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Current Federal Estate Tax Supports Public Priorities

By Ben Secord

Introduction

The federal estate tax is set to temporarily expire in 2010 and it is likely that Congress will take up reform legislation this year. Because it is an essential source of federal revenue, these upcoming decisions will have a significant impact on our ability to move forward on the most pressing priorities facing the nation and our state in a fiscally responsible manner.

As Congress moves forward with reform the following are important to consider:

- The estate tax provides significant revenue to the federal government.
- The vast majority of estates (99.8 percent) do not owe any estate tax and very few small businesses and small family farms owe any estate tax.[1]
- Among those estates that do pay the tax, the average estate pays less than one-fifth of the total value of their estate in taxes.[2]

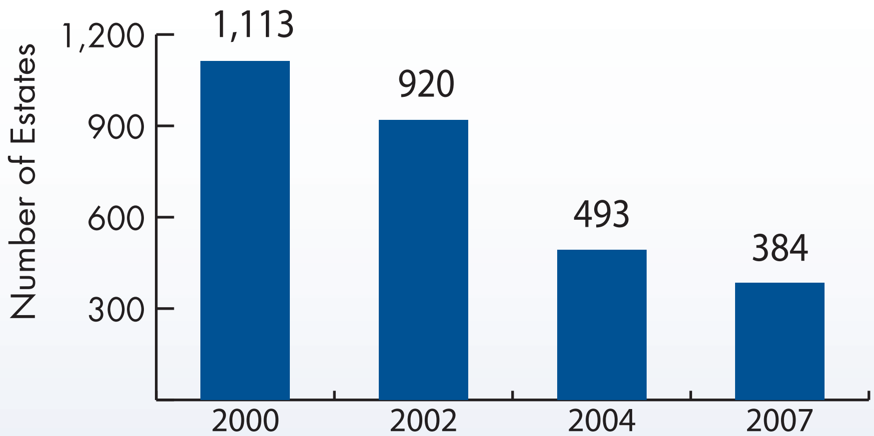
Background

The federal estate tax is a tax levied on an individual's assets at the time of transfer of the estate to heirs. The taxable estate is calculated by assessing fair market value of all assets including cash and securities, real estate, insurance, trusts, annuities, business interests and other assets. Deductions are made for mortgages and other debts, estate administration costs, property left to one's spouse, and donations to qualified charities. Currently, the first $3.5 million of an individual's estate ($7 million for a couple) is exempt from the estate tax. Only the value above that amount is subject to the tax. Many states, including Washington, have state versions of the estate tax as well.

Estate tax revenues have been steadily declining since the Bush tax cuts enacted in 2001. Over that time, per person and per couple exemptions have risen gradually while the top tax rate has fallen. For example, in 2002, the individual exemption was $1 million ($2 million per couple) and the top tax rate was 50 percent. Currently, the exemption is $3.5 million ($7 million per couple) and the top tax rate is 45 percent.

As a result of these changes, the number of estates owing the tax has fallen dramatically. In 2000, when the exemption per individual was $675,000, about two in 100 estates

Figure 1: Number of Estates in Washington Subject to the Federal Estate Tax, 2000-2007



Source: Statistics of Income Data from the Internal Revenue Service (IRS)

nationwide owed some estate tax.[4] Currently, just one in every 500 estates across the country owes any tax, less than one-eighth as many as in 2000.

Here in Washington, the number and share of estates that owed federal estate taxes has dropped significantly in recent years. As Figure 1 above shows, in 2000, more than 1,000 Washington estates paid some federal estate tax. But by 2007, fewer than 400 paid any tax, less than one percent of all estates.[5] Based on national trends and the growing exemption levels, the Tax Policy Center estimates that less than 200 estates would owe the tax in 2011, if current levels are maintained.[6]

The estate tax provides an important revenue stream

The estate tax helps to fund a number of essential investments in areas like health care, education, and national security. From 2000-2008, the estate tax generated annual revenues ranging from $22 billion to $30 billion.[7] Revenues have varied from year to year because of changing exemption levels and rates of taxation and due to the fluctuating number of deceased in any given year.

However, this only tells part of the story. Along with direct revenue lost from the estate tax, there is also money lost from related gift and income taxes and from additional expenditures that accrue from increased interest payments on the national debt. Permanent repeal of the estate tax would cost the treasury more than $800 billion in lost revenue and increased interest payments over the first ten years (2012-2021).[8]

Most people will never pay the estate tax

Levied on only the wealthiest families in the country, the estate tax is the most progressive federal tax. Currently, 99.8 percent of all estates pay no federal estate tax. Weakening the tax would mean a tax cut for only the wealthiest two out of every 1,000 estates—resulting in either a tax shift to less well-off taxpayers, cuts in crucial federal investments, or increases in our national debt.

There is a misconception that the estate tax has an adverse effect on small family-owned farms and businesses. According to an analysis by the Tax Policy Center (TPC), only about 110 small farms and businesses across the country would owe any estate tax in 2011 if the 2009 parameters were made permanent.[9] In Washington State, the TPC estimates that only two small family farms or businesses would owe any estate tax in 2011, under the 2009 parameters.[10] Furthermore, among those small family-owned enterprises that do owe the estate tax, there are protections through a number of exemptions that help mitigate the impact of the tax on their business. (Provisions include allowing farms to appraise real estate holdings at farm use value instead of fair market value, a 14-year installment payment plan and a special deduction for family-owned businesses.[11])

Tax rate is fair and reasonable

At 45 percent, the current highest marginal tax rate may seem high, but that rate is not indicative of what estates actually pay in proportion to their value. The first $3.5 million ($7 million for a couple) is exempt from any tax. As a result, for the estates that owe taxes under current law, the average effective tax rate — the percentage of the estate's value that is paid in taxes — is less than 19 percent. For taxable estates valued at $10 million or less, the average estate tax owed is roughly 11 percent. Even the largest estates—those valued at $20 million and above—pay an average of only 21 percent.[12]

Weighing options for reform

When considering reform options, Congress should ensure that the estate tax generates adequate revenue in an equitable way. It is important to continue provisions that mitigate the impact of the tax on small family enterprises, but those provisions should not be so wide that they create loopholes and encourage abuse.

President Obama has proposed making the 2009 parameters permanent. Compared to current law, the President's proposal would cost $391 billion through 2021. Under this proposal, less than a quarter of one percent of estates would owe any tax in 2011.[13] The 2009 levels were assumed in the Congressional Budget Resolution, passed by both chambers of Congress at the end of April. The Resolution is non-binding, but it does help instruct spending limits for the federal budget.

Enacting the President's proposal would be more fiscally responsible than some other proposed estate-tax changes. Senators Blanche Lincoln and John Kyl have called for weakening the estate tax by raising the exemption to $5 million per individual and $10 million per couple and lowering the tax rate to 35 percent. Only the wealthiest estates stand to benefit from the Lincoln-Kyl proposal, and the wealthiest of these stand to benefit most. Estates valued at $20 million or more would receive an average tax cut of $3.5 million.[14] Between 2012 and 2021, it is estimated that this proposal will cost the federal government $153 billion in lost revenue and increased interest payments when compared to the President's proposal.[15]

In the House, Representative Shelley Berkley has introduced legislation mimicking the parameters of the Lincoln/Kyl proposal. The Berkley proposal phases in the tax cut over time, but it would still be very costly to the treasury. Over the next decade, it would add nearly $100 billion to the federal deficit when compared to the President's proposal.[16] By 2019,

Figure 2: Current Federal Estate Tax Proposals

Proposal	Exemption (Individual)*	Tax Rate	Cost Compared to Current Law (2012-2021)
President Obama (Freeze 2009 Parameters)	$3.5 Million	45%	$391 Billion
Lincoln-Kyl	$5 Million	35%	$544 Billion
Berkley^	$5 Million	35%	$482 Billion

* Exemptions would be doubled for married couples
^ Under the Berkely proposal, the exemption would gradually rise from $3.5 million in 2009 to $5 million in 2019. During the same period, the tax rate would fall from 45 percent to 35 percent.

Source: Center on Budget and Policy Priorities

the parameters would mirror those reflected in the Lincoln/Kyl proposal.

Figure 2 above provides a side-by-side comparison of some of the proposals before Congress. In addition to these proposals, Washington State Representative Jim McDermott has proposed legislation that would generate more revenue by setting the exemption levels according to 2008 parameters, $2 million per individual or $4 million per couple. His proposal also features a progressive rate structure which would tax estates at different rates according to their value.

Conclusion

Given the severity of the current recession and the major investments the federal government must make to spur recovery, the long-term revenue implications of any estate tax proposal should be considered. Estate tax revenue lost over the next ten years will likely result in tax increases elsewhere or significant reductions in investments in key priorities like health care, education and the environment. Adjustments to the tax should be made with the larger budgetary picture in mind. Maintaining a strong estate tax is a step in the right direction toward restoring our long-term fiscal stability.

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Endnotes

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