CENTER ON BUDGET AND POLICY PRIORITIES

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IF DONE PROPERLY, REFORMING THE ESTATE TAX COULD PRESERVE MUCH-NEEDED REVENUE

The full report can be viewed at http://www.cbpp.org/3-16-05tax.htm

A new Center report shows that the estate tax can be reformed in a way that would exempt large numbers of estates from the tax while preserving much-needed revenue that would be lost if the tax were permanently repealed.

Under current law, the estate tax will be repealed entirely in 2010, only to return the following year when the tax cuts enacted in 2001 expire. The Administration favors repealing the estate tax permanently. That, however, would cost nearly $1 trillion over the first decade that repeal would be extended (when the added interest payments on the debt are included), significantly worsening the nation's already severe long-term budget problems. On the other hand, most in Congress do not favor letting the tax return to its pre-2001 form, which would exempt the first $1 million of an estate's value from the tax and set the top tax rate at 55 percent.

Therefore, many in Congress are looking to reform the estate tax rather than repeal it. Two possibilities are to retain the tax in its 2008 form, when the exemption level will be $2 million for an individual ($4 million for a married couple) and the top tax rate will be 45 percent, or in its 2009 form, when the exemption level will be $3.5 million for an individual ($7 million for a couple) and the top tax rate will be 45 percent. An analysis of estimates prepared by the Urban Institute-Brookings Institution Tax Policy Center finds that:

- **Raising the exemption level would significantly reduce the number of estates subject to the tax.** In 2011, there would be 61 percent fewer estates subject to the estate tax if it were retained with a $2 million exemption level than if it were retained with the $1 million exemption level set in current law. There would be 84 percent fewer estates subject to the tax if the exemption level were set a $3.5 million — in other words, five-sixths of the estates that otherwise would be taxable would be exempt.

  At these higher exemption levels, very few small businesses and farms in the nation would be subject to the estate tax, as the table at right shows.

How Many Small Farms or Businesses Would Face Estate Taxes Under Different Exemption Levels?

Exemption level	Number of taxable estates in 2011 in which a small business or farm comprises the majority of the estate
$1.0 million	760
$2.0 million	210
$3.5 million	50

- **These higher exemption levels would still yield a reasonable amount of revenue if coupled with a 45 percent tax rate**. Retaining the estate tax in its 2008 form, with a $2 million exemption and a 45 percent top rate, would preserve 68 percent of the estate tax revenue that would be lost under repeal. Retaining the tax in its 2009 form, with a $3.5 million exemption and a 45 percent top rate, would preserve 44 percent of the lost revenue. (See table at right.)

How Much Estate Tax Revenue Would Be Preserved if the Estate Tax Were Reformed Rather Than Repealed?		
If the top tax rate were:	… and the exemption level were:	… the share of estate tax revenue that would be preserved is:
45%	$2.0 million	68 percent
45%	$3.5 million	44 percent
15%	$2.0 million	21 percent
15%	$3.5 million	13 percent

- **However, most of the revenue saved by raising the exemption level would be lost if the top rate were also lowered to 15 percent.** Some suggest that the top tax rate be reduced from 45 percent to 15 percent, equal to the rate on capital gains income. However, at a 15 percent rate, an estate tax with a $2 million exemption would preserve only about one-fifth of the revenue that would be lost under repeal, as the table shows. With a $3.5 million exemption, the tax would preserve only 13 percent of these revenues; the remaining 87 percent would be lost.

  Also, the vast majority of the benefits of lowering the rate would flow to the largest estates. Over one-third of the gains from cutting the rate from 45 percent to 15 percent (at a $2 million exemption) would go to the 4 percent of taxable estates worth over $20 million, saving each of them an average of about $8 million.

- **Moreover, the *effective* tax rate for estates subject to estate taxes is well below the top tax rate.** The main reason for this is that estates owe tax only on the taxable part of the estate, not its full value. The taxable portion is the amount that exceeds the exemption level, after that amount has been reduced by deductions for charitable bequests and estate taxes paid to state governments.

  The Tax Policy Center estimates that, under an estate tax with a $2 million exemption and a 45 percent top rate, taxable estates would on average pay an effective tax rate of *only 18 percent* in 2011, meaning that only 18 percent of the estate's total value would be due in estate taxes. With a $2 million exemption and a 15 percent rate, the effective rate for taxable estates would be only 6 percent on average in 2011.

- **A "reformed" estate tax that combines a high exemption and a low rate would differ little from repeal.** A recent *Wall Street Journal* editorial suggested taxing estates at the capital gains rate and raising the exemption level to $10 million. Such a "reform" would preserve a mere 6 percent of the estate tax revenue lost under repeal. Even setting the exemption level at $5 million, with a 15 percent rate, would preserve only one-tenth of the revenues that would be lost under repeal; the remaining 90 percent of revenues still would be lost.

The nation's daunting fiscal problems raise serious questions about the affordability of repealing the estate tax permanently. Reforming the tax instead could preserve much-needed revenue. But a reform that relies on low estate tax rates has the same problem as permanent repeal: it would lose massive amounts of revenue and worsen the long-term budget outlook.