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CONGRESS SHOULD NOT WEAKEN THE ESTATE TAX BEYOND 2009 PARAMETERS

By Chuck Marr and Gillian Brunet

The House of Representatives this week is expected to consider permanently extending the current estate tax, under which only 1 in 500 estates face the tax and those that do pay, on average, an effective rate of less than 20 percent.

The House will vote on the Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009 (H.R. 4154), introduced by Rep. Earl Pomeroy (D-ND). A rival bill introduced by Rep. Shelley Berkley (D-NV) and several other House members (H.R. 3905) would further weaken the estate tax and lose more revenue. The Berkley bill would cost over $80 billion more over the first decade alone than extending the current tax,[1] and all of these additional tax benefits would flow to the wealthiest 0.2 percent of estates in the nation.

The federal estate tax has shrunk considerably in recent years. Meanwhile, the nation is on an unsustainable fiscal course, with record deficits that are projected to reach much higher levels in the future decades. Thus, extending the 2009 tax represents the far more reasonable, equitable, and affordable approach.

Only 1 in 500 Estates Pay Any Estate Tax Under Current Rules

The 2001 tax-cut law has scaled down the estate tax considerably. Under the current rules, only the largest 1 in 500 hundred estates pay any tax; that is, 99.8 percent of estates are passed on completely tax-free.

For the relatively few wealthy estates that are taxable, the tax applies only to the value of the estate that exceeds the exemption level of $3.5 million per individual or $7 million per couple. Because of

[1] The $82 billion difference in cost between the Berkley and Pomeroy proposals is over the 2012-2021 period (the first decade in which the effects of further estate tax changes would be fully felt) and includes the effects of increased interest payments on the national debt, as a result of deficit financing. Because none of the current major estate tax proposals include offsets, all of the cost estimates in this paper include the interest costs. The Joint Committee on Taxation has estimated that the Berkley proposal would cost $280 billion over 2010-19 (compared to $234 billion for the Pomeroy proposal), but this figure understates the cost both because it excludes interest costs and because the proposal would not be fully in effect until 2011, and the revenue effect lags by a year.

this and other tax breaks built into estate tax law, taxable estates owe less than 20 percent of their value in tax, on average — well below the estate tax's marginal rate of 45 percent.[2] Moreover, much of the value of large estates consists of unrealized capital gains that have never been taxed to begin with.[3]

In short, the current estate tax parameters are generous, and Congress set them at a time when the federal government was enjoying a large budget surplus. Under these parameters, an individual can inherit, tax-free, a trust fund worth $3.5 million, or more than a middle-class family that makes $70,000 a year earns in a lifetime.[4]

Going Beyond 2009 Rules Would Be Unaffordable and Inequitable

Under current law, the estate tax is scheduled to disappear in 2010 and then return in 2011 under the rules in place before 2001, with a $1 million exemption per person and a top rate of 55 percent. If that happened, there would be 44,230 taxable estates nation-wide in 2011, according to the Urban Institute-Brookings Institution Tax Policy Center.

The House bill to make the 2009 parameters permanent would cut the number of taxable estates in 2011 by *85 percent*, to 6,420 estates nation-wide. Compared to continuing current law, the House bill would cost $391 billion over 2012-2021, the first decade in which its effects would be fully felt.[5]

Berkley Proposal Nearly as Costly as Lincoln-Kyl Proposal Once Phased In

The Berkley proposal would go considerably further than extending the 2009 rules, eventually raising the exemption level to $5 million per individual ($10 million per couple) and reducing the rate to 35 percent. This would cost $82 billion more over the 2012-2021 period than extending the 2009 rules, yet it 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 would be even more expensive compared to extending the current rules. The proposal uses a budget gimmick to keep its cost down in the budget window (2010-2019) — it slowly phases 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.[6]

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[2] According to the Urban Institute-Brookings Institution 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.

[3] According to a 2000 study, unrealized capital gains make up 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.

[4] Total lifetime 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. In addition to the large amounts that wealthy individuals can pass on tax free after death, an individual can provide $13,000 each year during his or her lifetime to another individual on a tax-free basis through the annual gift tax exclusion.

[5] This $391 billion cost, a CBPP estimate based on estimates from the Joint Committee on Taxation, consists of $315 billion in forgone revenue and $76 billion in higher interest payments on the debt.

Further Cuts Would Provide Virtually No Benefit to Small Businesses and Farms

Reducing the tax below its 2009 level is not necessary to protect small businesses and farms, nearly all of which already are exempt from the tax under the 2009 rules. *Only 100 small business and farm estates in the entire nation would owe any estate tax in 2010 if the 2009 rules were extended*, according to the Tax Policy Center, and virtually none of them would have to be sold to pay the tax.[7]

Thus, though the proponents of greater cuts in the estate tax argue that they are needed to protect small businesses and farms, the fact is that small businesses and farms would gain very little from such proposals.

Further Cuts Also Could Weaken Economy Over Time

A group of affluent families has funded research claiming to show that repealing the tax 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. A recent report by the nonpartisan Congressional Research Service reaches the same conclusion:

> [I]t appears difficult to argue for repeal of the estate tax to increase private saving. Even if the responsiveness to the estate and gift tax is as large as the largest empirical estimates … the effect on savings and output would be negligible and more than offset by public dissaving [i.e., by the increase in deficits that would result from estate-tax repeal]. Indeed, if the only objective were increased savings, it would probably be more effective to simply keep the estate and gift tax and use the proceeds to reduce the national debt.[8]

Similarly, the Berkley proposal would likely weaken long-term economic growth by adding to already unsustainable levels of deficits and debt.[9]

With the nation on an unsustainable fiscal path and many middle-class families losing their jobs and their homes, it is hard to justify a costly new tax cut for the nation's wealthiest estates so they can pass on even larger inheritances tax-free. Making the 2009 rules permanent is a more reasonable approach, and it would provide needed certainty to estate tax law.

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6 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.

7 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, 2010," November 18, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0440.pdf. 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.

8 Jane G. Gravelle and Donald J. Marples, "Estate and Gift Taxes: Economic Issues," Congressional Research Service, November 27, 2009.

9 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.