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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ESTATE TAX REPEAL CONSIDERED BY SENATE

The Senate is expected to vote this week on permanent repeal of the estate tax. The House of Representatives has already voted to make repeal permanent, by passing H.R. 8. The debate is being influenced again by the revenue estimate of the cost of repeal prepared by the Congressional Joint Committee on Taxation (JCT). The JCT estimate is not credible. Repeal would raise, not lower federal revenues. We have written before about peculiar assumptions underlying the JCT work in this area. Sadly, those peculiarities continue to poison the estimates and the debate.

We all pay the estate tax. It is a burden on everyone. It particularly punishes owners of small businesses, and discourages other savers. It retards capital formation, which reduces wages and hurts workers.

Background

The estate and gift tax (federal transfer tax) collects a small amount of revenue but does a great deal of economic damage. It is the third or fourth layer of tax on the same income (income saved rather than income consumed).[1] It discourages capital formation and productivity growth, which reduces wages and hurts workers. It is one of the least efficient federal taxes, in that its high marginal rates create a lot of economic distortion per dollar of revenue raised. If income redistribution is the objective of the tax, there are less damaging ways to achieve it.

In 2001, Congress voted to phase the estate tax out. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the unified credit and reduced estate and gift tax rates through 2009, and repealed the estate tax (but not the gift tax, which would remain in force) for the year 2010, the last year of the (then) budget window. However, if no further action is taken, the estate tax would re-emerge in 2011, and the unified credit amounts and rates for both taxes would revert to pre-2001 levels in 2011.

As a revenue offset for the estate tax repeal in 2010, the Act ended the "step-up in basis at death" for capital gains on assets in estates, as of 2010. Under old treatment, the tax basis for the heir of an inherited asset is not the original price paid by the decedent, but the price at his or her death. Accrued gains are forgiven. Under the 2001 Act, the decedent's original price basis would generally carry over to the heirs, and the capital gains, when taken, would be subject to the 15 percent tax rate on long term gains, and to regular tax rates on short term gains.[2] The Act continues a limited step-up to shelter small estates not now subject to the estate tax from the added capital gains levy.[3]

The Senate vote on H.R. 8

The Senate would follow the House action by voting on H.R. 8, to repeal the estate and generation skipping tax permanently as of 2010, continuing thereafter the 2001 Act's substitution of carry-over basis for the step-up at death, as moderated by the limited step-up to protect small estates. The gift tax would remain, at the reduced tax rate of 35 percent as provided in the 2001 Act.

Revenue scoring

At its peak in 2000, the unified estate and gift tax was collecting $28.9 billion; the estate tax portion was $24.8 billion, and the gift tax portion was $4 billion. The reductions in the 2001 Tax Act are estimated to have brought the total down to $24.8 billion in 2004; $23.4 billion for the estate tax and $1.4 billion for the gift tax. With assets growing over time, these numbers would be expected to rise in the future if the law reverts to the pre-2001 statute. CBO projects combined estate and gift tax revenues of $45 billion in fiscal year 2012 and $61 billion in fiscal year 2015 under old law.[4] (Based on the historical record, about 85 to 90 percent would be estate tax, the rest gift tax.)

The estate tax reduces federal revenue, because of the steps people take to avoid the tax and the damage the tax does to jobs and incomes. Its repeal should be made permanent.

The JCT estimates that permanent repeal of the estate tax will cost about $55 billion in 2012, $73 billion a year by 2015, and $79 billion by 2016. This is more than the tax is projected to raise! (Treasury Department estimates are roughly comparable.)[5] The apparent revenue loss from estate tax repeal in these estimates is due to a short run focus, static revenue estimation, and a truly twisted argument involving the gift tax and purported tax avoidance.

Members of Congress and the media may have thought that the elimination of the step-up was enough to pay for the estate tax repeal, as the JCT scores it. In its tables of so-called tax expenditures, the JCT has estimated that the exclusion of capital gains at death, if old law returns, will cost the Treasury about $65 billion a year by 2010, which is a bit more revenue than the restored estate tax is projected to collect.[6] How, then, could the combination of the two steps — repeal of the estate tax and repeal of the step-up — result in a revenue loss?

Much of the answer is that H.R. 8 retains a limited step-up in basis for the assets of small estates so they would not pay more than under the old estate tax, which reduces the revenue that closing the "tax expenditure" would bring in. To achieve its cost estimate, the JCT must be predicting that nearly all of the saving from the step-up repeal would be lost. Also, according to the JCT, if the tax rate on capital gains on assets held until death falls to 15 percent, many donors will stop giving their assets away while they live in order to avoid the 35 percent gift tax. Thus, the projected gift tax revenues (which are relatively minor, running about $6 billion to $9 billion a year by then) will decline. The JCT counts the decline in the gift tax receipts as part of the cost of the repeal proposal. Given the small size of the projected gift taxes, the cost estimates on repealing the estate tax are a real stretch.

Furthermore, there are two other offsetting factors that need to be considered in the revenue loss estimate which the JCT ignores. First, as will be explained below, gifts can reduce federal tax revenues as well as raise them. Second, the JCT ignores the economic effect of the estate tax on capital formation and wages.

Gift considerations. To avoid the estate tax, many people give their assets away earlier in life than they otherwise would. They may give as much as they like to tax exempt groups. People may also give up to $12,000 a year to each of as many donees as they like without eating into the lifetime unified credit against the estate and gift taxes. Once they give the assets away, they will pay no further income tax on the earnings of these assets, thus avoiding the taxes they would have paid if they kept the assets until death.

The gifts to tax exempt entities also generate an immediate income tax deduction for the donors, and the entities, being tax exempt, will owe no income tax on the subsequent earnings of the assets. Furthermore, individual recipients of these gifts — perhaps younger relatives of the donors — are often in lower income tax brackets than the donors, and will owe less tax on future earnings than the donors would have had to pay. Also, the gifts may be made to the recipients' Roth IRAs and yield no further revenue. In either case, the government loses tax revenue on

the subsequent earnings of the assets (interest, dividends, capital gains, rents, etc.).

Every year, several million households are in a position to make such donations, and to make them year after year to avoid future estate taxes. The totals, and the resulting tax savings, must be enormous. Prior to the 2003 tax rate cap of 15 percent on dividends and capital gains (recently extended through 2010), Stanford Professor B. Douglas Bernheim estimated that the loss of income tax revenue from this gift-related avoidance technique was larger than the revenue from the estate tax.[7] Much of this effect will remain, even under the 15 percent caps, and even if the caps are extended beyond 2010.[8]

Growth considerations. The second offset is that the estate tax 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 and payroll tax revenue lost due to the lower wages and capital income is larger than the estate tax revenue.[9] Combined, these two avoidance and economic responses strongly suggest that the estate tax must be reducing income and payroll tax revenue by more than it brings in, resulting in a net revenue loss to the Treasury. In our opinion, repeal of the estate tax would raise revenue over time.

History of Odd Estimates. Note the irony in the recent flap over the JCT estimates. Back in 2001, Congress was considering eliminating both the estate tax and 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, that issue would be moot. However, when the JCT estimated the cost of repealing both the estate and gift taxes in 2001, it came up with huge revenue loss if the gift tax repeal was included, and spooked the Congress into retaining the gift tax, which is now creating controversy again.

In the 2001 revenue estimating process, the Joint Committee claimed that the gift tax was needed to "protect" capital gains revenue under the income tax from a possible avoidance scheme. The JCT assumed a bizarre plan in which gifts could be used to duck capital gains taxes if no gift tax were in place. It involved giving one's assets (without gift tax) 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 if Congress did not end the step-up provision).

The JCT concern was bizarre, because the scheme would be too risky to attempt. The foreign friend might keep the money (and dear Aunt Maude might bequeath the money to darn Cousin Fred instead). The real objection to the Joint Tax estimate, however, was 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.

So in 2001 the gift tax was retained (albeit at a reduced 35 percent rate) and step-up was ended to protect capital gains revenue to make it O.K. to end the estate tax. Now the JCT is using the argument that extending estate tax repeal would harm gift tax revenue! It seems that no matter what bogeyman is slain to assuage the fears of the JCT, there is always another bogeyman right behind to scare us into keeping bad tax law in place.

Conclusion

We all pay the estate tax. It is a burden on everyone. It particularly punishes owners of small businesses, and discourages other savers. It retards capital formation, which reduces wages and hurts workers. The estate tax reduces federal revenue, because of the steps people take to avoid the tax and the damage the tax does to jobs and incomes. Its repeal should be made permanent.

The Joint Tax Committee's concern about the effect of the loss of gift tax revenue on the total revenue cost of the proposal is foolish. The JCT

revenue estimate ignores offsetting changes in donor behavior and economic activity. If it is taken seriously, and if Congress wants gift tax revenue sooner rather than capital gains revenue later, the solution is to reduce the gift tax rate to the same 15 percent as would be applied to capital gains on assets held until death.

Stephen J. Entin
President and Executive Director

Endnotes

1. The tax system hits income that is saved and invested much harder than income used for consumption. Income is taxed when first earned. If used to buy consumption goods or services, there is no further federal income tax, only a few selected excises. But if the after-tax income is saved to buy a claim on assets, the returns on the saving — interest, dividends, capital gains, and partnership or proprietorship income — are taxed, which is double taxation. In the case of stock, there is an added corporate tax on the corporate income before the dividends are paid, and before reinvestment of retained earnings that raises the share price — triple taxation. If the saving outlives the saver, and the unspent assets exceed a modest exempt amount, the federal unified transfer (estate and gift) tax imposes another layer of federal tax on the already multiply-taxed saving. This is an added layer of tax even for tax-deferred saving, which is subject to the estate tax and is taxed again as income to the heir (if not a spouse). Thus, all saving in estates has already been or will soon be taxed under the income tax, and any taxation of estates is an added layer of tax on saving.

2. The idea that ending the step-up in basis is a required trade-off for ending the estate tax is an old tax policy shibboleth, which we explain in detail in *IRET Congressional Advisory* 185, "Estate Tax Repeal Considered By House". 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 exist in a saving-consumption neutral tax system, which most fundamental tax reform systems would adopt.

3. To avoid a 2010 tax hike on small estates that currently pay no estate tax but would be hurt by losing the step-up, the 2001 Act allowed a partial step-up in basis, up to $1.3 million for assets transferred to general beneficiaries, plus an additional $3 million step-up for assets transferred to a surviving 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 an estate as is now covered by the unified credit, but would subject assets received from larger estates to a capital gains tax, generally 15 percent on long term gains.

4. Nonna A. Noto, "Estate and Gift Tax Revenues: Several Measurements," CRS Report for Congress, Updated March 16, 2006, Congressional Research Service, Library of Congress, Tables 10 and 11.

5. *Ibid*., Table 12.

6. Joint Committee on Taxation, Table: "Estimating Effects of H.R. 8," JCX-20-05, April 13, 2005.

7. 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.

8. The tax rate differential between donors and donees has been reduced somewhat since the 2003 Tax Act, which created 15 percent tax rate caps on qualified dividends and capital gains, reducing the taxes that the donees would have paid on the earnings. However, that same 2003 Act reduced the long term capital gains tax rate from 10 percent to 5 percent for the lowest income earners (those in the 10 and 15 percent tax bracket) through 2007, and a zero capital gains rate in 2008. These caps have recently been extended through 2010, maintaining a significant differential. The caps are due to expire in 2011. Even if they are extended further, there would still be a large tax rate differential on interest, non-qualified dividends, and rents, and a more modest differential on qualified dividends and capital gains, between upper racket donors and lower bracket or tax exempt donees.

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

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.