Center on Budget and Policy Priorities

POLICY POINTS

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THE COMING ESTATE-TAX SHOWDOWN: REPEAL, SO-CALLED "COMPROMISE," OR REAL REFORM?

Next week, the Senate plans to vote on what is probably the most important tax issue this year: whether to permanently repeal all, or nearly all, of the estate tax. The House already has voted for permanent repeal. The Senate was set to vote on the issue last fall, but backed away after Hurricane Katrina hit. Finance Committee Chairman Charles Grassley said then it would be "a little unseemly" to eliminate the tax "at a time when people are suffering."

Though many people affected by the Gulf Coast hurricanes still are suffering today, the war in Iraq continues at considerable cost, and large budget deficits are forecast as far as the eye can see, the Senate is once again poised to consider estate-tax repeal. Permanent repeal would cost nearly $1 trillion between 2012 and 2021, the first decade in which its costs would be fully felt. (This cost includes $776 billion in revenue loss and $213 billion in higher interest payments on the federal debt.) In light of the controversy this week over cuts in homeland security funding for a number of communities, it also is worth noting that the annual revenue loss from repealing the estate tax is about the same as *total federal spending on homeland security nationwide.*

The estate tax has received increasing public attention in recent weeks, but two critical facts remain poorly understood: the tax has shrunk considerably in recent years, and several so-called "compromise" proposals being pushed in the Senate would cause nearly as much budgetary damage as full repeal.

Only 0.5 percent of estates now pay any estate tax whatsoever, and this number is falling.

- The value of an estate that is exempt from taxation has increased from $1.35 million per married couple in 2000 to $4 million per couple in 2006, and will increase further to $7 million per couple in 2009. (The exemption levels are half these amounts for individuals.)

- As a result of the increase in the exemption level, the number of taxable estates has dropped from more than 50,000 in 2000 to fewer than 13,000 in 2006, and it will fall to about 7,000 in 2009. In percentage terms, that means a little over 2 percent of all estates were subject to the tax in 2000, 0.5 percent are subject to the tax today, and by 2009 that number will fall to 0.3 percent, meaning only 3 out of every 1,000 people who die will owe any tax.

- Proponents of estate-tax repeal frequently argue that repeal is needed to prevent large numbers of family-owned farms and businesses from having to be liquidated to pay the tax. A recent Congressional Budget Office study exploded this myth. It estimated that if the estate tax had existed in its current form back in 2000, 90 percent of the farm estates that owed estate tax that year — and nearly three-quarters of the family-owned businesses that owed estate tax that year — would have been entirely exempt from the tax. Had the tax existed in its *2009* form back in 2000, fewer than 100 family businesses and only 65 farm estates nationwide would have owed any estate tax. Further, CBO found that of these family businesses and farms, most would have sufficient liquid assets to pay the tax without having to sell any of the business or farm assets.

The leading "compromise" proposal would lose 84 percent as much revenue as full repeal, reduce the effective tax rate to just 6 percent, and cause a significant drop in charitable giving.

- Senator Kyl (R-AZ), a proponent of repeal, has acknowledged that support for repeal is eroding and that repeal may not receive the needed 60 votes in the Senate. If repeal fails in the Senate, Senator Kyl and other repeal proponents will try to lock in a substantial reduction of the estate tax now due to their fear that Congress will become less willing to forgo estate tax revenue in coming years, as the large fiscal challenges posed by the baby boomers' retirement grow closer. Senator Kyl has proposed a "compromise" that would retain the tax with a rate of 15 percent and an exemption level of $10 million per couple. The Kyl proposal would lose 84 percent as much revenue as full repeal, according to Congress's Joint Committee on Taxation.

- The Kyl proposal also would harm the nation's charities by largely eliminating an important incentive for charitable giving. CBO and other researchers have found that the estate tax leads extremely affluent people to donate substantially more to charities than they otherwise would, because such donations sharply reduce their estate tax liability. Repealing the tax thus would have a "devastating" effect on charitable giving, concluded a recent report by the Urban Institute-Brookings Institution Tax Policy Center. CBO has estimated that if there had been no estate tax in 2000, charitable donations by individuals would have been as much as $25 billion lower than they actually were that year. That amount exceeds total corporate donations to charity in 2000.

Similarly, the Kyl proposal would sharply reduce charitable donations by eliminating most of the tax incentive to donate, since each $1 in donations would reduce an estate's tax liability by only 15 cents. (As the Tax Policy Center analysis noted, reforming the estate tax by raising the exemption level rather than slashing the tax rate "would have considerably smaller effects" on charitable giving because it would not affect this tax incentive.)

- Senator Kyl has argued that since a substantial part of big estates consists of capital gains, which are taxed at a 15-percent rate, the estate-tax rate should not exceed 15 percent. This argument ignores the fact that wealthy married filers are not allowed to exempt their first $10 million of capital gains income when they file their income tax. Under Senator Kyl's proposal, in contrast, the first $10 million of a couple's estate would be exempt from estate tax. Therefore, the *effective* tax rate on taxable estates under the Kyl proposal — in other words, the share of the estate that would have to be paid in taxes — would be just 6 percent, according to the Tax Policy Center.

- Reportedly, Senator Baucus (D-MT) is considering proposing another costly "compromise" plan that would cause significant budgetary damage. The plan combines an exemption level of $7 million per couple with a graduated tax rate of 15 percent, 25 percent, and (for estate values in excess of $20 million per couple) 35 percent. The reported Baucus plan would lose 74 percent as much revenue as full repeal, according to the Tax Policy Center.

In reforming the estate tax, increasing the exemption level makes more sense than cutting the tax rate.

- The main reason for the sharp drop in the number of estates subject to the estate tax between 2000 and 2009 is the large increase in the exemption level during that period. Raising the exemption level targets tax relief on smaller estates, mostly by exempting many of them from the tax entirely. In 2006, nearly four-fifths of the benefits of the changes made to the tax under the 2001 tax law will go to estates valued at less than $5 million.

- Conversely, the main reason for the large revenue losses under the Kyl proposal — and, to a lesser degree, the Baucus proposal — is its deep cut in the estate tax rate. Cutting the rate targets tax relief on larger estates, since they pay tax on a larger amount of assessed value than smaller estates do. (Also, cutting the rate does not exempt any estates from the tax.) As a result, 96 percent of the benefits of changing the tax from its 2009 form to the Kyl proposal would go to estates larger than $5 million.

- For both of these reasons, if the goal of estate-tax reform is to relieve smaller estates from the tax while preserving a substantial share of revenue and focusing the tax on the estates most able to pay, freezing the tax at its 2009 level (with a $7 million exemption for couples and a 45-percent rate) is far superior to the Kyl or Baucus proposals. Over time, the Kyl and Baucus proposals would cost hundreds of billions of dollars more than freezing the tax at its 2009 level, and *all* of this extra cost would go to reducing taxes further on estates larger than $7 million per couple ($3.5 million per individual).

- Freezing the tax at its 2009 level would preserve about 60 percent of the revenue that would be lost by permanent repeal, according to the Joint Committee on Taxation, while totally exempting 997 of every 1,000 people from the tax. And because of the large exemption (as well as other exemptions and deductions available under law), taxable estates would pay only about 17 percent of their value in taxes.