IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ESTATE TAX REPEAL CONSIDERED BY HOUSE

The House of Representatives is in the process of considering a permanent repeal of the estate tax. The estate tax (but not the gift tax) is scheduled to expire in 2010, but would re-emerge in 2011 without Congressional action.

There are five issues that merit attention as the debate proceeds: treatment of capital gains, revenue scoring, the gift tax, timing, and economic impact.

Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the unified credit and reduced tax rates through 2009, and repealed the estate tax (but not the gift tax) for 2010. For 2010, the Act replaces the step-up in basis at death with an exempt amount of $1.3 million for capital gains taken by beneficiaries, plus an additional $3 million exemption for capital gains taken by a spouse. Any gains above those amounts require the carry-over of the decedent's original cost basis. The exempt amounts would protect about as much of the estate as is now rendered tax exempt by the unified credit, but would subject assets received from larger estates to a capital gains tax.

The bills

The House will vote on H.R. 8 this week. H.R. 8 would repeal the estate and generation skipping tax permanently as of 2010, continuing the 2001 Act's substitution of exempt amounts on capital gains for the step-up at death. The gift tax would remain. H.R. 8 is a vast improvement over current law, and should be adopted.

An alternative approach, H.R. 64, has been offered by Representative Cox. H.R. 64 would repeal the estate, generation skipping, and gift taxes effective January 1, 2005. H.R. 64 would give a better tax result and better timing, but is not the bill being considered.

The Senate may take up the issue later. In the Senate, S. 420 resembles H.R. 8. Senator Sessions plans to introduce a bill to make the same changes as S. 420, but move the effective date to 2005. The sooner, the better.

> ***If we have come to the realization that the estate tax is inherently unfair and counterproductive, then let us end the tax at once.***

Treatment of capital gains

Under pre-2001 law, and through 2009, the tax basis of an ordinary inherited asset (one not in a pension arrangement) is "stepped up" to current market value at the death of the owner. Capital gains accrued by the decedent are "forgiven." The decedent's original tax basis (acquisition cost) of the transferred asset is not "carried over" to the beneficiary. By contrast, proceeds from assets in qualified pension plans and regular IRAs, which were originally tax deferred, are taxed at ordinary tax rates when the beneficiaries withdraw funds from the plans. In effect, they have carry-over basis (zero for pensions and traditional deductible IRAs; the amount of original contributions to non-deductible IRAs).

Repeal of the estate tax would remove a 55 percent tax on the capital gains contained in the largest estates, but repeal of step-up for assets outside of retirement plans would substitute carry-over basis and a 15 percent tax rate on long term capital gains, or ordinary tax rates on short term capital gains, in excess of the exempt amounts. This effort to trim the questionable static revenue loss results in giving only partial relief to beneficiaries of the largest estates. Note that carry-over basis can be tricky to calculate if the decedent did not leave good records for the executor and beneficiaries. (Under current law, gifts retain the original carry-over basis of the donor. Presumably, the donor, who is still alive, provides the information with the gift.)

The idea that ending the step-up in basis is a trade-off for ending the estate tax, and that the repeal of the estate tax warrants elimination of the step-up, is an old tax policy shibboleth. It was recognized that imposing both an estate tax on assets (the price of which may have risen since the asset was first acquired, thus including a capital gain) and a capital gains tax when the asset is sold by the beneficiary of the estate, imposes two taxes on the same capital gain. That was the original reason for enacting the step-up, which eliminates the capital gains tax for assets subject to the estate tax.

However, both the estate tax and the capital gains tax are added layers of tax on saving that do not fall on income used for consumption. They both contribute to the tax bias against saving under the income tax system. Neither treatment would be permitted under a saving-consumption neutral tax system, which most fundamental tax reform systems would adopt. (These are also called consumed-income, or consumption-based taxes, and include the national retail sales tax, the VAT, the Flat Tax, the old and new versions of the USA tax, the cash flow or inflow-outflow tax, etc.).

Under fundamental tax reform, neutral treatment of saving is achieved in one of two ways. Income added to saving may be tax deferred (deducted in the year made) until it is withdrawn for consumption, at which time the principle and returns on the saving are taxed (including the proceeds of asset sales, inclusive of gains, if not reinvested), as in a traditional IRA, 401(k) plan, or pension. Alternatively, income is taxed when earned, the saving is done out of after-tax income, and the returns are not taxed, as in a Roth IRA or tax-exempt bond. Either approach puts the tax treatment of saving on an equal footing with that of income used for consumption.

Current income tax treatment of inherited capital gains is consistent with neutral tax treatment and fundamental reform plans. If the saving that went into the estate was done after-tax, it was not deductible, so excluding a capital gain at death via step-up in basis is appropriate, akin to a Roth IRA. A tax deferred plan that becomes part of an estate, including any capital gains it contains, becomes taxable income to the beneficiary, with no step-up.

Repeal of step-up, albeit for only the largest estates, would be a step backward toward a pure, uniformly biased income tax. Retention of the step-up would be a step forward toward a neutral tax. In effect, it would extend Roth IRA-type treatment to assets held until death.

Gift tax

Elimination of the estate tax should be accompanied by elimination of the gift tax. The gift tax was imposed to block evasion of the estate tax by giving one's assets to one's heirs before death. With no estate tax, the issue is moot.

Revenue scoring

Does the cost of repealing the estate tax require re-imposing a capital gains tax, or leaving the gift tax in place? No. The apparent revenue loss from estate tax repeal is due to a short run focus and static revenue estimation. In the real world, there would be no long run revenue loss.

According to short run, static revenue scoring, repeal of the tax estates tax would cost about $337 billion over ten years (even though the tax is currently running at about $24 billion per year). In the real world, however, the estate tax probably loses revenue over time, and its repeal would raise revenue after a few years.

How can that be? To avoid the tax, many people give their assets away earlier in life than they otherwise would. The recipients are often in lower tax brackets than the donors, so the government loses tax revenue on the subsequent earnings of the assets. Stanford Professor B. Douglas Bernheim has estimated that the loss of income tax revenue from this avoidance technique is larger than the revenue from the estate tax.[1] The estate tax also increases the tax bias against saving and investment and raises the cost of capital, thereby reducing the capital stock, labor productivity, wages, and capital income. Gary and Aldona Robbins of Fiscal Associates estimate that the income tax revenue lost due to the lower wages and capital income is larger than the estate tax revenue.[2] These avoidance and economic responses suggest that the estate tax may be reducing income tax revenue by twice what it seems to raise. The lost income tax revenue would re-emerge over time if the tax were repealed.

An exaggerated estimate of the revenue loss from gift tax repeal led to its retention in the 2001 tax act. The Joint Tax Committee assumed a bizarre scheme by which gifts could be used to duck capital gains taxes if no gift tax were in place. It involved giving one's assets to a foreign friend who could sell them in a country with no capital gains tax, after which the friend would give back the proceeds to the U.S. owner. Alternatively, one could give one's assets to moribund Aunt Maude, who would will them back with a step-up in basis upon her imminent demise. These schemes would be too risky to attempt. The foreign friend might keep the money, and dear Aunt Maude might will the money to darn Cousin Fred instead.

The real objection to the Joint Tax estimate, however, is that the IRS would certainly outlaw the procedure, collapsing it into one taxable sale. Nonetheless, the Joint Tax Committee assumed repeal of the gift tax would lead to a $280 billion "leakage" of capital gains revenue. That estimate, if it has not yet withered from scorn, should be ignored.

Timing and economic impact

The sooner that the estate tax is repealed, the sooner people can stop engaging in wasteful estate planning. With more certainty that the tax will not re-emerge, people would be encouraged to resume the saving, investment, and expansion of family businesses that have been stymied by the tax. The economic gains from the reduction in the tax on capital income would be realized sooner.

Conclusion

If we have come to the realization that the estate tax is inherently unfair and counterproductive, then let us end the tax at once. It is unreasonable to continue the high rate of tax on estates of people who die between now and the end of 2009. It is reminiscent of the senseless slaughter of soldiers in the hours between the time the warring powers agreed to the Armistice that ended the fighting in World War I and the moment it took effect (on the 11th hour of the 11th day of the 11th month of 1918). Who will be the last decedent subject to the estate tax?

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President and Executive Director

Endnotes

1. B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, Lawrence H. Summers, ed., (Cambridge, MA: MIT Press, 1987) pages 113-138.

2. Gary Robbins and Aldona Robbins, "The Case for Burying the Estate Tax," *IPI Policy Report*, No. 150, Institute for Policy Innovation, Lewisville, TX, 1999.
