National Center for Policy Analysis

BRIEF ANALYSIS
No. 574
For immediate release:
Monday, October 9, 2006

Killing the Death Tax

by Danielle Georgiou

This summer, the Senate fell short of the super-majority needed to bring to a vote a measure permanently repealing the estate tax. This means the current reduced-rate estate tax will revert to the full pre-2001 rates of up to 55 percent by 2011 unless other action is taken. The Senate's lack of action prompted the House to pass the Estate Tax and Extension of Tax Relief Act (H.R. 5970), which would extend estate tax relief beyond 2010, but would not eliminate the tax. This is unfortunate. The evidence shows that the estate tax does little to redistribute wealth and may not provide any net government revenues.

The Estate Tax: Past and Present. The estate tax was first enacted in 1916 on estates larger than $50,000 (equivalent to nearly $1 million today) and the top rate was 10 percent. By the 1930s, the top estate tax rate reached 70 percent on estates larger than $50 million ($666 million in today's dollars), and by 1936, it was a full 11 percent of federal revenue.

In 1997, Congress lowered the maximum rate to 55 percent. In 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) into law. Among its provisions was a gradual phase-out of the estate tax and its full repeal for one year:

- The top marginal estate tax rate will gradually drop to 45 percent in 2009 (down from 55 percent in 2001), while the amount exempted from the tax will increase from $675,000 to $3.5 million.
- In 2006, for example, the top tax rate is 46 percent, and the exemption amount is $2 million.
- In 2010, the estate tax will disappear altogether for one year but, due to the law's sunset clause, returns in 2011 at the pre-2001 rates; estates greater than $1 million will be taxed at a top rate of 55 percent.

The repeal for one year only was due to congressional budget rules. But supporters expected a future Congress to take permanent action. Current opposition to a full and permanent repeal of the tax prompted the House to pass H.R. 5970. The bill would continue to use the traditional stepped-up method for determining capital gains taxes on estate assets, but limit its use in 2010:

- Through 2009, inherited assets sold by the heir would be taxed only on the stepped-up value, which is the difference between the fair market value of the asset at the time the estate is valued, and its appreciated value at the time of sale.
- In 2010, however, estate assets exceeding $1.3 million will be subject to "carry-over" valuation, which is the difference between the appreciated value of the asset and its price when originally purchased by the deceased.

Instead of the total phase-out of the estate tax in 2010, the House bill would institute a permanent lower rate. [See the table.] Between 2010 and 2015:

- The exemption amount would gradually increase to $5 million and would be indexed for inflation thereafter.
- Estates up to $25 million would be taxed at the capital gains tax rate (which is currently 15 percent, but will increase to 20 percent in 2011 unless the lower rate is extended).

Estate Tax Proposal
(H.R. 5970)

Calendar Year	Exemption Amount	Highest Tax Rate ($25 Million or More)
2010	$3.75 million	40%
2011	$4 million	38%
2012	$4.25 million	36%
2013	$4.5 million	34%
2014	$4.75 million	32%
2015	$5 million	30%
After 2015	$5 million indexed for inflation annually	30%

Source: "H.R. 5970: Estate Tax and Extension of Tax Relief Act of 2006," House Republican Committee, July 28, 2006, and 109th Congress, "H.R. 5970," U.S. Government Printing Office, July 31, 2006.

Dallas Headquarters: 12770 Coit Rd., Suite 800 • Dallas, TX 75251• 972-386-6272 • Fax: 972-386-0924 • Web site: http://www.ncpa.org
Washington Office: 601 Pennsylvania Ave., N.W., Suite 900, South Building • Washington, D.C. 20004 • 202-220-3082• Fax: 202-220-3096
For more information, contact the NCPA Communications Department at 972/386-6272 or 800/859-1154.

- Any amount above $25 million would be subject to an estate tax rate of 40 percent in 2010, with a gradual reduction in the rate to 30 percent by 2015.

In addition, estate assets would continue to be valued on a stepped-up basis.

The Estate Tax Burden Does Not Fall on the Super-Rich. A common misconception is that the estate tax is paid mainly by the very rich. In fact, for estates beyond a certain size, the burden tends to fall as the size of estates increases. Thus, the estates of those who have accumulated a modest fortune at the end of their careers or in family-owned business may face a higher rate than the estate of a billionaire. Through expensive estate planning, the very wealthy are able to minimize their estate tax burden. Consider:

- The effective estate tax rate on estates of $5 million to $10 million is 16.8 percent.
- However, for estates of $20 million or greater, the tax consumes only 13.5 percent of the estate.

The Estate Tax Does a Poor Job of Redistributing Wealth. Another misconception is that the estate tax is an effective tool for redistributing wealth. Because wealth and income are both highly mobile in the United States, most fortunes are earned rather than inherited and rarely survive past the second generation. Moreover, wealth and poverty are never static; Americans often move up and down the economic ladder depending on their personal circumstances and the state of the economy at a given time. Indeed, Congress' Joint Committee on Taxation (JCT) has resisted inclusion of the estate tax in its tables showing the distribution of the tax burden by income groups, owing to uncertainty about who actually bears the burden of the estate tax.

Furthermore, the impact of the estate tax on saving and capital formation negates much of the redistributive effect of the tax. Economist Joseph Stiglitz notes that to the extent that the estate tax reduces the capital stock, it raises the return to the remaining capital. Hence, it makes the rich even richer.

The Estate Tax Does Not Add Much to Federal Revenues. The estate tax generates little revenue for the federal government. Federal budget data indicates that the estate tax will raise $28 billion this year, accounting for only 1.2 percent of total federal revenues. Furthermore, it is estimated that the estate tax costs the private sector one dollar to comply for every dollar in revenue. This means that the true cost of the estate tax to the economy this year is at least $56 billion.

However, capital gains tax revenue could increase if the estate tax were repealed. That would occur if the current stepped-up basis on assets were replaced by carry-over basis. According to JCT:

- Much of the value in large estates consists of unrealized capital gains, which currently avoid capital gains taxes because asset basis is stepped-up to market value at death.
- That has the effect of reducing federal revenues by more than $50 billion annually.

Under current law, when the estate tax disappears in 2010, any assets that are sold will be taxed on a carry-over basis — in effect, a capital gains tax on their value since they were first acquired by the decedent. This would allow the government to pick up a part of the $50 billion in lost revenue to offset the revenue loss from estate tax repeal. The Senate bill proposed a permanent carry-over basis, but the partial repeal passed by the House retains the stepped-up basis. However, even if stepped-up basis is retained, eliminating the estate tax would increase the capital stock and thus produce higher incomes and more income tax revenues.

It's Time to Bury the Estate Tax. Congress is not considering full repeal at the moment; but lowering the estate tax rate and raising the exemption would be a step in the right direction. However, the estate tax is inefficient, economically harmful, does a poor job of redistributing wealth and doesn't raise much revenue. A better policy would be permanent repeal.

Danielle Georgiou is a policy intern with the National Center for Policy Analysis.