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HOUSE TO VOTE ON PERMANENT REPEAL OF ESTATE TAX

Estate Tax Reform, Rather Than Repeal, Could Preserve Much Needed Revenues And Help Restore Social Security Solvency

by Joel Friedman and Arloc Sherman

The House of Representatives is expected to consider legislation this week to make permanent the repeal of the estate tax, without offering any offsets to pay for this costly tax cut. As part of the tax-cut package enacted in 2001, the estate tax is being gradually reduced before being repealed altogether in 2010. But the provisions of that tax-cut package expire after 2010; as result, the estate tax is slated to be reinstated in 2011.

- The Joint Committee on Taxation estimates that extending repeal beyond 2010 would reduce revenues by $290 billion through 2015, including $72 billion in 2015 alone.

- But the Joint Tax Committee's estimate essentially captures only the cost of four additional years of estate tax repeal. The revenues losses associated with 10 more years of repeal — for the period from fiscal year 2012 through fiscal year 2021 — are much higher, about $745 billion.

- When the associated $225 billion in higher interest payments on the debt are taken into account, *the total cost of repealing the estate tax for a decade would be nearly $1 trillion.*

Estate Tax Repeal Unaffordable Given Long-Term Fiscal Realities

The high cost of permanently repealing the estate tax would come just at the time when the budget is confronted by the retirement of the baby-boom generation. The cost of the baby boomers' retirement, particularly if health costs continue their rapid rise, will push the deficit to steadily higher levels, requiring borrowing at an unsustainable rate.

These fiscal realities are leading many to question the feasibility of repealing the estate tax, and there is considerable discussion of proposals to *reform* the estate tax rather than repeal it.[1] Reform is politically necessary because the estate tax that otherwise would take effect in 2011 — under which the estate tax exemption level would be only $1 million and the top estate tax rate would be 55 percent — has little support.

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[1] For a discussion of the impact of estate tax reform options, see Joel Friedman and Ruth Carlitz, "Estate Tax Reform Could Raise Much Needed Revenue," Center on Budget and Policy Priorities, March 16, 2005; and Leonard Burman, William Gale, and Jeffrey Rohaly, "Options to Reform the Estate Tax," Tax Policy Center, March 2005.

A number of reforms are under discussion. Possible options include making permanent the estate tax scheduled to take effect in 2008 or 2009, the years just before repeal. In 2008, the estate tax exemption is set at $2 million for an individual ($4 million for a couple); in 2009, the exemption rises to $3.5 million ($7 million for a couple). A top rate of 45 percent applies in both years.

Although both of these reform proposals are themselves costly relative to the estate tax law that is slated to take effect in 2011, they nonetheless would save significant levels of revenue relative to full repeal. Continuing repeal of the estate tax past 2010 would lose all of the estate tax revenue that would be collected under current law. In contrast, a $2 million exemption and a 45 percent rate would maintain 68 percent of the estate tax revenue that would be lost under repeal, and a $3.5 million exemption and a 45 percent rate would maintain 44 percent of the revenue, according to estimates by the Urban Institute-Brookings Institution Tax Policy Center.[2]

Estate Tax Revenues and the Social Security Shortfall

These additional revenues are very significant. Consider, for example, the proposal by former Social Security Commissioner Robert Ball that the estate tax revenues raised under a reformed estate tax be dedicated to the Social Security Trust Fund as a way to help close the trust fund's shortfall.

The Chief Actuary of the Social Security Administration has estimated that maintaining the estate tax at the 2009 levels — with a $3.5 million exemption and a 45 percent top rate — would raise enough revenue to cover more than one-quarter of the shortfall in the Social Security Trust Fund over the next 75 years, as measured by the Social Security Trustees. The trustees estimate the shortfall to be 0.65 percent of GDP, while the revenue raised by this reform would equal 0.2 percent of GDP.[3] The Congressional Budget Office projects a smaller shortfall (0.36 percent of GDP). Under CBO assumptions, the estate tax revenues collected under this reform would close *about half* of the 75-year shortfall. A reform with a $2 million exemption and a 45 percent rate (the law in 2008) would close an even great portion of the Social Security shortfall.

If the estate tax is *not* retained and no estate-tax (or other) revenues are dedicated to the Social Security Trust Fund, it will be necessary to reduce Social Security benefits or increase payroll taxes to a greater degree to restore solvency to the trust fund.

Repealing Estate Tax Would Lead to Lower Charitable Giving

Retaining an estate tax would continue an important incentive for charitable giving. The Congressional Budget Office and other researchers have found that the estate tax encourages

[2] Note that these Tax Policy Center estimates reflect only the impact of estate tax changes on estate tax revenues; Joint Committee on Taxation estimates also include the associated effects on income tax revenues.

[3] An estate tax with a $3.5 million exemption and a 45 percent rate would, according to the Social Security Actuary, raise estate tax revenues equal to 0.5 percent of taxable payroll over the next 75 years. This compares to a 75-year shortfall in the Social Security Trust Fund of 1.92 percent of taxable payroll, as measured by the trustees, and 1.0 percent of taxable payroll, as measured by CBO.

Effective Estate Tax Rates Are Much Lower Than Top Rate

Some imply that people would pay almost half their estate to the government if the estate tax rate were kept at 45 percent. This fuels the portrayal of the estate tax as a "confiscatory" tax. However, given the availability of a sizeable up-front deduction for all estates, as well as allowable deductions for charitable bequests and estate taxes paid to states, combined with estate planning strategies, taxpayers have the opportunity to shield a large share of their estates from taxation. As a result, the actual proportion of an estate that goes to pay the estate tax — the effective rate of taxation — is much lower than the top tax rate.

The most recent estate tax return data from the Internal Revenue Service show that in 2003, taxable estates faced an average effective tax rate of only *18.8 percent*. Estates in the $5 million to $10 million range faced the highest effective tax rates — about 29 percent. The largest taxable estates, those worth over $20 million, had a lower average effective rate — 16.5 percent — primarily because of the size of their charitable bequests. These 2003 data primarily reflect estate tax paid under the 2002 law (because of the roughly nine-month lag after the decedent's death in the payment of estate taxes). The 2002 law set the exemption level at $1 million and the top rate at 50 percent.

The Tax Policy Center estimates that if the exemption were set at $3.5 million and the top rate at 45 percent, taxable estates in 2011 would face an average effective rate of 17.4 percent.

wealthy individuals to donate considerably more to charity, since estate tax liability is reduced through donations made both during life and at death.[4]

- CBO found that if there had been no estate tax in 2000, charitable donations would have been between $13 billion to $25 billion lower than they actually were.

- *This amount exceeds the total amount of all corporate charitable donations in the United States*, which equaled $11 billion in 2000.

- It approaches the total amount — $25 billion — that foundations contributed for charitable causes in 2000.

In contrast, if the exemption were set at either $2 million or $3.5 million, total charitable giving would have declined by about $1 billion to $6 billion, according to CBO, a modest fraction of the loss of associated with full repeal.

Few Estates Would Pay Estate Tax At Higher Exemption Levels

Reforming the estate tax could raise significant revenues. Yet it would affect only a small number of very large estates. With an exemption of $3.5 million, only 8,500 estates would face the estate tax in 2011, according to the Tax Policy Center. These 8,500 taxable estates

[4] Congressional Budget Office, "The Estate Tax and Charitable Giving," July 2004. For further analysis of the CBO report, see David Kamin, "New CBO Study Finds That Estate Tax Repeal Would Substantially Reduce Charitable Giving," Center on Budget and Policy Priorities, July 31, 2004

represent about 0.3 percent of all the persons who are expected to die in 2011. In other words, the estates of 997 of any 1,000 people who die would be totally exempt from the tax.

Further, at these exemption levels, extremely few small businesses and farms would be subject to the estate tax. The Tax Policy Center estimates that at a $3.5 million exemption level in 2011, there would only be 50 taxable estates in the entire nation in which a small farm or small business (those valued at less than $5 million) comprised a majority of the estate (and the estate thus might have too few assets to pay the estate tax without selling some or all of the farm or business).

House Bid to Repeal Estate Tax Contrasts Starkly With Proposals to Cut Assistance for Vulnerable Americans

The House debate over estate tax repeal comes at the same time Congress is considering substantial cuts in programs that assist low-income families with children, the elderly, and people with disabilities. The House-passed budget resolution calls for an estimated $30 billion to $35 billion in cuts over the next five years in Medicaid, food stamps, and programs for low-income families and individuals that are under the jurisdiction of the House Ways and Means Committee. These programs include the Earned Income Tax Credit for low- and moderate-income working families, the Supplemental Security Income program for poor individuals who are elderly or have severe disabilities, foster care and adoption assistance, the Temporary Assistance for Needy Families block grant, assistance for abused and neglected children and their foster and adoptive families, and child care assistance.[5]

The families and individuals at risk of losing benefits as a result of such funding cuts are at the far end of the economic spectrum from the beneficiaries of estate tax repeal. For example, the typical family that receives food stamps, SSI, the earned income tax credit, or Medicaid had median income of approximately $17,000 in 2002, according to the Center's tabulations of Census Bureau survey data. Adjusted for inflation, this amount would equal less than $21,000 in 2011 dollars.

In sharp contrast, repealing the estate tax would benefit only the wealthiest families. If the estate tax exemption were set at $2 million, the median value of taxable estates in 2011 would be at least $3.5 million, according to Tax Policy Center estimates, and about three-quarters of the estate tax would be paid by estates worth more than $5 million. If the estate tax exemption were set at $3.5 million, the median value of taxable estates would be about $7 million in 2011, and three-quarters of the estate tax would be paid by estates worth more than $10 million.

[5] See Sharon Parrott, Arloc Sherman, Bradley Hardy, "House Budget Resolution Would Require Much Deeper Cuts In Key Low-Income Programs Than Senate Budget Plan: Depth and Breadth of Cuts a Key Issue in the Budget Resolution Conference" http://www.cbpp.org/3-30-05bud.htm, Center on Budget and Policy Priorities, March 30, 2005.