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Myths and Realities About the Estate Tax

By Chye-Ching Huang and Nathaniel Frentz

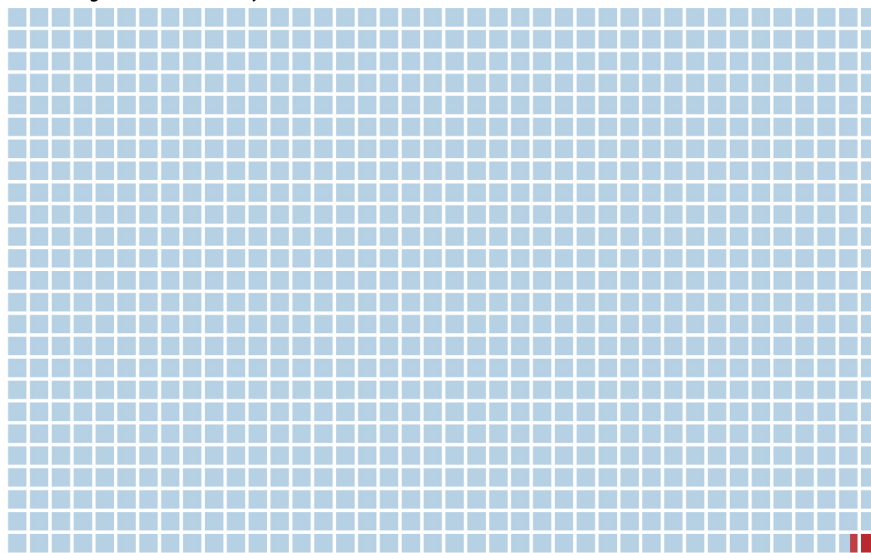
The estate tax is a tax on property (cash, real estate, stock, or other assets) transferred from deceased persons to their heirs. Only the wealthiest estates in the country pay the tax because it is levied only on the portion of an estate's value that exceeds a specified exemption level, currently \$5.25 million per person (effectively \$10.5 million per married couple).¹ The estate tax thus limits, to a modest degree, the large tax breaks that extremely wealthy households get on their wealth as it grows, which can otherwise go completely untaxed. Though the estate tax has been an important source of federal revenue for nearly a century, a number of myths continue to surround it.

Myth 1: The estate tax is best characterized as the “death tax.”

Reality: Everybody dies, but only the richest 0.14 percent of estates pay any estate tax.

The estate tax is best characterized as a tax on very large inheritances by a small group of wealthy heirs. Today, only the estates of the wealthiest 0.14 percent of Americans² — fewer than

Only 1.4 out of every 1,000 estates (0.14%) will owe any estate tax in 2013 according to the Tax Policy Center



2 out of every 1,000 people who die — owe any estate tax whatsoever because of the high exemption amount, which has more than quadrupled since 2001.

¹ The American Taxpayer Relief Act of 2013 set the estate tax exemption to \$5.25 million for 2013 (effectively \$10.5 million for a couple), and indexed that level for inflation in future years. The top rate was set at 40 percent. See Internal Revenue Bulletin 2013-5, *Revenue Procedure 2013-5*, January, 2013, <http://www.irs.gov/pub/irs-drop/rp-13-15.pdf>.

² Tax Policy Center Table T13-0019.

Advocates of repealing the estate tax often call for “killing the death tax,” but, in reality, repeal would amount to a massive windfall for the inheritances of the wealthiest 0.14 percent of Americans. Other observers, such as the columnist E. J. Dionne, have characterized repeal as the “Paris Hilton tax cut.”³

Myth 2: The estate tax forces estates to turn over half of their assets to the government.

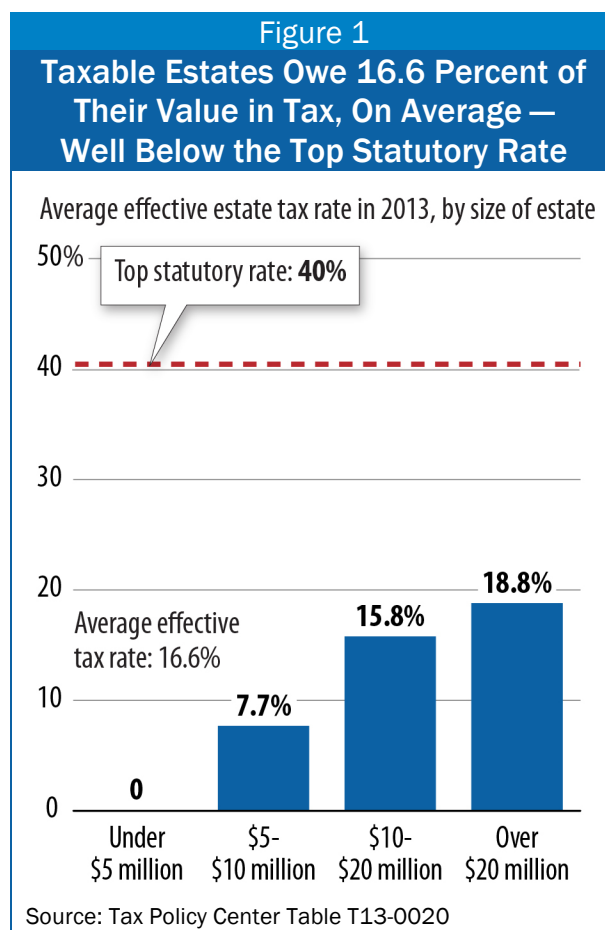
Reality: The few estates that pay any estate tax generally pay less than one-sixth of the value of the estate in tax.

Today, 99.86 percent of estates owe no estate tax at all, according to the Urban-Brookings Tax Policy Center (TPC).⁴ Among the 3,780 estates that owe any tax, the “effective” tax rate — that is, the percentage of the estate’s value that is paid in taxes — is 16.6 percent, on average.⁵ That is far below the top estate tax rate of 40 percent (see Figure 1).

There are several reasons why the effective rate is so much lower than the top rate. First, estate taxes are due only on the portion of an estate’s value that exceeds the exemption level; at the current exemption level of \$5.25 million, a \$6 million estate would owe estate taxes on \$750,000 at most. Second, heirs can often shield a large portion of an estate’s remaining value from taxation through various deductions.⁶

Myth 3: Weakening or repealing the estate tax wouldn’t significantly worsen the deficit because the tax doesn’t raise much revenue.

Reality: Repealing the estate tax would increase the deficit by at least \$200 billion over the next ten years.



³ E. J. Dionne Jr., “The Paris Hilton Tax Cut,” *Washington Post*, April 12, 2005, <http://www.washingtonpost.com/wp-dyn/articles/A45305-2005Apr11.html>.

⁴ Tax Policy Center Table T13-0019.

⁵ Tax Policy Center Table T13-0020.

⁶ See Chye-Ching Huang, “Congress Should Not Weaken Estate Tax Beyond 2009 Parameters,” Center on Budget and Policy Priorities, March 11, 2009, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2356>, and Aviva Aron-Dine and Joel Friedman, *New Estate Tax Anecdotes Dredge Up Old Myth That the Estate Tax Claims Half of an Estate*, Center on Budget and Policy Priorities, June 14, 2006, <http://www.cbpp.org/6-14-06tax.htm>.

TPC estimates that the estate tax will generate about \$200 billion over 2013-2022 under current law.⁷ This is roughly the same amount that the government will spend over this period on the Food and Drug Administration, the Centers for Disease Control and Prevention, and the Environmental Protection Agency combined.

Although significant deficit reduction has been enacted since 2010, when the Simpson-Bowles deficit-reduction plan was released, most budget experts agree that more is needed to address our longer-term fiscal problems as the economy strengthens. Even without the loss of these estate tax revenues, deficit reduction is difficult. Cuts enacted so far will affect funding for programs ranging from education and medical research to law enforcement and environmental protection, as well as for programs that alleviate hardship and expand opportunity for low- and moderate-income Americans. It would be irresponsible for policymakers to add \$200 billion to the task of deficit reduction by cutting the taxes of a few wealthy estates while at the same time asking for further sacrifices from other Americans.

Myth 4: The costs of complying with the estate tax nearly equal the amount of revenue the tax raises.

Reality: The costs of estate tax compliance are relatively modest and are consistent with the costs of complying with other taxes.

Studies find that all of the various public and private costs associated with estate tax compliance — including the Internal Revenue Service’s (IRS) costs of administering the tax and the costs that taxpayers bear in terms of estate planning and administering an estate when a person dies — equaled about 7 percent of estate tax revenues in 1999.⁸ These costs are consistent with the compliance costs for other taxes. For instance, administrative and compliance costs equal about 14.5 percent of the revenue raised by the individual and corporate income taxes and about 2 percent to 5 percent of the revenue raised by sales taxes.⁹

In addition, the number of individuals and estates that bear these costs has fallen markedly as the estate-tax exemption level has risen since 2001.

Part of the confusion around the cost of estate tax compliance is that some estimates incorrectly include the cost of activities that would be necessary even *without* an estate tax — hiring estate executors and trustees, drafting provisions and documents for the disposition of property, and allocating bequests among family members, for example. These activities account for about half of all costs sometimes associated with estate planning.

⁷ Tax Policy Center Table T13-0019.

⁸ Relative to 1999, estate tax revenues are now lower, but there are also fewer taxable estates, and those that are taxable are also much larger on average due to the higher exemption level. As a result, there is no reason to believe that compliance costs as a share of estate tax revenue are necessarily much higher today.

⁹ See Joel Friedman and Ruth Carlitz, *Cost of Estate Tax Compliance Does Not Approach the Total Level of Estate Tax Revenue*, Center on Budget and Policy Priorities, June 9, 2006, <http://www.cbpp.org/cms/?fa=view&id=389>.

Myth 5: Many small, family-owned farms and businesses must be liquidated to pay estate taxes.

Reality: Only a handful of small, family-owned farms and businesses owe any estate tax at all, and virtually none would have to be liquidated to pay the tax.

TPC estimates that only 20 small business and farm estates nationwide will owe *any* estate tax in 2013.¹⁰ (TPC's analysis defined a small-business estate as one with more than half its value in a farm or business and with the farm or business assets

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These 20 estates will owe just 4.9 percent of their value in tax, on average.

valued at less than \$5 million.) This figure represents only 0.00075 percent of all estates — that is, about one out of every 130,000 estates of people who die this year. Furthermore, these 20 estates will owe just 4.9 percent of their value in tax, on average.¹¹

These findings are consistent with a 2005 Congressional Budget Office (CBO) study that exploded the myth that many small businesses and farms have to be liquidated to pay the estate tax.

CBO found that of the few farm and family business estates that would owe any estate tax under the rules scheduled to be in effect in 2009, the overwhelming majority would have sufficient liquid assets (such as bank accounts, stocks, bonds, and insurance) in the estate to pay the tax without having to touch the farm or business.¹² Because the current rules are even more generous than the policies CBO analyzed, even fewer estates today would be forced to sell farm or business assets.

Furthermore, for the few taxable estates that would face any liquidity constraints, there are special provisions written into the law for them — such as the option to spread estate tax payments over a 15-year period and at low interest rates — that would allow them to pay the tax without having to sell off any of the farm assets.

Myth 6: The estate tax constitutes “double taxation” because it applies to assets that already have been taxed once as income.

Reality: Large estates consist to a significant degree of “unrealized” capital gains that have never been taxed; the estate tax is the only means of taxing this income.

Much of the money that wealthy heirs inherit would never face any taxation were it not for the estate tax. In fact, that's one reason why policymakers created the estate tax in 1916: to serve as a

¹⁰ Tax Policy Center Table T13-0020.

¹¹ Tax Policy Center estimates. The average rate falls far below the 40 percent top marginal estate tax rate primarily because of the tax's \$5.25 million exemption (effectively \$10.5 million for a couple).

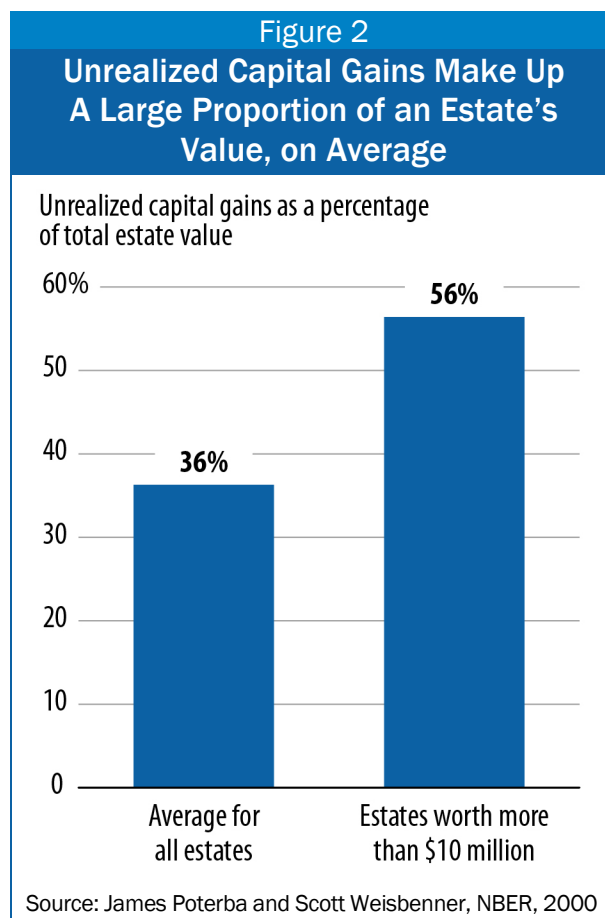
¹² Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses*, July 2005, <http://www.cbo.gov/publication/16897>.

backstop to the income tax, taxing the income of wealthy taxpayers that would otherwise go completely untaxed.

Capital gains tax is due on the appreciation of assets, such as real estate or an art collection, only when the owner “realizes” the gain (usually by selling the asset). Therefore, the increase in the value of an asset is never subject to income tax if the owner holds on to the asset until death.

These unrealized capital gains account for a significant proportion of the assets held by estates — a little more than one-third, according to a study by economists James Poterba and Scott Weisbenner.¹³ For the largest estates, the proportion is higher: 56 percent of the value of estates worth more than \$10 million comes from unrealized capital gains. TPC estimates that in 2013, over half of all taxable estates are worth more than \$10 million and the average taxable estate is worth over \$22 million.¹⁴

The estate tax also serves as a modest corrective to other tax rules that provide massive tax benefits to income from wealth, such as the fact that capital gains are taxed at lower rates than wages and salaries. The top 0.1 percent of taxpayers — those with incomes above \$3.2 million — will receive more than 50 percent of the benefit of the preferential capital gains rates in 2015, worth about \$500,000 apiece.¹⁵ Other tax rules allow part of the income of the very wealthiest to go completely untaxed, even with the estate tax.¹⁶



Myth 7: If policymakers decide to retain the estate tax, the logical top rate would be 20 percent, the same as the top capital gains rate.

Reality: To match the effective tax rate on capital gains, the estate tax would need to be less — not more — generous than the current tax.

¹³ James Poterba and Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains At the Time of Death*, NBER, July 2000, p. 19, <http://www.nber.org/papers/w7811>.

¹⁴ Tax Policy Center Table T13-0020.

¹⁵ Tax Policy Center Table T13-0081.

¹⁶ Chye-Ching Huang and Chuck Marr, “Raising Today’s Low Capital Gains Tax Rates Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits,” Center on Budget and Policy Priorities, September 19, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3837>.

Since the estate tax serves, in part, to tax capital gains that have not otherwise been taxed, some people have proposed taxing estates at the top capital gains rate, which the American Taxpayer Relief Act of January 2013 set at 20 percent. This argument is flawed: the capital gains tax rates typically apply to all capital gains income, whereas the estate tax applies only to the part of an estate that exceeds the exemption level.

Under the current estate tax with a 40 percent top rate, taxable estates face an effective rate of only 16.6 percent. For the effective estate tax rate to match the 20 percent capital gains rate, the tax must be set higher. TPC estimates that if it were set at the 2009 parameters of a \$3.5 million exemption per person (\$7 million per couple) and a 45 percent top rate, then the average effective estate tax rate would be 19.2 percent in 2013, close to the 20 percent top capital gains rate.¹⁷

Myth 8: Eliminating the estate tax would encourage people to save and thereby make more capital available for investment.

Reality: Eliminating the estate tax would not substantially affect private saving, and it would greatly increase government dissaving (i.e., deficits); as a result, it would more likely reduce the amount of capital available for investment than increase it.

A Congressional Research Service report found that the estate tax's net impact on private saving is unclear — it causes some people to save more and others to save less — and that its overall impact on *national* saving, a critical determinant of the amount of capital available for private investment, is likely negative. “[I]f the only objective [of eliminating the estate tax] were increased savings,” the report concluded, “it would probably be more effective to simply keep the estate and gift tax and use the proceeds to reduce the national debt.”

The reason is simple: while repealing the estate tax might lead some people to save more, it also would lead the government to borrow more to offset the lost revenue. Government borrowing “soaks up” capital that would otherwise be available for investment in the economy. In the case of estate-tax repeal, the added government borrowing would more than outweigh any added private saving, leaving the economy no better off and quite possibly worse off.¹⁸

Myth 9: The United States taxes estates more heavily than do other countries.

Reality: Measured as a share of the economy, U.S. estate tax revenues are below the international average for taxes on wealth.

The claim that the United States taxes estates more highly than other countries is based on a misleading comparison of the top *statutory* estate tax rates across countries. As Myth 2 explains, the effective U.S. estate tax rate is well below the top statutory rate. Also, many countries tax accumulated wealth by means of wealth or wealth transfer taxes (such as inheritance taxes) rather than through an estate tax, so international comparisons must take these other taxes into account.

¹⁷ Tax Policy Center Table T12-0325

¹⁸ See Aviva Aron-Dine, *Estate Tax Repeal Would Decrease National Saving*, Center on Budget and Policy Priorities, June 8, 2006, <http://www.cbpp.org/cms/?fa=view&id=352>.

And some countries levy taxes on a broader tax base than others (that is, they allow fewer exemptions and other special preferences). As a result, experts agree that the appropriate way to compare taxes across countries is to look at revenues as a share of gross domestic product (GDP), not at statutory tax rates.

Of the 34 members of the Organisation for Economic Co-Operation and Development (OECD), 28 levied some form of estate tax, inheritance tax, or other wealth or wealth transfer tax in 2010 (the latest year for which full data are available). U.S. estate and gift tax revenues as a share of GDP were well below average among these 28 countries.

Myth 10: The estate tax unfairly punishes success.

Reality: The estate tax affects only those most able to pay, and the funds it raises help support a range of programs that benefit the nation.

The estate tax is the most progressive component of a tax code that overall is only modestly progressive, particularly when regressive state and local taxes are taken into account. The money it raises helps to fund essential programs, from health care to education to national defense. If the estate tax were weakened or repealed, other taxpayers would have to foot the bill for these programs, face cuts in the benefits and services provided, or bear the burden of a higher national debt.

Like other Americans, the very wealthy benefit from public investments in areas such as defense, education, health care, scientific research, environmental protection, and infrastructure, and they rely even more than others on the government's protection of individual property rights (since they have so much more to protect). Bill Gates, Senior, a prominent advocate of retaining a strong estate tax, has explained that wealthy individuals benefit from the government because it "protects their business activities, the traditions that enable them to rely on certain things happening, that's what creates capital and enables net worth to increase."¹⁹

It is appropriate that people who have prospered the most in this society help to preserve it for future generations through tax revenues that derive from their estates. President Theodore Roosevelt stated in 1906 that "the man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government."

¹⁹ Excerpts from a Center on Budget and Policy Priorities conference call, June 1, 2006, <http://www.cbpp.org/6-1-06tax-transcript.pdf>.