

# IRET Congressional Advisory

## INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

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### KILL THE DEATH TAX

#### The Federal unified estate and gift tax (a.k.a. the Death Tax)

The Federal government imposes a unified estate and gift tax on transfers of property by lifetime gift or at death, above certain exempt amounts. (See Chart 1.) The rates are graduated. Prior to the Economic Growth and Tax Reconciliation Act of 2001, the bottom marginal tax rates were offset by a credit (exempting the first \$625,000 of an estate in 2001), but once the estate reached taxable levels, the tax

rates started at 37%. The estate tax had a flat top rate of 55% on the largest estates. (The lower graduated tax rates on estates below \$3 million were offset by a higher rate of 60% — i.e., 55% plus a 5% surtax — applied to estates between \$10 million and \$17.184 million). Beneficiaries were allowed a "step-up in basis" for future capital gains on inherited assets. That is, their acquisition price was assumed to be the market value of the assets at the death of the decedent (or at the time of receipt by the beneficiary), rather than the original purchase price of the decedent. This

**Chart 1**  
**Marginal Tax Rate Schedule Of Federal Estate And Gift Tax**

*For 2001*

If Taxable Estate/Gift is: Over:	But not over:	The Marginal Tax Rate is:
\$ 0	\$10,000	18%*
10,000	20,000	20%*
20,000	40,000	22%*
40,000	60,000	24%*
60,000	80,000	26%*
80,000	100,000	28%*
100,000	150,000	30%*
150,000	250,000	32%*
250,000	500,000	34%*
500,000	750,000	37%*
750,000	1,000,000	39%
1,000,000	1,250,000	41%
1,250,000	1,500,000	43%
1,500,000	2,000,000	45%
2,000,000	2,500,000	49%
2,500,000	3,000,000	53%
3,000,000	10,000,000	55%
10,000,000	17,184,000	60%
Over 17,184,000		55%

\* A Credit offsets the tax on the first \$675,000 of lifetime transfers in 2001, effectively making the tax rate zero on transfers below \$675,000.

*Changes in Future Years*

Year	Estate Tax		Gift Tax	
	Top Tax Rate	Lifetime Amount Exempted by Credit	Top Tax Rate	Lifetime Amount Exempted by Credit
2001	60%	675,000	60%	675,000
2002	50%	1,000,000	50%	1,000,000
2003	49%	1,000,000	49%	1,000,000
2004	48%	1,500,000	48%	1,000,000
2005	47%	1,500,000	47%	1,000,000
2006	46%	2,000,000	46%	1,000,000
2007	45%	2,000,000	45%	1,000,000
2008	45%	2,000,000	45%	1,000,000
2009	45%	3,500,000	45%	1,000,000
2010	Estate Tax Repealed†		35%*	1,000,000
2011	Old Estate and Gift Tax Returns‡			

Estate Tax Credit reduced by amt of Credit used against Gift Tax.

\*Gift tax only  
† Estate Tax repealed but bequests may be subject to capital gains tax.  
‡ 2001 Tax Act disappears at end of 2010, unless extended or made permanent.

effectively prevented the double taxation of the asset by the capital gains tax as well as the estate tax.

The 2001 Tax Act provided for a gradual lowering of the tax's top rate, an increase in the credit, and the elimination of the 5% surtax. In 2007, the top marginal rate is 45%, and the amount of estate exempted from the estate tax is \$2 million (but the exemption for the gift tax is only \$1 million). Under the 2001 Tax Act, the estate tax (but not the gift tax portion) will vanish in 2010, but it will reappear in 2011 – at the old, extremely high rates – as the 2001 Tax Act sunsets, unless the Congress votes to extend the 2001 provisions. In 2010, beneficiaries will lose the step-up in basis. It will be replaced by a capital gains basis adjustment of \$1.3 million per estate, plus \$3 million for a surviving spouse.

### Generation skipping tax

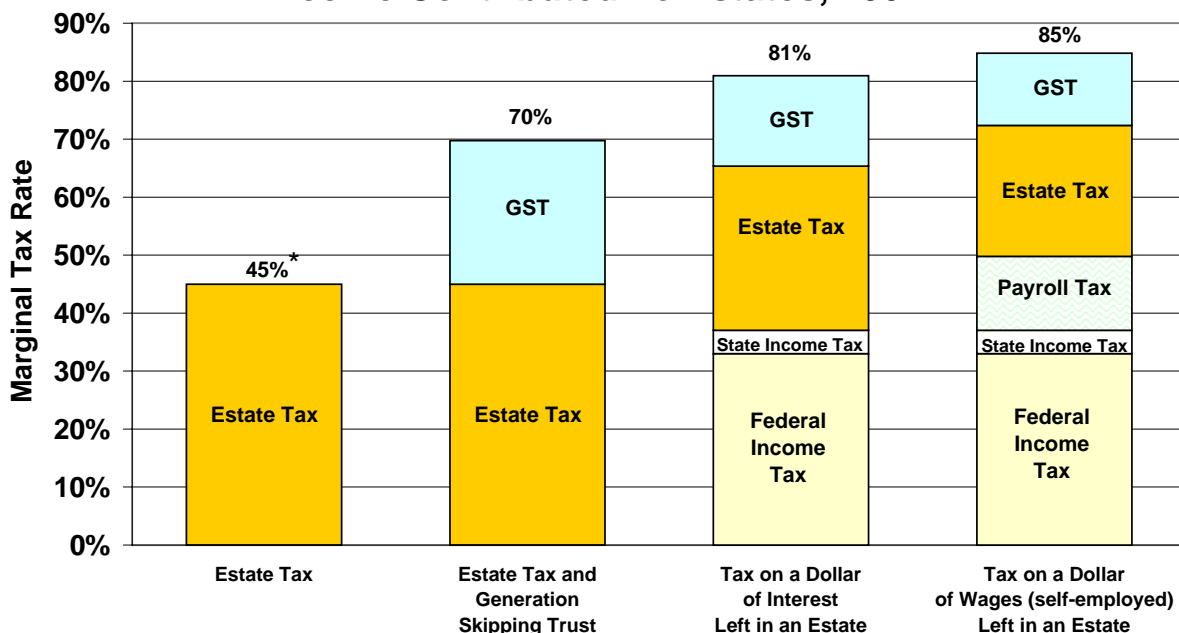
There is an added tax, called the generation skipping tax (GST), if a bequest goes to a grandchild or other relative more than one generation removed

from the decedent. The GST rate is equivalent to imposing a 45% tax on the estate as if it had gone to a child, and then imposing another 45% rate on the remaining 55% of the estate as if it had gone from the child to the grandchild. Congress didn't want to miss out on any potential revenue by letting anyone's death go untaxed! In 2007, the combined GST/death tax rate can reach nearly 70% (69.75%, to be exact). (See Chart 2.) Prior to the 2001 Tax Act, the top rate with the GST was just under 80% (79.75%, to be exact).

### Saving or working to add to an estate brings higher tax rates

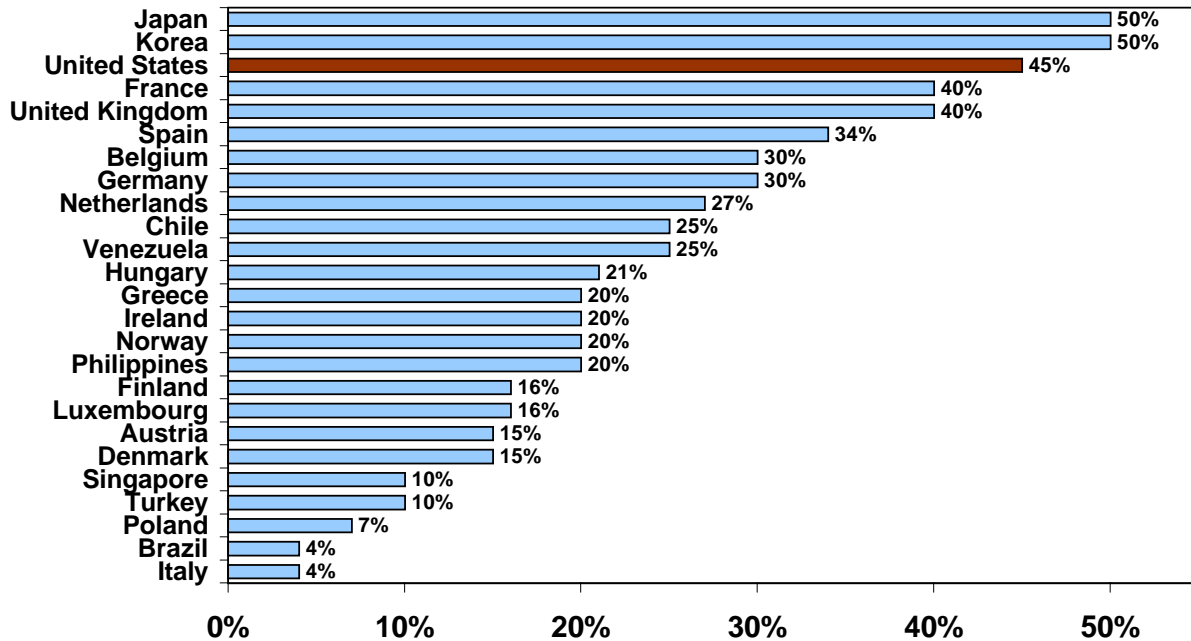
Suppose that a near-to retirement, self-employed, upper-middle income couple, in the next-to-the-top rate tax bracket, were thinking of working an extra year just to add to an estate. Prior to the 2001 Tax Act, their federal income tax rate would have been 35%, and their combined federal and state income, payroll and estate tax rates could have easily exceeded 78% (or even 90% with the GST). That produced quite an incentive to retire instead of continuing to

**Chart 2 Marginal Tax Rates On Estates And Income Contributed To Estates, 2007**



\* 45% Estate Tax Rate becomes effective in 2007.  
Assumes married couple in 33% tax bracket, who are self-employed, with a 6% state income tax.  
Computed prior to Estate Tax Repeal, which is now scheduled for 2010.

**Chart 3**  
**U.S. Death Tax Rate Among World's Highest**



**Source: American Council for Capital Formation, "New International Survey Shows U.S. Death Tax Rates Among Highest," August 2007**

work or to reinvest interest or dividends in an estate. In 2007, the same worker in the current 33% bracket would face tax rates of over 72% (nearly 85% with GST). (See Chart 2.) These rates are scheduled to rebound to the pre-2001 rates in 2011.

**The U.S. death tax rate among highest of industrial nations**

Chart 3 shows that the United States death tax rate is one of the highest in the world. Many leading nations have no death tax, including three of the big-four emerging tigers, Russia, China, and India. Brazil has a top estate tax rate of 4%. Some of the other nations without estate taxes include Canada, Mexico, Sweden, Australia, and New Zealand.<sup>1</sup>

**An added tax on capital formation**

The U.S. tax system punishes the saving and investment that creates jobs and makes the country grow. Income that is saved is taxed more heavily

than income that is used for consumption. The income tax raises the cost of saving by more than the cost of consuming, and tilts behavior away from saving. There are at least four layers of possible tax on income that is saved.

- 1) Income is taxed when first earned. If you use the after-tax income to buy food, clothing, or a television, you can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).
- 2) But if you buy a bond or stock or invest in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits, or capital gains received on the saving (which is a tax on the "enjoyment" that you "buy" when you save).
- 3) If the saving is in corporate stock, there is also the corporate tax to be paid before any

distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business and create a capital gain, corporate income is taxed twice.)

- 4) If a modest amount is left at death, it is taxed again by the estate and gift tax.

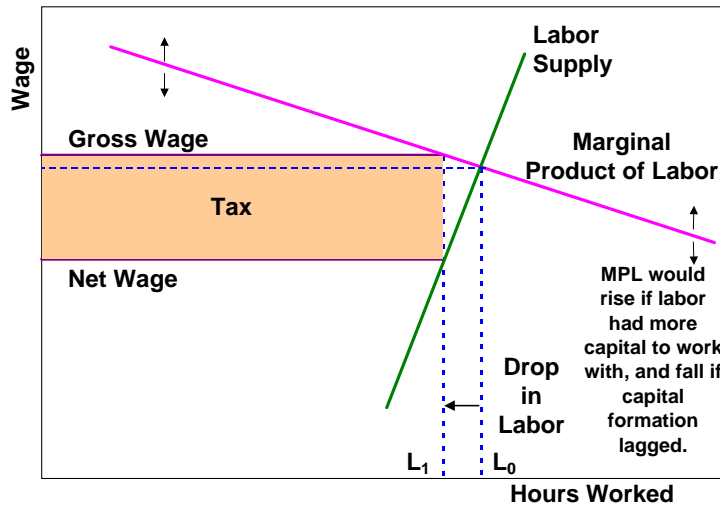
Every cent saved to create an estate has either been taxed already when the decedent (and the companies she or he may have owned shares in) paid income taxes, or, if the saving is in a tax-deferred retirement plan, it will be subject to the heir's income tax. The estate tax is always an extra layer of tax.

**Taxing capital hurts labor by reducing productivity and wages**

Charts 4 and 5 illustrate how taxes reduce the quantities of labor and capital. When you tax something, you get less of it. Any tax is borne in part by the supplier and in part by the consumer or employer of the taxed item, but the split can vary depending on behavior. Furthermore, taxing one factor of production can hurt other factors. Taxes are often shifted from where they are imposed to others in the economy.<sup>2</sup>

The supply of labor is rather inelastic. Primary workers have limited ability to vary their hours worked or participation in the work force, and such workers are assumed to bear most of any taxes imposed on labor, including the income tax and the entire payroll tax, both the employee and employer shares. Second workers in the family, the self-employed, teenagers, and wealthier individuals have somewhat more flexibility, but even they bear most of the tax on their labor income.

**Chart 4 Effect of Tax On Labor**



The quantity of capital is far more sensitive to taxes than is the quantity of labor. It is easy and enjoyable to consume instead of save, or invest abroad instead of in the United States, if the rate of return on saving and investment is driven down by rising taxes. When we tax capital, the amount of plant, equipment, and buildings shrinks until it is again earning a normal rate of return, after tax.

**Chart 5 Effect of Tax On Desired Capital Stock**

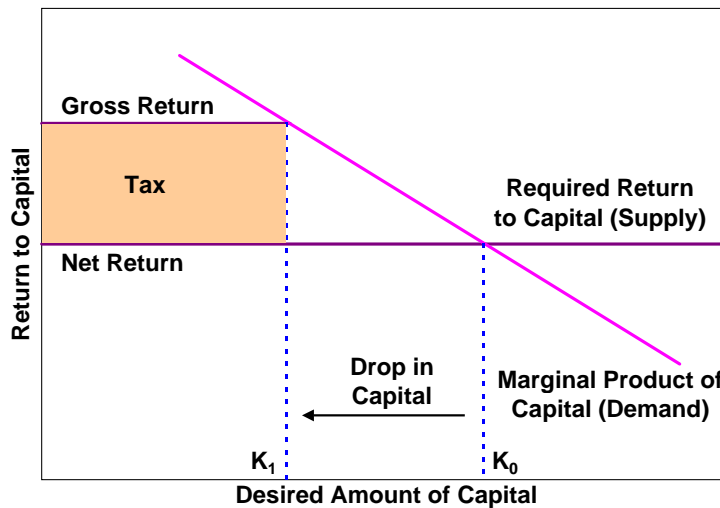


Chart 6 shows that the shrinkage of the capital stock in the presence of high tax rates reduces the productivity of labor, the wage, and the number of jobs. Workers bear the bulk of the taxes imposed on capital.<sup>3</sup> Modern

economists have shown, through numerous studies, that the work force is better off if taxes on capital income are reduced or eliminated.

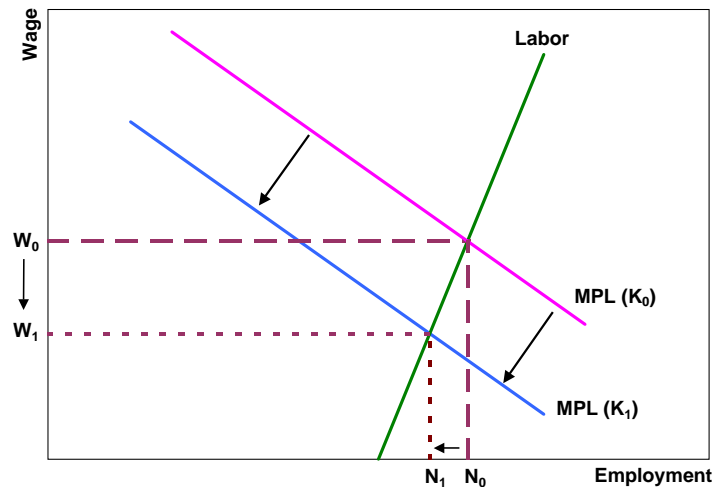
## Death tax, killer of growth and killer of revenue

The estate tax is one of the most egregious destroyers of investment, because its rates are so very high at the margin. It is one of the most inefficient of all taxes. The heirs do not bear the full cost of the estate and gift taxes. These taxes add to the tax on capital formation, and result in a reduced stock of capital. The economic consequences of the reduced capital stock are largely borne by the labor force.

In spite of (or because of) its horrendously high tax rates, the death tax probably doesn't raise any net revenue for the government. Professor B. Douglas Bernheim of Stanford estimates that avoidance of the estate tax by giving assets to children, most of whom are in lower income tax brackets than their parents, costs more in income tax revenue on the earnings of the assets than the estate tax picks up.<sup>4</sup> Gary and Aldona Robbins of Fiscal Associates estimate that the reduced saving and capital formation lower GDP and

wages by so much that the resulting reductions in income and payroll tax collections exceed the estate tax take.<sup>5</sup> If Bernheim and the Robbinses are each even half right, the tax loses money. Estate tax repeal would pay for itself, and would encourage wealth and job creation.

**Chart 6 A Smaller Stock Of Capital Reduces Wages**



We estimate that eliminating the death tax would add about 1.1% to the private sector GDP. Restoring it would eradicate that gain. In today's terms, it would deprive us of \$120 billion per year in lost income, on which the federal government would collect more than \$35 billion in taxes. That is more than the current death

tax brings in (about \$26 billion in 2007) and more than the peak take in 2001 (about \$29 billion).

Taxes that reduce jobs, income, and GDP so much that they actually lose money are insane.

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President and Executive Director

*This paper was originally presented at the American Family Business Institute's Media Briefing and Seminar in Durham, New Hampshire on September 5, 2007.*

## *Endnotes*

1. American Council for Capital Formation Special Report, "New International Survey Shows U.S. Death Tax Rates Among Highest," Washington, DC, August 2007.
2. For more on the economic burden of taxation, see Stephen J. Entin, "Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004.
3. Taxing capital hurts labor a lot. For example, consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?
4. B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, ed. Lawrence H. Summers (Cambridge, MA: MIT Press, 1987) pp. 113-138.
5. Gary Robbins and Aldona Robbins, "The Case for Burying the Estate Tax," *IPI Policy Report*, No. 150, Institute for Policy Innovation, Lewisville, TX, 1999.