

# SPECIAL REPORT

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## The Federal Estate Tax: Will It Rise From the Grave in 2011 or Sooner?

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The scheduled but nevertheless unexpected repeal of the federal estate tax in 2010 and the prospect of its reinstatement in 2011 bring debate over the estate tax, or “death tax,” to the fore again.

Some of the arguments are new: Would it be constitutional for Congress to reinstate the estate tax retroactively for 2010? But some of the arguments are a century old or more: Does the estate tax accomplish any worthwhile social purpose? Is it a good way to raise revenue?

Here we condense and update some earlier Tax Foundation studies on this age-old topic, with specific reference to the recent, surprising death and potential new life for the estate tax.

### Why the Estate Tax Was Repealed For Just One Year

The first of many tax cuts during the last decade was enacted in May 2001. That was the so-called Bush tax cut, formally known as the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, pronounced egg-tray).

### Key Findings

- *The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, also known as the Bush tax cut of 2001, began phasing out the estate tax. The rate dropped from 55% in 2001 to 45% in 2009 to full repeal in 2010; meanwhile, the exemption level rose steadily as well, from \$1 million to \$3.5 million.*
- *The repeal is only scheduled to be in effect for one year, 2010, after which the estate tax is scheduled to revert to 2001 law. President Obama has proposed making 2009 law permanent, and most tax analysts believe that is the most likely legislative outcome.*
- *On the pro-repeal side, the one-year repeal in 2010 is seen as a great improvement in tax policy that should be made permanent because the tax is unfair, preposterously complex and far more economically damaging per dollar of tax collected than any other individual tax.*
- *Many opponents of repeal consider any tax on the nation's wealthiest people, dead or alive, as the best sort of tax. They never liked EGTRRA or President Bush's subsequent tax cuts as a package, and they particularly disliked the repeal of estate taxation.*

One of EGTRRA's most historically significant provisions was to put the federal estate tax on the slow boat to full repeal. Each year after enactment the top tax rate dropped by one point so that it fell from 55% in 2001 to 45% in 2009. Meanwhile, the exemption level was rising steadily, too, from \$1 million to \$3.5 million (see Table 1). This rising exemption level eliminated estate tax liability for many small estates that would have owed a small amount. Not until this year, 2010, did the law schedule a full repeal.

As the end of 2009 approached, all tax analysts thought the Democratic congress would intervene and prevent repeal, but Congress was busy with health insurance and so 2010 is the first year since 1916 that a person can die without creating an estate that must pay the federal estate tax.

That may change, however. Democratic Party leaders have pledged to retroactively tax the estates of people who die during 2010, although executors and constitutional lawyers are weighing in with concerns.<sup>1,2</sup> Whether or

*Table 1*

*The Long History of Federal Estate and Gift Taxes 1916-2011*

Year	Estate Tax Exemption	Lifetime Gift Tax Exemption	Annual Gift Tax Exclusion	Maximum Estate Tax Rate	Maximum Gift Tax Rate
1916	\$50,000	None	None	10%	0%
1917-23	\$50,000	None	None	25%	0%
1924-25	\$50,000	\$50,000	\$500	40%	25%
1926-31	\$100,000	None	None	20%	0%
1932-33	\$50,000	\$50,000	\$5,000	45%	34%
1934	\$50,000	\$50,000	\$5,000	60%	45%
1935-37	\$40,000	\$40,000	\$5,000	70%	53%
1938-40	\$40,000	\$40,000	\$4,000	70%	53%
1941	\$40,000	\$40,000	\$4,000	77%	58%
1942-76	\$60,000	\$30,000	\$3,000	77%	58%
1977	\$120,000	\$120,000	\$3,000	70%	70%
1978	\$134,000	\$134,000	\$3,000	70%	70%
1979	\$147,000	\$147,000	\$3,000	70%	70%
1980	\$161,000	\$161,000	\$3,000	70%	70%
1981	\$175,000	\$175,000	\$3,000	70%	70%
1982	\$225,000	\$225,000	\$10,000	65%	65%
1983	\$275,000	\$275,000	\$10,000	60%	60%
1984	\$325,000	\$325,000	\$10,000	55%	55%
1985	\$400,000	\$400,000	\$10,000	55%	55%
1986	\$500,000	\$500,000	\$10,000	55%	55%
1987-97	\$600,000	\$600,000	\$10,000	55%	55%
1998	\$625,000	\$625,000	\$10,000	55%	55%
1999	\$650,000	\$650,000	\$10,000	55%	55%
2000-01	\$675,000	\$675,000	\$10,000	55%	55%
2002	\$1,000,000	\$1,000,000	\$11,000	50%	50%
2003	\$1,000,000	\$1,000,000	\$11,000	49%	49%
2004	\$1,500,000	\$1,000,000	\$11,000	48%	48%
2005	\$1,500,000	\$1,000,000	\$11,000	47%	47%
2006	\$2,000,000	\$1,000,000	\$12,000	46%	46%
2007-08	\$2,000,000	\$1,000,000	\$12,000	45%	45%
2009	\$3,500,000	\$1,000,000	\$13,000	45%	45%
2010	None	\$1,000,000	\$13,000	0%	35%
2011+ (1)	\$1,000,000	\$1,000,000	\$11,000	55%	55%

(1) These values would prevail if the current year ends with no congressional action. If Congress follows the President's budget proposal, 2009 law will become permanent for 2011 and beyond.

Source: Internal Revenue Service; CCH Inc.; Julie Garber's "Annual Exclusion from Gift Taxes, 1997-2010"

1 See Ryan Donmoyer, "Estate Tax Expiration Sets Up Battle on Retroactive Restoration," Bloomberg, December 17, 2009, at <http://www.bloomberg.com/apps/news?pid=20601103&sid=amAp4mEjffFQ>.

2 See Lee A. Sheppard, "Would Estate Tax Reinstatement Be Constitutional?" *Tax Notes*, January 12, 2010, in which she analyzes *United States v. Carlton*, 512 U.S. 26 (1994) and concludes that a retroactive estate tax would be constitutional because the estate tax was merely suspended, not repealed, and would not be a "new" tax.

not a retroactive reinstatement of the estate tax is constitutional, it is certainly a symptom of bad legislation and administration because executors of estates created in 2010 must act on current law and distribute inherited assets in a timely fashion. It would be disgraceful for Congress to force executors to rescind those distributions.

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Alas, as if the estate tax weren't complex enough, this congressional incompetence – scheduling a one-year repeal in law and then actually reviving it – has made the situation even worse, and people need professional estate tax planning more than ever. For example, despite the repeal of the estate tax, the gift tax is still intact, and the \$13,000 annual gift tax exclusion is still in force for 2010. Gifts to registered charities are exempt, however. Registered charities almost all campaign for estate taxation, believing some of their gifts are motivated by estate tax avoidance.

Coincidentally, though, charitable gifts are probably more tax-advantaged this year than they will be in the future due to the one-year repeal of the Pease limitation on itemized deductions.<sup>3</sup>

## **The Bush Tax Cuts Merely Put The Estate Tax to Sleep**

During the legislative fight over the Bush tax cuts in 2001, Senate Republicans could not predict with certainty that they would reach the 60-vote threshold of support that would have enabled them to make the tax cuts permanent, so EGTRRA was passed as a reconciliation bill which needs only 51 votes. They did eventually get 62 votes; nevertheless, because the bill was passed under reconciliation, revenues further than 10 years in the future could not be changed. And so, on December 31, 2010, all of EGTRRA, along with estate tax repeal, will expire and revert to 2001 law.

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Despite a decade of Democratic Party invective about how unfair and irresponsible the Bush tax cuts were, President Obama's current budget calls for keeping most of them. Even for estate taxation, there is a compromise. Instead of reverting to 2001 law with its 55% top rate and \$1 million exemption, the President suggests making 2009 law permanent, and most tax analysts believe that is the most likely legislative outcome.

## **A Brief Review of the Estate Tax and Fight to Repeal It**

The movement to repeal the estate tax had gained steam throughout the 1990s, and in 1997, the effort appeared to yield its first fruit. The Taxpayer Relief Act of 1997 included two

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<sup>3</sup> See Patrick Fleenor, "PEP and Pease: Repealed for 2010 But Preparing a Comeback," *Tax Foundation Special Report*, No. 178, Tax Foundation, April 2010 at <http://www.taxfoundation.org/publications/show/26260.html>.

estate tax provisions: a slowly rising “unified credit” (which raised the wealth threshold at which the tax kicks in); and a higher exemption level for small family-owned businesses and farms, which are slightly less likely to have sufficient liquid assets to pay the tax and may instead opt to sell or break up the business.

The exemption proved to be a disappointment, however, as it was difficult for businesses to meet the complex, strict standards to qualify for the exemption. Seeing this legislative effort fall victim to the legendary complexity of the estate tax rejuvenated the movement for total repeal, and as a result, the summer of 2000 brought the controversial tax closer to the brink of elimination than it had been in over 70 years.

H.R. 8, the Death Tax Elimination Act, targeted not only the estate tax, but also the gift tax and the generation skipping tax (GST). These three taxes comprise the unified transfer tax system.

### The Federal Transfer Tax System

The federal transfer tax is unique in our federal tax system in that it is a tax on wealth.

As J.D. Foster, Ph.D., of the Tax Foundation explained in testimony before the House Ways and Means Committee in 1995:<sup>4</sup>

*Table 2*

*Federal Estate and Gift Tax Collections  
1995-2011 (Millions)*

1995	\$ 14,763	2006	\$ 27,877
1996	\$ 17,189	2007	\$ 26,044
1997	\$ 19,845	2008	\$ 28,844
1998	\$ 24,076	2009*	\$ 23,482
1999	\$ 27,782	2010*	\$ 17,011
2000	\$ 29,010	2011*	\$ 25,035
2001	\$ 28,400	2012*	\$ 22,514
2002	\$ 26,507	2013*	\$ 23,577
2003	\$ 21,959	2014*	\$ 25,566
2004	\$ 24,831	2015*	\$ 27,634
2005	\$ 24,764		

\*Estimates  
Source: Fiscal Year 2011 Budget of the United States, Historical Tables, Table 2.5.

The estate tax is not a tax on income, though it can influence the incentives to earn income; it is not a tax on consumption, though it can influence consumption; nor is it a tax on a particular activity. It is a tax on the net economic product of an individual after all other economic activity has concluded.

In addition to taxing the wealth that decedents leave behind, the estate tax includes wealth transfers: wealth given from one living person to another (amounts over \$10,000 are subject to the gift tax), and transfers to grandchildren or more distant descendants, which are subject to the GST.

For the first 119 years following their inception, transfer taxes were used only sporadically, in times of national emergency. They were levied on wealthy people who were expected to make special sacrifices in times of crisis.

The Stamp Act of 1797 marked the estate tax’s first use: It was used to raise revenue for military purposes during a period of conflict with France.

It was repealed in 1802 and during the 19th century was enacted two more times in different forms, each time for a period of less than a decade, before becoming a permanent part of our tax system in 1916 – just three years after the federal income tax came into being. The gift tax and GST were not added until later as backstops to prevent estate tax avoidance, which became rampant as soon as wealthy people realized the tax was no longer an emergency appeal to their patriotism but just the most complex regular feature of the federal individual tax system.

Congress raised transfer tax rates rapidly during the 1930s, and the resulting revenue accounted for as much as 9.7 percent of all federal receipts during the latter part of the decade, the highest in the history of the tax.

<sup>4</sup> See Congressional Budget Office, “Economic and Budget Issue Brief: Federal Estate and Gift Taxes,” December 18, 2009, at [http://www.cbo.gov/ftpdocs/108xx/doc10841/Estate\\_GiftTax\\_Brief.shtml](http://www.cbo.gov/ftpdocs/108xx/doc10841/Estate_GiftTax_Brief.shtml)

The next big change came with the Tax Reform Act of 1976. It created the GST, which imposed a tax on trusts for grandchildren or subsequent generations, curtailing a popular avoidance technique; it eased restrictions on hard-hit small businesses and family farms; and it united some provisions of the gift tax and estate tax by replacing their separate exemptions with a unified tax credit.

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These changes were intended to ensure that gifts given during the benefactor's life were added to the value of his estate and therefore subject to the same tax rates as the rest of his estate. The transfer of a decedent's estate to his heirs is, in a sense, simply his final gift.

Throughout the 1980s and '90s, further changes were made in transfer tax law. The most significant before EGTRRA were products of the 1997 Taxpayer Relief Act. The effective exemption created by the unified credit was raised from \$600,000 to \$625,000 and was scheduled to continue increasing each year until 2006. That was rendered moot by passage of EGTRRA in 2001.

### **Arguments For and Against Making Estate Tax Repeal Permanent**

Because this debate has been going on so long, most of the arguments on both sides are petrifed. On the pro-repeal side, the one-year repeal

in 2010 is seen as a great improvement in tax policy that should be made permanent because the tax is unfair, preposterously complex and far more economically damaging per dollar of tax collected than any other individual tax. The estate tax can prevent small businesses and farmers from passing their businesses on to the next generation. It penalizes saving and capital formation. And it discourages the creation of new wealth by America's most innovative, productive entrepreneurs.

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An argument heard less often is that the traditional social rationale for estate taxation – preventing excessive concentration of wealth – is obsolete. The U.S. economy has become so dynamic that a constant turnover occurs among the wealthiest people. Instead of the same few families staying at the top of the heap for generations, new American entrepreneurs constantly emerge and soar past older fortunes. For example, IRS data on the highest-earning 400 tax returns show that between 1992 and 2007, only seven taxpayers appeared continuously in that top tier of income earners. Meanwhile, 2,515 taxpayers made only one appearance in that group during the 16 years studied. One argument for repeal, then, is that the economy has changed fundamentally since 1916 and has solved the concentration-of-wealth problem far more efficiently than the estate tax ever did or could.

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5 These critics often did favor, however, the raising of the exemption level. Vice President Gore favored it in 2000, and many prominent Democrats since have supported exemption levels in the \$3-to-\$8 million range.



Against repeal, many people consider any tax on the nation's wealthiest people, dead or alive, as the best sort of tax. They never liked EGTRRA or President Bush's subsequent tax cuts as a package, and they particularly disliked the repeal of estate taxation.<sup>5</sup>

The current congress and administration are mostly in this latter camp, so there's not much doubt that the estate tax will be back in 2011, probably exactly as it was in 2009.

### How Much Revenue Does the Estate Tax Bring In, and How Much Does It Scare Away?

Even though federal estate tax rates were falling throughout the decade, and the exemption level was rising, revenue held steady at about \$25 billion each year between 2001 and 2009. Receipts were as high as \$28 billion when the economy was strong and the stock market up, and as low as \$23 billion when the economy weakened, as it did in 2008 and 2009. The one-year repeal of the federal estate tax in 2010 drives down the U.S. Budget's predicted revenue from transfer taxes to \$17 billion this year, and then revenue rebounds in 2011 and beyond in anticipation of the law's reinstatement.

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But is this the whole revenue story? No, even though the estate tax has been reporting approximately \$25 billion a year in revenue,

much of that has been diverted from other treasury accounts. For example, capital gains revenue would be much higher over time without the estate tax. Regular income tax revenue would be higher, too.

### *Estate Tax Repeal Boosts Capital Gains Tax Revenue*

To prevent assets in estates from being double-taxed by both the estate tax and the capital gains tax, the so-called step-up in basis was, until 2010, part of estate tax law. By that rule, assets to be transferred were valued at their current market value on the date of death – “stepped up” from the original purchase price – leaving the heir with no taxable gain if he sold the inherited asset for an amount that equaled the value on the date he inherited it.

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However, when the estate tax reached full repeal on January 1, 2010, the step-up was also repealed, leaving heirs with taxable gains when they sell. This is mitigated somewhat by an EGTRRA provision that exempts \$1.3 million of an estate's increased value from the capital gains tax and \$3 million for transfers to a spouse. Nevertheless, many heirs will end up paying higher capital gains taxes on assets inherited during 2010.<sup>6</sup> For people who have been planning their estates to take advantage of the step-up, its temporary and possibly permanent disappearance is upsetting. However, the step-up is a bad tax law that encourages people to cling to assets until death for tax reasons when they have actually wanted to sell them for many years.

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6 This will not be the case if estate taxes are levied retroactively on estates created in 2010.

*Estate Tax Repeal Boosts Wage Tax Revenue*

The estate tax depresses income tax collections in at least three ways: by shifting wealth into non-profits that pay no taxes, by maximizing tax planning deductions and by imposing wasteful compliance costs.

Most scholars assert that the estate tax significantly increases bequests to charities as taxpayers try to avoid paying estate tax. These assets end up producing capital income for tax-exempt charities instead of remaining in the estate where taxpaying recipients would have earned the money.

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*One would hope that on occasion, economic and administrative efficiency could trump political rhetoric about taxes, and agreement to make estate tax repeal permanent would be a good place for that to start.*

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Consider a \$1 million charitable gift made to reduce estate tax liability. If the charity invests the gift and earns 8 percent annually, then it will earn \$80,000 annually, tax free. Suppose there were no estate tax, and the donor, who pays income tax at the 35 percent rate, had held onto the asset. He will then earn \$80,000 in taxable income and pay \$28,000 in tax the next year. Suppose he would reinvest all the after-tax income, live for ten years, and at death leave the account to his heirs who pay a 15 percent income tax rate. Over a 20-year period, then, this \$1 million would generate over \$625,000 in income tax revenue, but because of the estate tax it will generate none. This is not to dismiss the value added to society by charities, and not all bequests to them are motivated by the estate tax. However, some registered charities do less public good than the government would do with the tax revenue.

Another way that permanent estate tax repeal would boost income tax revenue is reduced estate planning, which is phenomenally expensive and tax deductible. Since individuals paying estate planners are usually in the upper-income tax brackets, their deductions are substantial. Absent the estate tax, these individuals would probably shift their spending to non-deductible expenses, or they would save them. Either way, current or future income tax receipts would be higher.

One final savings that the federal government would achieve with full estate tax repeal is compliance cost, both for taxpayers and the IRS. The resources devoted to estate tax compliance would probably be redirected into other areas of tax collection, areas which the estimators have historically scored as increasing collections significantly.

## Conclusion

The estate tax is complex to the point of absurdity, to the point where even a savvy lawyer or accountant would be a fool to plan his own estate if he had substantial wealth. The money it raises is largely diverted from other government accounts, generating perhaps a small net collection. In short, the arguments for making repeal permanent are strong. One would hope that on occasion, economic and administrative efficiency could trump political rhetoric about taxes, and agreement to make estate tax repeal permanent would be a good place for that to start. And yet, we prepare for the estate tax's return from the dead on January 1, 2011.

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For two useful articles about recent developments in estate taxation, see Mary Randolph, J.D., “Estate Tax: What on Earth Is Happening in 2010?” (<http://www.nolo.com/legal-encyclopedia/article-32263.html>) and Denis Clifford, “Reduce Estate Tax by Making Gifts” (<http://www.nolo.com/legal-encyclopedia/article-30095.html>).



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