes, commonly referred to as "pick-up" taxes, impose no additional burden on taxpayers. The pick-up taxes provide revenue to the state without increasing the estate tax payment the heirs must make beyond that which they would otherwise make under the federal estate tax. Because the state estate taxes generally are enacted in ways that specifically tie them to the provisions of the federal credit, they would be repealed automatically if the federal estate tax is repealed. This would result in large revenue losses for states.

In 35 of the 50 states, the state estate tax equals the maximum amount of the state credit against the federal estate tax, with there being *no other* state estate or inheritance tax. Some 15 states also have their own inheritance or estate taxes, a portion of which qualifies as a pick-up tax. In these 15 states, the state law specifies that if the amount of the state tax is less than the credit allowed against federal taxes, the state tax is increased to the amount of the credit.

The repeal of the federal estate tax would negate a compromise reached between the federal government and the states many years ago when the federal estate tax was first enacted. The federal estate tax was established in the early 1900s. Until that time, the taxation of estates

Repealing the Estate Tax Would Reduce Charitable Bequests

As part of his faith-based initiative, President Bush has been promoting charitable giving. For instance, he proposes to extend the deduction for charitable donations, currently available only to taypayers who itemize deductions, to taxpayers who do not itemize – typically moderate-income families. President Bush's proposal to eliminate the estate and gift tax, however, would remove an enormous tax incentive for the wealthy to make charitable gifts.

Current estate tax law includes an unlimited charitable deduction; no estate tax is due on funds bequeathed to charities. For the largest estates that are subject to the 55 percent marginal estate tax rate, each additional $1,000 given to charity reduces estate taxes by $550. In 1997, more than 15,500 estates took advantage of this provision, making — and deducting — donations worth more than $14 billion. (This includes the charitable deductions taken by all estates required to file estate tax returns in 1997, some of which were taxable and some of which had sufficient total deductions and credits to eliminate estate tax liability.)

The charitable deduction is most heavily used by the largest estates. In 1997, charitable deductions equaled 30 percent of the total gross assets of taxable estates valued over $20 million, as compared to about three percent of the assets of smaller estates. Over half of the taxable estates of more than $20 million took a deduction for charitable bequests in 1997; these estates gave a total of $7.5 billion to charity, averaging more than $41 million in donations per estate. This is one of the reasons that estates valued at $20 million or more have lower effective estate tax rates than estates valued between $1 million and $20 million. (See Table 1.)

The research on the effect of the estate tax on charitable giving has consistently shown that levying estate taxes increases the amount of charitable bequests. A recent study by Treasury Department economist David Joulfaian analyzed the tax returns of people who died in 1992.[*] Joulfaian found that eliminating the estate tax would reduce charitable bequests by about 12 percent overall. Had there been no estate tax in 1997, charities thus would likely have received about $1.7 billion less in bequests than they did.

The actual loss to charity is likely to be greater than is implied by looking solely at bequests, however, because some people with significant estates make charitable contributions while they still are alive with the intention of reducing both their income taxes *and* the amount of their assets on which the estate tax will be levied. If a person gives to charity through the popular device known as a charitable remainder trust, for example, the assets do not show up in the estate tax statistics. Under a charitable remainder trust, the person transfers assets to the trust. The trust provides the person a stream of income for the remainder of his or her life, and whatever remains in the trust at the end of the person's life goes to a charity. The person gets an immediate income tax deduction for the amount that will go to charity, computed based on his or her life expectancy (as determined actuarially). In addition, amounts transferred in this manner are considered to have been transferred prior to death and are not included in the estate when the donor dies. In 1997, a total of 82,176 charitable remainder trusts were in existence, containing assets totaling $60.5 billion. Charitable remainder trusts are just one example of charitable donations that may take place toward the end of life that reduce both income taxes and estate taxes.

[*] David Joulfaian, *Estate Taxes and Charitable Bequests by the Wealthy*, NBER Working Paper 7663, April 2000.

and inheritances was considered the prerogative of the states. States objected to the establishment of a federal estate tax because they felt it infringed on one of their traditional tax bases. As a compromise, Congress included the state credit in the federal tax, thereby guaranteeing states a portion of the estate tax base.

In recent years, a number of states have changed their own estate and inheritance taxes to rely solely on a pickup tax equal to the maximum federal credit. This has left them vulnerable. If the federal estate tax — and therefore the federal credit — are repealed, the action would repeal automatically the estate taxes of most of these states. Other states that have retained some version of their own estate or inheritance tax are likely to lose some, but not all, of their revenues from this source.

While it could be argued that states could retain this revenue by reinstating a state estate or inheritance tax, in many states, this would be unlikely to occur. It would require the passage of new legislation in each state establishing what would be labeled a new tax. This could be very difficult to accomplish in the current political climate. (As noted, in states with pickup taxes, the pickup tax does not increase the amount of tax levied on an estate but simply shifts some of the revenue from the federal government to the state. If the federal estate tax is repealed, any action by these states to impose an estate tax would likely be attacked as constituting an increase in tax burdens.)

Tables in the Appendix show the anticipated amount of revenue loss from repeal of the federal estate for each state. The total revenue loss for all states, had the federal estate tax been repealed for fiscal year 2000, would have been approximately $5.5 billion — $4.4 billion for the states solely relying on the pickup tax and $1.1 billion for the states using the pickup tax along with their own estate or inheritance taxes.

Estate tax revenues are expected to grow by approximately 60 percent between now and 2010, when estate tax repeal would be fully in effect in the legislation Congress has passed. State pickup tax revenues would likely grow in tandem with the federal revenues, and the revenue loss to states when the repeal would be fully in effect in 2010 would approach $9 billion a year.[9]

Conclusion

Repeal of the estate tax would provide massive benefits solely to the wealthiest and highest-income taxpayers in the country. There would be a high cost for providing these benefits; the federal revenue loss would be about $60 billion a year when the repeal is fully in

[9]For additional explanation of these calculations, see Elizabeth C. McNichol, Iris J. Lav, and Daniel Tenny, *Repeal of the Federal Estate Tax Would Cost State Government Billions in Revenue*, CBPP, Revised December 12, 2000.

effect a decade from now, while states would lose another approximately $9 billion in estate tax revenues.

Few family farms and businesses are subject to the estate tax. To the extent that policymakers feel the estate tax unduly burdens small, family-owned businesses and farms, however, far more efficient and less costly solutions are available to alleviate those problems.

The estate tax is an integral part of our tax system; if it is repealed, large amounts of income — the unrealized capital gains income of very high-income taxpayers — would never be taxed at all. Moreover, repealing the estate and gift taxes would open up new loopholes that would encourage many new schemes for income tax avoidance. Finally, research suggests that repeal of the estate tax would cause a significant decline in charitable giving.

In short, there is little reason to repeal the estate tax, and many reasons to retain it.

Appendix Table 1
State Revenue from Credit
Against the Federal Estate Tax For State Taxes Paid
(for states with a pickup tax only)

State	**FY 2000 State Estate Tax Revenues** (millions of dollars)
Alabama	$68.0*
Alaska	1.8*
Arizona	80.6
Arkansas	21.6
California	937.0*
Colorado	65.1
Delaware	41.0
Florida	779.1*
Georgia	155.0
Hawaii	22.8
Idaho	11.1
Illinois	360.0*
Kansas	62.9
Maine[1]	45.8
Massachusetts	166.5
Michigan	187.0*
Minnesota	82.5
Missouri	132.7
Nevada[2]	76.7
NewMexico	16.1
NorthCarolina[3]	152.7*
NorthDakota	6.1
Oregon	47.8
RhodeIsland	34.2
SouthCarolina	42.7
Texas	249.1
Utah[4]	65.1
Vermont	13.6
Virginia	165.6*
Washington	86.9
WestVirginia	21.1
Wisconsin	133.5
Wyoming[5]	50.8
Total	**$4,382.4**

*Projection
Sources: Average federal credit: *Statistics of Income Bulletin*, Internal Revenue Service, Summer 1999. FY 2000 Revenues: CBPP survey of state revenue officials.

Notes:
1. The Maine revenue figure has been adjusted downward by $13 million to correct the effects of one-time accounting changes in fiscal year 2000.
2. Nevada's FY 2000 estate tax revenue was unusually high. The FY 1999 revenue, which is more typical, was 24.2 million dollars.
3. North Carolina's inheritance tax has been repealed, but continued to generate revenue in fiscal year 2000. The number above is the projected revenue for fiscal year 2001, which does not include any inheritance tax revenue.
4. Utah's FY 2000 estate tax revenue was unusually high. The FY 1999 revenue, which is more typical, was 8.9 million dollars.
5. Wyoming's FY 2000 estate tax revenue was unusually high. The projection for fiscal year 2000 was 7.5 million dollars; the actual revenue was the figure given above.

Appendix Table 2
State Revenue from Credit
Against the Federal Estate Tax For State Taxes Paid
(for states with their own inheritance or estate taxes)

STATE	**Estimated Revenue from Pickup of Federal Credit, FY 2000** (millions of dollars)
Connecticut	$140
Indiana	21
Iowa	35
Kentucky	37
Louisiana	50
Maryland	78
Mississippi	22
Montana	8
Nebraska	20
New Hampshire	25
New Jersey	158
New York	450
Ohio	38
Oklahoma	0
Pennsylvania	30
South Dakota	6
Tennessee	11
Total	**$1,129**

Sources: Average federal credit: *Statistics of Income Bulletin*, Internal Revenue Service. FY 2000 revenue: CBPP survey of state revenue officials.
State Notes
Connecticut - Connecticut is phasing out its inheritance tax. The actual revenue from succession taxes in fiscal year 2000 was $30 million dollars from the estate tax and $198 million dollars from the inheritance tax. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place based on revenue numbers from recent years and the projected fiscal impact of the inheritance tax phase-out.
Louisiana - Louisiana is phasing out its inheritance tax. The actual revenue from inheritance and estate taxes combined was projected to be $79 million in fiscal year 2000. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place based on the 2000 revenue estimates and estimates for the period during which the inheritance tax is being phased out.
Maryland - Maryland's inheritance tax rate is being reduced over the next two years, causing Maryland's estate tax revenue to increase somewhat. In FY 2002, Maryland revenue from the pickup to the federal credit is projected to be $81 million.
Mississippi - Mississippi's non-pickup estate tax has been repealed, but continues to generate a small amount of revenue. The non-pickup estate tax is estimated to have added less than $200,000 to FY 2000 revenue.
Montana - Montana passed a referendum eliminating the non-pickup inheritance tax for deaths after December 31, 2000. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place.
New Jersey - New Jersey's estate tax revenue has fluctuated in recent years. The number above represents the average for fiscal years 1998 through 2000.
New York - New York's estate tax has been repealed, but it continues to generate revenue.The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the non-pickup estate tax not been in place. It is based on the revenue numbers from recent years and the projected fiscal impact of the non-pickup tax repeal.
Ohio - Ohio's estate tax is being reduced over the next two years, but this reduction is expected to have a minimal effect on pickup tax revenues. Fiscal year 2000 data were not available for Ohio. The number above is from fiscal year 1999.
Oklahoma - Oklahoma's estate tax always exceeds the federal credit.
Pennsylvania - Pennsylvania cut inheritance tax rates in 2000. This cut will increase the amount of revenue that comes from the pickup of the federal credit, but the amount of the increase is unknown.
South Dakota - South Dakota passed an initiative eliminating the non-pickup inheritance tax for deaths after June 30, 2001. The number above is an estimate of the amount of revenue the estate tax would have generated in fiscal year 2000 had the inheritance tax not been in place.
Tennessee - The exemption for Tennessee's separate inheritance tax is scheduled to increase along with the federal exemption. After this increase takes effect, a much higher proportion of Tennessee's estate tax revenue will come from the pickup to the federal credit. By the time the exemption reaches $1million, almost all of Tennessee's estate tax revenue will come from the pickup tax. A state official estimates that when the exemption reaches $1 million, Tennessee will receive approximately $50 to $60 million in revenue from the pickup tax.