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BERKLEY ESTATE TAX BILL WOULD ADD BILLIONS TO DEFICIT WHILE BENEFITING ONLY WEALTHIEST 1 IN 500 ESTATES

By Chuck Marr and Gillian Brunet

A new estate tax bill introduced by Representative Shelley Berkley (D-NV) and others would cost $91 billion more over the first decade (2012-2021) than extending the tax under its current rules as the President has proposed, yet would benefit only the nation's wealthiest 0.2 percent of estates since they are the only ones subject to the tax under the current rules. In subsequent decades, the Berkley proposal (H.R. 3905) would be even more expensive compared to extending the current estate tax rules; the proposal keeps its cost down in the initial years by phasing in its estate tax cuts over a decade, with its full costs not showing up until after 2019.

Ultimately, the Berkley proposal would increase deficits and debt by nearly as much as a proposal by Senators Blanche Lincoln and Jon Kyl, which it mirrors once it is phased in fully.[1] Like the Lincoln-Kyl proposal, the Berkley bill would eventually allow wealthy individuals to pass on $5 million per person — $10 million per couple — to their heirs tax-free and would cut the tax rate that applies to the taxable portion of estates from 45 percent to 35 percent.

Reducing the estate tax below its 2009 level is not needed to protect small businesses and farms, nearly all of which already are exempt from the tax under the 2009 rules. Only 110 small business and farm estates in the entire nation would owe any estate tax in 2011 if the 2009 rules were extended, according to new estimates from the Urban Institute-Brookings Institution Tax Policy Center, and virtually none of them would have to be sold to pay the tax.[2] Thus, while small businesses and farms may be used as "poster children" to promote this proposal, they would gain little from it.

The current rules already are generous. Under them, an individual can inherit on a tax-free basis a trust fund worth $3.5 million, or more than a middle-class family that makes $70,000 a year — and

[1] For more on the Lincoln-Kyl proposal, see Chuck Marr and Jason Levitis, "Lincoln-Kyl Estate Tax Amendment Is Both Unnecessary and Unaffordable," Center on Budget and Policy Priorities, revised April 10, 2009, http://www.cbpp.org/files/4-2-09tax.pdf.

[2] See Tax Policy Center, "$3.5 Million Exemption and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2011," October 6, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2473&DocTypeID=7. We follow the Tax Policy Center definition of a small business or farm estate as one in which more than half of the value of the estate is in a farm or business and the farm or business assets are valued at less than $5 million.

pays taxes on those earnings every year — earns in a lifetime.[3] With the nation on an unsustainable fiscal path and many middle-class families losing their jobs and their homes, it is difficult to justify providing the top 0.2 percent of estates — the estates of the wealthiest 1 in every 500 people who die — with a costly new tax cut so they can pass on even larger inheritances tax-free.

Background

In 2009, estates valued at up to $3.5 million per individual ($7 million per couple) are exempt from the estate tax. That means that under current law, inheritances from 99.8 percent of estates are passed on tax-free.

For estates that are taxable, the tax applies only to the value of the estate that exceeds the exemption level. Because of this, plus other special tax breaks built into estate tax law, taxable estates face an average effective tax rate of less than 20 percent, well below the top marginal rate of 45 percent.[4] In other words, on average, the tax levied on the tiny number of estates that are taxable equals less than 20 percent of the value of these estates. It also should be noted that much of the value of large estates consists of unrealized capital gains that have never been taxed.[5]

The estate tax is scheduled to be temporarily repealed in 2010 and then to return in 2011 under the rules in pre-2001 law, with a $1 million exemption per person and a top tax rate of 55 percent. President Obama has proposed making the 2009 estate tax rules permanent. This would lock in all of the estate tax cuts implemented between 2002 and 2009, at a cost of $391 billion over the first decade in which its effects would be fully felt (2012-2021).[6] Some policymakers, however, have proposed going further and eliminating even more of the tax.

In April, Senators Jon Kyl (R-AZ) and Blanche Lincoln (D-AR) introduced a plan to raise the exemption to $5 million for an individual and $10 million per couple (indexed for inflation) and lower the tax rate to 35 percent. Over the 2012-2021 period, the Lincoln-Kyl proposal would add $153 billion more to the deficit than making the 2009 rules permanent — and $544 billion more than allowing the tax to return to its level under the pre-2001 law.

About $119 billion of the added costs of the Lincoln-Kyl proposal, relative to maintaining the 2009 rules, would consist of forgone revenue. The rest would come from higher interest payments

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[3] Total earnings for the middle-class family would be approximately $3 million. For simplicity of argument, assume that all amounts are present values, as inflation effects do not alter the overall story. The trust fund example assumes that the couple has two children and gives each $3.5 million. This is conservative because additional monies can be transferred tax-free each year during one's life. Currently, an individual can provide $13,000 to another individual through the "annual gift tax exclusion." A couple, therefore, can currently gift $52,000 tax-free to another couple in 2009.

[4] According to the Tax Policy Center, taxable estates would pay an average effective tax rate of 18.9 percent in 2011 if the 2009 estate tax rules were made permanent. In other words, the taxes they pay would equal 18.9 percent of the estates' value, on average.

[5] According to a 2000 study, unrealized capital gains comprise 56 percent of the value of estates worth more than $10 million. See James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains At the Time of Death," p. 19, NBER, July 2000.

[6] This $391 billion cost relative to allowing the tax to return to its level under the pre-2001 law consists of $315 billion in forgone revenue and $76 billion in higher interest payments on the debt.

TABLE 1: Estate Tax Parameters Under Berkley Bill		
Year	Tax-Free Per-Person Exemption	Tax Rate
2009	$3,500,000	45%
2010	$3,650,000	44%
2011	$3,800,000	43%
2012	$3,950,000	42%
2013	$4,100,000	41%
2014	$4,250,000	40%
2015	$4,400,000	39%
2016	$4,550,000	38%
2017	$4,700,000	37%
2018	$4,850,000	36%
2019 and thereafter	$5,000,000	35%

on the national debt due to increased government borrowing. *All* of the $119 billion in tax-cut benefits would go to the wealthiest 0.2 percent of estates.

Slow Phase-In Masks Bill's True Cost

On October 22, Representative Berkley (D-NV), a prior advocate of estate tax repeal, and Representatives Kevin Brady (R-TX), Devin Nunes (R-CA), and Artur Davis (D-AL) introduced H.R. 3905, which would shrink the estate tax by increasing amounts every year for the next ten years. Starting in 2019, the exemption level and tax rate would be identical to those in the Lincoln-Kyl proposal.

The Berkley proposal would add $482 billion to the deficit over the 2012-2021 period — $62 billion less than Lincoln-Kyl but $91 billion more than continuing the 2009 estate tax rules.[7] This estimate does not illustrate the Berkley proposal's true cost, however, because the proposal would not fully phase in until 2019. (See Table 1.)

By phasing in the Lincoln-Kyl parameters gradually over a decade, the Berkley bill's sponsors seem to be asserting that Lincoln-Kyl is unaffordable in the short run but affordable in the long run, as though the nation's fiscal outlook were likely to steadily improve. Virtually every fiscal analyst across the political spectrum, however, regards the long-term fiscal path as unsustainable, with our fiscal problems growing worse, not better, over time, and with an increasing risk to the economy with each passing decade.[8]

In 2019, the year the tax cuts in the Berkley proposal would reach their full dimensions, annual interest on the debt is expected to hit $900 billion — more than the entire projected cost of Medicare that year or of total appropriations for all non-defense discretionary programs. Over the long run, the Berkley proposal would essentially have the same detrimental effects as Lincoln-Kyl, likely necessitating larger tax increases on the middle class or steeper cutbacks in various federal

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[7] Tax Policy Center, "Revenue Impact of Various Estate Tax Reform Proposals, 2010-2019," October 27, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2491&DocTypeID=5.

[8] See Kris Cox, James Horney, and Richard Kogan, "The Long-Term Fiscal Outlook Is Bleak: Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System," Center on Budget and Policy Priorities, December 16, 2008, http://www.cbpp.org/files/12-16-08bud.pdf.

programs than would otherwise need to be made — or compromising economic growth by adding to already-unsustainable long-term deficits and debt.

Arguments for Cutting Estate Tax Further Lack Foundation

The bill's sponsors and other supporters of weakening or eliminating the estate tax have argued that this would help small businesses and farms and strengthen the economy. These claims are without foundation.

- **Bill would provide virtually no benefit to small businesses and farms.** As noted, nearly all small farms and businesses already are exempt from the estate tax under the 2009 parameters. Indeed, a Tax Policy Center analysis of a proposal similar to the Lincoln-Kyl proposal found that *less than one quarter of 1 percent* of its cost, relative to the cost of making the 2009 rules permanent, would go for tax cuts for estates that consist primarily of small businesses or farms.

  New Tax Policy Center estimates show that if the 2009 estate tax rules are extended, only 110 small business and farm estates in the entire nation would owe any estate tax in 2011 and thus would benefit from weakening the tax beyond its 2009 level. Moreover, virtually none of the few estates that would owe the tax would have to be liquidated to pay it. A Congressional Budget Office study found that all but a handful of the farm estates that would owe any tax under the 2009 parameters would have sufficient liquid assets on hand (such as bank accounts, stocks, and bonds) to pay the tax without having to touch the farm or business.[9] Those few small business and farm estates that might conceivably face a liquidity problem would have other options — such as spreading their payments over a 14-year period — that would allow them to pay the tax without selling off any of the business or farm assets.

  In 2001, when the estate tax affected many more estates and had a much higher effective rate than it does today, the American Farm Bureau Federation acknowledged to the *New York Times* that it could not cite a single example of a farm having to be sold to pay estate taxes.[10]

- **Bill would likely weaken economic growth, not strengthen it.** A group of affluent families has funded research that claims to show estate tax repeal would spur economic growth. Mainstream economists, however, have dismissed this research, which the Tax Policy Center explains "gets the economics all wrong" by ignoring the economic impact of higher deficits (which increase government borrowing and thereby reduce the pool of saving available for investment) and exaggerating the likely increase in private saving if the tax were repealed. Similarly, the Berkley proposal would likely weaken long-term economic growth by adding to already unsustainable levels of deficits and debt.[11]

In addition, the bill would introduce unnecessary complexity and uncertainty to the estate tax. The bill would increase the estate tax exemption and lower the estate tax rate every year for the next

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[9] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

[10] David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *New York Times,* April 8, 2001.

[11] See Chye-Ching Huang, Gillian Brunet, and Chuck Marr, "Reports Calling for Estate Tax Repeal Seriously Flawed," Center on Budget and Policy Priorities, July 7, 2009, http://www.cbpp.org/files/7-7-09tax.pdf.

Bill Could Also Harm State Budgets by Undermining State Estate Taxes

In what would represent a major change in policy, with adverse consequences for state governments, the Berkley proposal would gradually eliminate the federal estate-tax deduction for *state* estate taxes that are paid, reducing the deduction by 10 percent in 2010 and further reducing it each year until it disappeared completely for decedents dying in 2019 or later. While this would lessen the loss of *federal* revenues, it would harm *state* budgets.

State estate and inheritance taxes are an important revenue source for the 22 states that levy them, bringing in approximately $5.3 billion per year. Most of these dollars are deposited in state general funds, which principally pay for education, health care, and public safety.

Without the federal deduction, however, a number of these state estate and inheritance taxes — which already are under fire in a number of states — may have difficulty surviving, since repeal of the deduction would increase the cost to state estate tax payers. It also would lead to charges of unfair double taxation, because the federal estate tax would be leveled on the portion of estates that had already been taxed away at the state level.

Putting state revenue from estate and inheritance taxes at risk is particularly ill-advised given states' current fiscal conditions. The worst recession since the 1930s has caused the steepest decline in state tax receipts on record. As a result, even after making deep cuts in K-12 and higher education, health care, human services, and aid to local governments — and raising taxes in 30 states — states continue to face large budget gaps. This aspect of the Berkley proposal would make these budget shortfalls even larger.

ten years. With a new tax rate and exemption level each year, estate planning would become considerably more complex for the few estates that still owe tax. This complexity and uncertainty would add to the burden of estate planning, since both the exemption and the tax rate would vary noticeably depending on the year of an individual's death.

Business groups have indicated that stability and certainty are important components of estate tax reform. A permanent, stable solution — as would be produced by making the 2009 parameters permanent — is more desirable than the uncertainty that ten years of annual adjustments to the tax would create.

But most importantly, it is imperative that the permanent estate tax solution be fiscally responsible and fit the economic and budgetary challenges the nation faces today, as well as the even more daunting fiscal challenges it will encounter in the decades ahead. H.R. 3905 fails these tests.