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The Estate Tax: Even Worse Than Republicans Say

By
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Introduction

On July 25, Joint Economic Committee Republicans published a report criticizing the federal estate tax.[1] Their report called for either a significant reform or outright repeal of the estate tax. The report, which referenced four separate Tax Foundation studies and testimonies,[2] reached similar conclusions to those which we have reached with regard to the estate tax. But while the JEC Republican report makes strong arguments, we hope here to strengthen the case for repeal with additional evidence of compliance burdens inherent in the estate tax. Compliance costs are much more significant than is often understood, so much so that tax revenue is likely to actually increase upon repeal regardless of economic growth patterns in the coming years.

All of this analysis comes on the heels of major changes that are slated for the estate tax rate and exemption structure in 2013. It is important that legislators and taxpayers educate themselves with the economic literature on growth and compliance.

Estate Tax Update

The estate tax is a tax on an individual's ability to transfer property after his or her death. There have been numerous temporary estate taxes throughout America history, but the first permanent estate tax was established in 1916.

The current federal estate tax has three major parts: the traditional estate tax, the gift tax (a tax on transfer of wealth during life), and a generation-skipping transfer tax (a tax on transfers to generations at least twice removed).

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[1] Kevin Brady, Joint Economic Committee Republicans, *Cost and Consequences of the Federal Estate Tax: An Update* (July 25, 2012), http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3.

[2] Robert Carroll, *Income Mobility and the Persistence of Millionaires, 1999 to 2007*, TAX FOUNDATION SPECIAL REPORT NO. 180 (June 2010), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr180.pdf; David S. Logan, *The Economic Effects of the Estate Tax*, Testimony before the Pennsylvania House Finance Committee, Oct. 17, 2011, http://www.taxfoundation.org/research/show/27709.html; William Ahern, *The Federal Estate Tax: Will It Rise From the Grave in 2011 or Sooner?*, TAX FOUNDATION SPECIAL REPORT NO. 179 (May 2010), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr179.pdf;
J. Scott Moody, Wendy P. Warcholik, & Scott A. Hodge, *The Rising Cost of Complying with the Federal Income Tax*, TAX FOUNDATION SPECIAL REPORT NO. 138 (Dec. 2005), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr138.pdf.

The most major recent reform of the estate tax came under the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The exemption on the estate tax was consistently raised until a 1 year temporary total repeal occurred in 2010. However, instead of allowing the law to revert back to the top marginal rate of 60 percent (which would have occurred after the expiration of EGTRRA), a two year compromise was reached with an inflation adjusted $5 million exemption ($5.12 million today) and a 35 percent top marginal rate.

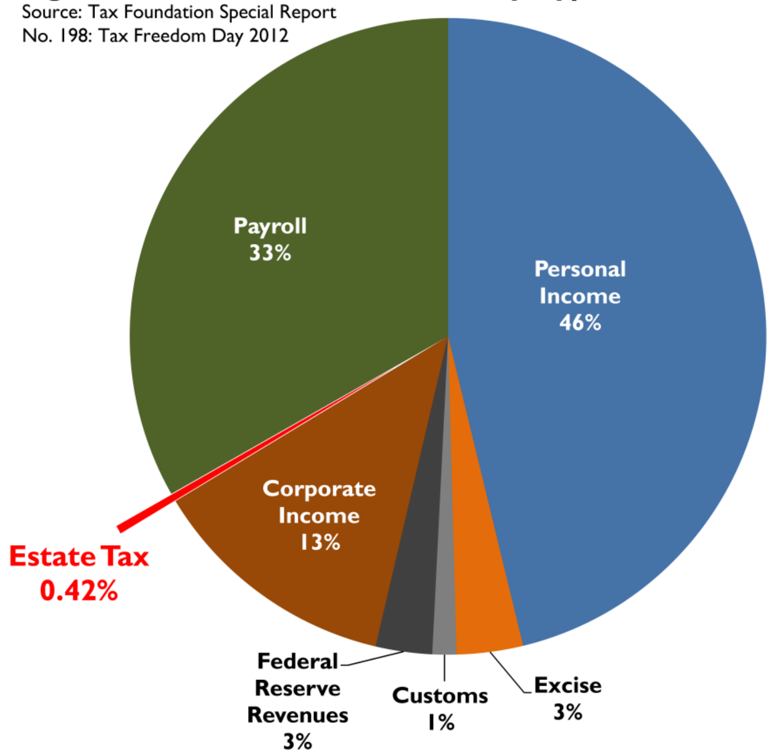
In January of 2013, the exemption is currently written to drop to $1 million and the top rate is set to increase to 55 percent, subjecting far more estates to the tax and taxing all at higher rates. According to recent reports, President Obama favors a $3.5 million exemption and a 45 percent top rate. This structure was originally included in the president's proposal this year to extend many of the Bush tax cuts but was eliminated from the proposal in late July following dissent from within the Democratic camp.[3]

Many Hassles, Low Collections

The justification for the estate tax has historically been twofold: the estate tax raises revenue and reduces income inequality. The JEC report effectively shows that the estate tax fails on both accounts.

Figure 1: Federal Tax Collections By Type, 2012

Source: Tax Foundation Special Report No. 198: Tax Freedom Day 2012



The estate tax is the smallest source of revenue of any major tax in the United States. In 2011, it raised roughly 0.32 percent of all federal revenue. In 2012, projections show that the estate tax will only raise 0.42 percent of federal tax collections (Figure 1). Not only is the tax revenue from the estate tax fairly insignificant, but the charitable deduction, along with "stepped up basis" asset valuations, ensure that income and capital gains tax revenues are kept artificially low as taxpayers make economic decisions to avoid the estate tax. The revenue gained from the estate tax is largely illusory, as lost revenue from estate tax repeal would be made up in other areas of the tax code.

The estate tax is often defended under the premise that it promotes equity, but the tax fails to achieve this goal. Inheritance accounts for just 2 percent of income inequality according to one study,[4] and other sources find that only

[3] Laura Sanders, *How to Control Your Heirs from the Grave,* WALL STREET JOURNAL, Aug. 11, 2012, http://online.wsj.com/article/SB10000872396390444900304577579020960854732.html?mod=ITP_businessandfinance_5.

[4] Alan S. Blinder, TOWARD AN ECONOMIC THEORY OF INCOME DISTRIBUTION (Cambridge, MA: MIT Press, 1974).

27 percent of wealthy households accumulated any wealth at all through inheritance.[5] As the JEC Republicans highlight, only one in five children of a wealthy parent will be wealthy at their retirement.[6] In effect, the estate tax does not soak the rich; it instead soaks their less-than-wealthy heirs.

The Estate Tax Reduces Savings

As pointed out by the JEC, the estate tax has since its inception decreased capital stock by $1.1 trillion due to discouragement of savings and the taxing of intergenerational transfers, which are perhaps the largest source of aggregate capital in the economy.[7] The estate tax discourages savings by promoting a "die broke" mentality, as untaxed consumption becomes relatively cheaper than savings for those who intend to build wealth and bequeath a gift to inheritors, such as children or grandchildren.[8]

The estate tax encourages consumption over savings and reduces capital stock, which leads to lower growth and lower living standards.[9] The tax also disproportionally hurts small businesses with illiquid assets, such as farms and manufacturing firms, and discourages re-investment into those types of businesses.

Compliance Costs: Hidden Drags on the Economy

While the JEC addresses many concerns with the federal estate tax, including briefly mentioning compliance costs for small businesses, the true situation may be even worse than the picture they paint because of the size of the compliance costs associated with the tax. It is not merely the time and costs to small businesses which is significant, but the entire estate planning industry which has been created in response to the existence of a complex federal estate tax. This expensive industry, which contributes virtually nothing to economic growth, is wasteful, as the resources employed in this industry could be better utilized elsewhere.

Three studies found that the compliance costs associated with the estate planning industry exceed the revenue yield of the tax itself.[10] The largest compliance costs, those created by the hiring of estate planners, accountants, and life insurance providers, all help to effectively shield payment of the estate tax liability. Instead of the government raising revenue, it has effectively paid out a subsidy to these select industries by continuing to exact a complex tax that creates demand for their services. All of these compliance costs represent economic waste, as these human and capital resources would be employed elsewhere more productively if the tax were eliminated.

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[5] U.S. Trust & Bank of America Private Wealth Management, *U.S. Trust Insights on Wealth and Worth: Survey of High Net Worth and Ultra High Net Worth Americans 2011 Highlights* (2011).

[6] Kerwin Kofi Charles & Erik Hurst, *The Correlation of Wealth Across Generations* (Dec. 2002), http://faculty.chicagobooth.edu/erik.hurst/research/final_resub_jpe_dec2002.pdf. *See also* Jagadeesh Gokhale & Pamela Villarreal, *Wealth, Inheritance and the Estate Tax*, NCPA POLICY REPORT 289 (Sept. 2006), http://www.ncpa.org/pdfs/st289.pdf.

[7] Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation,* 89 JOURNAL OF POLITICAL ECONOMY 706 (Aug. 1981).

[8] Edward J. McCaffery, *Grave Robbers: The Moral Case against the Estate Tax,* POLICY ANALYSIS NO. 353 (Oct. 4, 1999).

[9] *Id.*

[10] Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes,* 45 National Tax Journal 119 (June 1992); Douglas Bernheim, *Does the Estate Tax Raise Revenue? in* 1 TAX POLICY AND THE ECONOMY 113 – 138; Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes,* NEW ENGLAND ECONOMIC REVIEW 19 (Nov./Dec. 1988).

Revenue Neutral: The Effects of Repeal on Federal Taxation

While the JEC rightfully criticizes the CBO's static scoring and highlights the faster economic growth estate tax repeal would cause, they omit two of the most important ways in which tax revenues would increase after repeal. First, according to one study, income and capital gains tax revenues will increase significantly if the estate tax is repealed even without an increase in economic growth.[11] Several articles have found that repeal would be revenue neutral, or even revenue positive, over a 10 year period if both the tax changes and economic growth are considered together.[12] This would be largely due to a change in estate evaluations from a "stepped up basis" to a "carryover basis," which would increase the incentives for capital gains realizations. A "stepped up basis" asset is one whose value is determined by the fair-market price at the time of death of the decedent, while a carryover asset is one whose value is determined by the adjusted basis (accounting for tax costs) at the time of purchase of the asset, which then "carries over" to the transferee. The carryover basis encourages the realization of capital gains, unlike the stepped up basis which encourages the owner to hold onto the asset. By switching to this rule after estate tax repeal, as assumed by Wilbur and Rueter, there is high likelihood that estate tax repeal will be revenue positive due to an increase in realized capital gains (which are taxed).

Also, the CBO found that income tax revenues would increase as a result of estate tax repeal, as the charitable deduction—which is often used as an estate tax avoidance strategy—would decrease, and more income would be taxed through the individual income tax code.[13]

Further, greater capital accumulation caused by the estate tax repeal would also increase capital stock and economic growth, further heightening all tax revenue increases.

Conclusion

As the JEC Republicans point out, the estate tax fails to raise significant revenue and reduce inequality. It causes serious damage to capital accumulation by reducing savings and also has high compliance costs. Its repeal would increase economic growth and some studies even find that it would raise tax revenues. The JEC report makes a strong argument for estate tax repeal, but after accounting for the higher tax revenue and larger compliance costs shown here, the estate tax becomes indefensible.

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[11] Wilbur A. Steger & Frederick H. Rueter, *The Revenue Effects of Estate Tax Repeal and Basis Step-Up Limits*, TAX NOTES 1314 (June 6, 2005).

[12] *See* Steger & Rueter, *supra* note 11. *See also* Stephen J. Entin, *A Score of the Death Tax Repeal Permanency Act*, American Family Business Foundation (Apr. 5, 2011).

[13] Congressional Budget Office, *The Estate Tax and Charitable Giving* (July 2004), http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5650/07-15-charitablegiving.pdf.