Center on Budget and Policy Priorities

POLICY POINTS

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NEW ESTATE TAX "COMPROMISE" EVEN COSTLIER THAN PREVIOUS ONE

This week the House approved a bill introduced by Ways and Means Chairman Bill Thomas to drastically scale back the estate tax on a permanent basis. The Senate is expected to vote on the measure next week.

An effort to push repeal of the estate tax through the Senate failed earlier this month. But as Senator Jon Kyl (R-AZ), a leading proponent of repeal, has noted, "certain types of compromises would be almost as good as full repeal." That is, they would eliminate nearly all of the tax, and thus nearly all of the revenue it generates. Senator Kyl has proposed one such so-called "compromise." The House has just passed another. Compared to a reasonable reform of the estate tax, both proposals would spend tens of billions of dollars more on tax breaks for the largest estates, and would reduce effective tax rates to *well below the capital gains rate* — and well below the federal payroll and income tax rates that American workers typically face.

- **The House proposal would increase deficits by more than three-quarters of a trillion dollars over its first full decade (2012-2021).** The House proposal would exempt the first $10 million of a couple's estate ($5 million for an individual) from taxation entirely. Amounts above these exemption levels but below $25 million would be taxed at the capital gains rate, and amounts above $25 million would be taxed at twice the capital gains rate. Thus, the cost of the House proposal *depends on the capital gains rate.*

The capital gains rate is currently 15 percent but is slated to return to 20 percent after 2010. If it does revert to 20 percent, the House proposal would cost $774 billion over the first ten years that its budgetary effects would be fully felt (2012-2021), when added interest payments on the debt are included. That's about three-quarters as much as the $1 trillion cost of repealing the tax entirely. (It's also slightly more than the $753 billion cost of the "compromise" proposed by Senator Kyl.)

However, Chairman Thomas and other Republican leaders in Congress have no intention of allowing the capital gains rate to return to 20 percent after 2010. They intend to extend the 15 percent rate. If that happens, the House bill would cost even more — more than $800 billion, or about 80 percent as much as repealing the tax entirely.

- **The proposal uses a gimmick — linking the estate tax rate to the capital gains rate — that allows it to be presented differently to groups on different sides of the estate tax debate.** To proponents of repealing the tax, the proposal can be described as having estate tax rates of 15 percent and 30 percent. Conversely, to make the proposal sound more appealing to those who are concerned about the high cost of eliminating most or all of the tax, it can be presented as having estate tax rates of 20 percent and 40 percent. Both descriptions cannot be true, of course. The proposal is designed with the hope of having it both ways politically.

The House proposal includes other features intended to attract votes, most notably a special-interest tax break for the timber industry. That measure, which is entirely unrelated to the estate tax, would reduce the capital gains taxes owed on certain timber sales. It was included to entice senators from timber-producing states to vote for the package and thereby to help secure the 60 votes needed to permanently eliminate most of the estate tax.

- **Under the proposal, the effective tax rate on estates would be less than one-third the top estate tax rate, and well below the capital gains rate.** The percentage of an estate that is actually paid in taxes, which is known as the effective tax rate, is much lower than the top estate tax rate. This is because the top rate is applied to only *part* of the estate. Under the House proposal, for example, if the capital gains rate remains at 15 percent, a couple with an estate valued at $26 million would pay no tax on the first $10 million, a 15 percent rate on the value of the estate between $10 and $25 million, and the 30 percent top rate only on the $1 million portion of the estate's value that exceeds $25 million.

If the capital gains rate remains at 15 percent, the average effective estate tax rate under the House proposal would be just *9 percent,* according to the Urban Institute-Brookings Institution Tax Policy Center. If the capital gains rate reverts to 20 percent, the average effective estate tax rate would be 12 percent. In either case, the effective tax rate for taxable estates would be less than one-third the top estate tax rate — and well below the capital gains rate.

- **The House proposal costs much more than simply extending the estate tax at its 2009 levels primarily because it would give much larger tax cuts to estates worth more than $10 million.** If Congress were to make permanent the estate tax levels that will be in effect in 2009 — when estates of less than $7 million for couples will be entirely exempt and the top rate will be 45 percent — only 3 of every 1,000 people who die will owe any estate tax.

Over the first full decade (2012-2021), the House estate-tax proposal would add roughly $350 billion more to the deficit than extending the tax at its 2009 level, assuming the capital gains rate stays at 15 percent. More than 70 percent of the estate tax revenue lost by opting for the House proposal over continuing the tax at its 2009 level would consist of larger tax breaks for estates worth more than $10 million. More than 40 percent of the lost revenue would consist of larger tax breaks for estates worth more than *$20* million, with these estates receiving an average tax cut of $5.6 million in 2011, according to the Tax Policy Center.

- **The Thomas proposal also would eliminate the estate tax deduction for *state* estate taxes.** This change, which would raise a modest amount of additional revenue for the federal government, would have a severe adverse impact on states' ability to raise revenue through state estate and inheritance taxes. Without the federal deduction, a number of these state estate and inheritance taxes — which already are under fire in a number of states — are likely to have difficulty surviving, since repeal of the deduction would significantly increase the burden of state taxes. It would likely be perceived as imposing a double tax burden on estates, since the federal tax would be imposed on the portion of an estate already used to pay state estate and inheritance taxes.

The House proposal does not represent a legitimate compromise on the estate tax issue. It would significantly worsen the nation's fiscal problems at the same time that the baby boomers' retirement and rising health care costs will be placing large strains on the federal government. It would impose large costs on the nation as a whole in order to give large new tax breaks to heirs of large, multimillion-dollar estates.