CENTER ON BUDGET AND POLICY PRIORITIES

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ESTATE TAX SHOULD BE REFORMED, NOT REPEALED

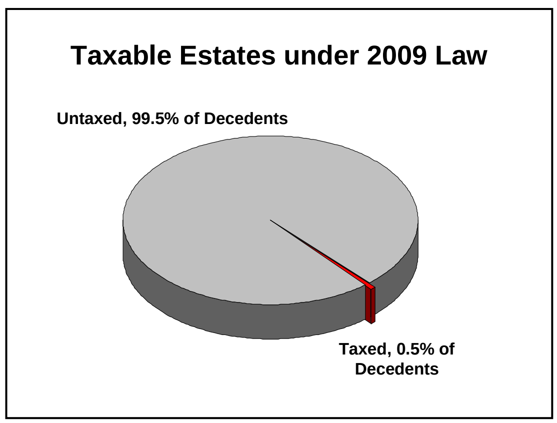
The full report can be viewed at http://www.cbpp.org/6-17-03tax.pdf

A new Center report, *Permanent Repeal of the Estate Tax Would Be Costly, Yet Would Benefit Only a Few, Very Large Estates,* examines a proposal the House is expected to vote on this week to repeal the estate tax permanently. (Under the 2001 tax-cut law, the estate tax is repealed in 2010 but then will reappear in 2011, since all parts of the 2001 law expire at the end of 2010.) As the report shows, reforming the estate tax would be far less costly than full repeal and would ensure that only a tiny fraction of extremely wealthy estates would face estate taxes.

- **Repeal would add roughly $80 billion a year to the deficit at the same time that the baby boomers' retirement will be placing serious strains on the federal budget.** The biggest costs of eliminating the estate tax will come in the years beyond the current ten-year budget window, when the baby boomers will be retiring in large numbers and Social Security and Medicare costs will be rising substantially as a result. Between 2014 and 2023, repeal will cost roughly $80 billion per year, or about $820 billion in total.

  In contrast, reforming the estate tax by retaining the tax at its 2009 level, with an exemption level of $3.5 million ($7 million for couples) and a top rate of 45 percent, would cost less than half as much as full repeal. Between 2014 and 2023, reform would save more than $460 billion compared to repeal.

- **Repeal would only benefit the wealthiest 0.5 percent of estates, very few of which are family businesses or farms.** In 2009, the year before the tax is repealed, only estates valued in excess of $3.5 million will be taxable. These estates are estimated to represent *less than one-half of one percent* of all estates. That is, for every 1,000 deaths, 995 people would be exempt from estate taxes altogether.

  Moreover, the estates that will be taxed will pay significantly less in 2009 than they do today because of the higher exemption level and lower rate. A married couple with a $10 million estate, for instance, will face an effective tax rate of only 13.5 percent under the 2009 exemption level and rate, as compared to an effective rate of 38.1 percent today.

  Some claim that estate tax repeal is needed to ensure that family businesses and farms do not have to be liquidated to pay the tax. In fact, the vast bulk of estates with a farm or family-owned business are not taxable even at the current exemption level ($1 million). Fewer still will be taxable at the 2009 level ($3.5 million). Moreover, a Treasury Department analysis found that raising the exemption level for family-owned farms and businesses to $4 million ($8 million for married couples), as then-Senator Daniel Patrick Moynihan proposed in 2000, would have exempted *almost all* family-owned farms and reduced the already small number of family businesses subject to the tax by nearly three-quarters. (For more on the issue of family farms and businesses, see *Estate Tax Affects Very Few Family Businesses*, at http://www.cbpp.org/2-7-01estateshort.htm.)

- **Repeal would reduce charitable giving.** Research shows the estate tax increases the amount of charitable contributions, particularly among large estates, as these donations are fully deductible and thereby reduce estate taxes. Repealing the tax would eliminate this tax incentive. A new study by Brookings economists Jon Bakija and William Gale estimates that repeal would have reduced charitable giving by about $10 billion in 2001, an amount "equivalent to the total grants currently made by the largest 110 foundations in the United States." Retaining the tax at a higher exemption level would maintain an important tax incentive for large estates to make charitable contributions.

Reforming the Estate Tax Preserves Options to Address the Social Security Shortfall

The amount saved by reforming rather than repealing the estate tax is equivalent to nearly one-quarter of the entire long-term Social Security shortfall, a not insignificant amount. Since neither party will agree to Social Security benefit cuts or payroll increases that are big enough to close the Social Security shortfall by themselves, additional funds will be needed. One solution would be to reform the estate tax, dedicate the remaining estate tax revenues to the Social Security Trust Fund, and use these revenues to help restore Social Security's long-term solvency.

Reform Addresses Estate Planning Problems Better than Repeal

Supporters of repeal have argued that long-range estate planning is virtually impossible under current law, which calls for the estate tax to be repealed in 2010 only to return in the next year. However, reforming rather than repealing the tax would likely be a more effective solution because reform avoids a complex problem known as "carry-over basis."

Today, when heirs sell an inherited asset, they owe capital gains tax only on the increase in the asset's value that occurred *after* they inherited it. If the estate tax were eliminated, this would change. Under the 2001 tax law, once the estate tax is phased out completely, heirs will have to determine the original purchase price of an inherited asset and, in some cases, pay capital gains when the asset is sold on the full increase in its value since the decedent purchased the asset. A similar carry-over basis requirement enacted in the 1970s was found to be so complicated as to be unworkable, and it was repealed before it took effect. Such a requirement, without which repeal of the estate tax would cause major problems and inequities in the taxation of capital gains, would not be necessary if the tax were reformed rather than repealed.

In sum, retaining the estate tax at its 2009 level would cost much less than repealing it and would avoid the complications associated with repeal. Given the serious deterioration in the federal budget picture over the past two years, reform is by far the more prudent course.