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REPEAL OF THE ESTATE TAX WOULD BE COSTLY: POTENTIAL ALTERNATIVES WOULD ALSO RESULT IN SUBSTANTIAL LOSSES

In early June, the US Senate is scheduled to vote on the permanent repeal of the federal estate tax. The Senate may also consider alternatives that would be nearly as costly as repeal. Congress is considering repeal or further cuts to the estate tax despite mounting deficits and looming budgetary challenges posed by the impact of the aging of the baby boomers on health care and Social Security costs. The vote on repeal would come just weeks after Congress approved $70 billion in tax cuts that primarily benefited the wealthy.

Why Is the Estate Tax a Big Issue in Congress Now?

Changes made to the estate tax in 2001 set the stage for the current debate. The 2001 tax bill gradually reduced the estate tax and repealed it altogether in 2010.[1] However, the provisions of the 2001 tax package expire after 2010. As a result, the estate tax is slated to be reinstated in 2011 with a tax exemption level of only $1 million per person - which would mean that considerably more estates would be taxed in 2011 than are under today's $2 million per person exemption - and at a top tax rate of 55 percent, as compared to the current rate of 46 percent. The Bush Administration proposes to permanently repeal the estate tax after 2010.

Permanent Repeal of the Estate Tax Would Be Costly

Permanent repeal of the estate tax would cost nearly $1 trillion between 2012 and 2021, the first 10-year period in which the costs would fully affect the budget. This cost includes both the revenues lost due to repeal ($776 billion) and the estimated costs of higher interest payments on the federal debt ($213 billion) associated with the lost revenues. In today's terms, the annual cost of repeal would exceed what the federal government currently spends on popular programs such as homeland security and education. These tax cuts would come at a time when Congress is also considering cuts to many domestic programs and services, including health care, veterans' benefits, education, and environmental protection.

Some Proposed "Reforms" Would Be Almost as Costly as Repeal

Supporters of repeal, such as Arizona Senator John Kyl, acknowledge that mounting federal budget deficits may make it difficult to achieve the votes necessary for full repeal. In fact, a vote on repeal was originally scheduled for last fall, but was delayed due to a concern that it would appear unseemly to provide a substantial tax break to the wealthiest Americans while Congress struggled to find funds for relief efforts in the wake of Hurricane Katrina. The possible lack of support for full repeal has prompted some to consider alternatives that would be almost as costly as full repeal. Senator Kyl, for example, has noted, "certain types of compromises would be almost as good as full repeal."[2]

Senator Kyl's has proposed to increase the size of an estate that is exempt from tax to $5 million per person ($10 million for a couple) and, more significantly, reduce the top estate tax rate to 15 percent. The Kyl proposal would lose 84 percent of the revenue lost by full repeal, according to estimates by the Congressional Joint Committee on Taxation.[3]

In contrast, retaining the estate tax as it will exist in 2009 under current law, with a top tax rate of 45 percent and a $3.5 million exemption ($7 million for a couple), would lose just 40 percent of the revenues lost through full repeal. The difference in the revenue loss between the two alternatives largely results from the impact of reducing the estate tax rate. That's because most estates that are taxed under current law would not owe tax with a $3.5 million exemption, while most of the revenues generated by the estate tax come from the largest estates, which disproportionately benefit from reducing the tax rate.

Current Law Exemption Levels Leave Only the Wealthiest Estates Subject to the Tax

Increasing the exemption level significantly reduces the number of estates subject to the tax (Table 1). At the current exemption level of $2 million ($4 million per couple) only about one-half of 1 percent of all estates are subject to the estate tax. When the exemption level rises to $3.5 million per person ($7 million per couple) in 2009, as it will under current law, only about three-tenths of 1 percent of estates will be taxable. Stated another way, 997 out of 1,000 estates would pay no estate tax in 2009 under current law with the $3.5 million per person exemption; only three of every 1,000 estates would be subject to the tax.

Table 1: Reduction in Number of Taxable Estates in 2006, Under the Changes Enacted in 2001

	Taxable Estates with $1 Million Exemption (Pre-2001 Law)	Taxable Estates with $2 Million Exemption (Current Law)	Reduction in Number of Taxable Estates	Percent Change
Estates Valued at Less Than $3.5 Million	28,740	4,750	-23,990	-83%
Estates Valued at More Than $3.5 Million	8,310	7,860	-450	-5%
Total	37,050	12,610	-24,440	-66%

Source: Urban-Brookings Tax Policy Center. Totals may not add due to rounding.

Estate Tax Facts

What is the estate tax? The estate tax is a tax levied when large accumulations of wealth are transferred from the estate of a person who has died to the estate's beneficiaries. The estate tax serves as a "back stop" to the income tax, ensuring that income, such as unearned capital gains, that is not taxed during an individual's lifetime is taxed when it is passed from one generation to the next.

Who is affected by the estate tax? In 2006, the tax only applies to estates larger than the $2 million per person ($4 million per couple) exemption level. Since 2001, the exemption level has gradually increased from $1 million per person. The exemption level will reach $3.5 million per person ($7 million per couple) in 2009.

Because of the high exemption levels, only the wealthiest one-half of 1 percent of Americans are subject to the tax today. In 2009, that number will drop even lower to approximately three-tenths of 1 percent (0.3 percent).

The "effective" rate: after deductions, how much do estates actually pay? Because of the large exemption and other deductions, the effective tax rate on estates is lower than the "statutory" or "nominal" rate. For instance, with a $3.5 million exemption per person and a top statutory rate of 45 percent, estates pay an average effective rate of only 9.0 percent. This is lower than the income tax rate imposed on capital gains and on earnings from wages and salaries.

How does the estate tax affect family-owned farms and businesses? A report by the Congressional Budget Office (CBO) concluded that just 4.1 percent of the estates subject to tax in 2000 – when the exemption level was $675,000 as compared to the current $2.0 million – were those of farmers or claimed the deduction for a qualified family-owned business.[5] These estates accounted for 0.1 percent of all deaths in 2000. Had the exemption level been $2 million in 2000, just 258 estates of farmers or family-owned businesses would have owed any tax whatsoever. The CBO also examined whether these estates had sufficient liquid assets to pay any tax owed and found that only 77 estates that would have owed tax with a $2 million exemption had insufficient liquid assets to pay their estate tax liability.

How does the estate tax affect charitable giving? The CBO and others have noted that the estate tax provides an incentive for wealthy individuals to donate to charitable organizations, both while they are alive and through their estate.[6] Repeal, or a substantial reduction of the tax, would remove that incentive. The CBO estimated that if the estate tax had been repealed in 2000, charitable contributions would have been $14 billion to $26 billion lower than they actually were. The CBO analysis suggests that leaving the tax in place for the largest estates would reduce charitable contributions and bequests to a substantially lesser degree.

Cutting the Estate Tax Rate Below Current Levels Loses Substantial Revenues While Only Helping the Wealthiest Estates

The estate tax rate will fall from 46 percent in 2006 to 45 percent in 2007 through 2009. Lowering the estate tax rate further does not reduce the number of estates that are subject to the tax; it only decreases the tax paid by those few remaining large estates facing the tax. Thus, the benefits of Senator Kyl's proposal, which substantially reduces the estate tax rate, go almost entirely to the wealthiest estates (Figure 1).

More importantly, significantly lower estate tax rates will result in large revenue losses. Reducing the tax rate, as proposed by Senator Kyl, accounts for the largest share of the revenue loss, even at the 2009 exemption level of $3.5 million per person (Table 2).

Table 2: What Would Be the Impact of Lowering the Estate Tax Rate?

If the Top Rate Is:	And the Exemption Level per Person Is:	The Share of Estate Tax Revenues Preserved Would Be:
45%	$2 million	78%
45%	$3.5 million	60%
15%	$2 million	32%
15%	$3.5 million	22%

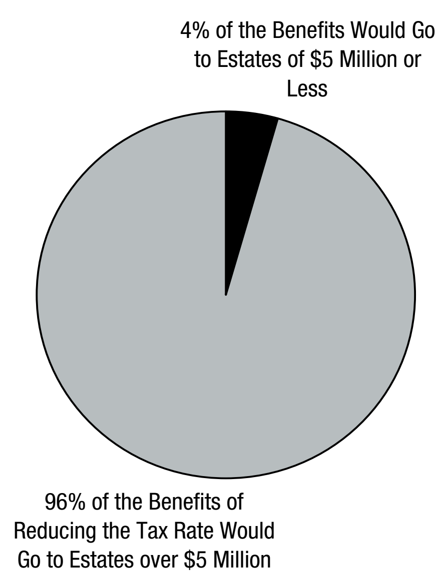
Source: Center on Budget and Policy Priorities from Joint Committee on Taxation and Tax Policy Center estimates

How Many California Estates Pay the Estate Tax?

IRS data show that of the 239,325 Californians who died in 2003, less than 3 percent of their estates – just 6,143 out of 239,325 deaths – paid any federal estate tax.[4] A smaller number pay the estate tax today since the exemption level has increased to $2 million per person.

Figure 1: Most of the Benefits of Reducing the Estate Tax Rate to 15 Percent Would Go to Large Estates

Difference Between Kyl Proposal and Maintaining 45 Percent Rate and $3.5 Million Exemption



Source: CBP calculations from Urban-Brookings Tax Policy Center data

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] Prior to the 2001 tax act, the top estate tax rate was 55 percent and the exemption was $1 million per person. In 2006, the top rate is 46 percent and the exemption is $2 million per person. In 2009, the rate will drop to 45 percent with an exemption of $3.5 million per person. The tax is repealed in 2010 and, under current law, would be reinstated in 2011 at the rate and levels prior to the 2001 tax measure.

[2] Quoted in Joel Friedman, *Estate Tax "Compromise" With 15 Percent Rate Is Little Different Than Permanent Repeal* (Center on Budget and Policy Priorities: Revised June 2, 2006).

[3] Joel Friedman, *Estate Tax "Compromise" With 15 Percent Rate Is Little Different Than Permanent Repeal* (Center on Budget and Policy Priorities: Revised June 2, 2006).

[4] According to the Internal Revenue Service, 5,641 California estates owed tax in 2004 when the exemption was $1.5 million per person. In 2006, the exemption is $2.0 million per person.

[5] Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses* (July 2005), p. 15.

[6] Congressional Budget Office, *The Estate Tax and Charitable Giving* (July 2004).