

Repeal of the Estate Tax: A Gift For The Rich or the End of an Unfair Burden?

“The [Estate] Tax is the number one reason that family farms, ranches, and small businesses are chopped up and sold in pieces to multinational conglomerates.”¹

--Rep. Christopher Cox (R-Calif.), Chair, House Policy Committee

“In reality, the Estate Tax is a tax on wealth, not death, and affects only the wealthiest 2% of Americans. Poverty, on the other hand, afflicts one in six American children.”²

--William H. Gates, Sr., father of Microsoft founder Bill Gates

In the 2000 presidential campaign, George W. Bush promised that, if elected, he would propose a sweeping program of tax cuts to return much of the projected government surplus to the American taxpayer. Upon being sworn in as President, Bush reiterated his commitment to cutting taxes, in order to “recover the momentum of our economy and reward the effort and enterprise of working Americans.”³ In keeping with this pledge, on May 26, 2001, the President pushed the Economic Growth and Tax Relief Reconciliation Act through Congress. Under this measure, income tax rates will be lowered gradually over the next several years, and various tax credits will be implemented or raised. One of the most controversial provisions of this new tax package is the repeal of the estate tax, a measure that would provide the wealthiest 2% of Americans with a tax cut that, by some projections, could cost the treasury \$294 billion over the next 10 years.⁴

The 2001 tax cut bill phases the estate tax out gradually, leading to complete repeal in 2010. In addition, it lowers all federal income tax rates above the 15% tax bracket incrementally between 2001 and 2006. The total value of the tax cut is estimated by the administration at \$1.35 trillion over the next decade.⁵ All the cuts, however, are due under current law to expire in 2011

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unless Congress re-enacts them permanently. This includes the repeal of the estate tax, which President Bush has asked Congress to make permanent this year.

The President and Republicans in Congress call the 2001 tax cuts good for all Americans, and hail the repeal of the estate tax as a long-overdue measure that will protect farmers and small businesses from an unfair, outdated and burdensome tax. Democrats, on the other hand, have called the Bush tax cut a gift for the very rich that all but ignores middle class families.⁶ The repeal of the estate tax, they argue, is a prime example of how the Bush agenda favors the very rich.

The debate over the estate tax raises important questions regarding the values of American society, and the role of the government in promoting those values. Those in favor of repealing the tax argue that it punishes hard work and discourages saving while making it harder for parents to provide a better life for their children. It threatens farms and small businesses, and taxes wealth that already has been taxed once as income while generating little real revenue. Opponents of repeal argue that the estate tax is a highly progressive measure aimed at the wealthiest Americans, and is an important tool to redistribute wealth and ensure equality of opportunity. It affects only a small percentage of Americans, and helps encourage charitable giving. Its repeal would be costly to both the federal government and the states, and would only benefit the very rich.

Americans have traditionally valued the right of individuals to succeed economically with minimal interference from the government. At the same time, our democratic traditions may be incompatible with the extreme concentration of wealth in the hands of a very few. The government can use its powers of taxation to limit this concentration of wealth, but is it right to do so at the expense of individual liberties?

The debate over the repeal of the estate tax focuses on these very questions. Is the government, through changes in tax laws that include the repeal of the estate tax, reducing an unfair burden on individuals, or is it promoting an unequal concentration of wealth that is incompatible with a political democracy? Is repeal of the estate tax promoting or denigrating the kind of society in which we want to live? In order to answer these questions, it is necessary to first look at what the estate tax is, and its role in the overall tax system.

What is the Estate Tax?

The estate tax is technically called the unified transfer tax.⁷ Essentially, it is a tax on transfers of wealth between individuals. This tax includes gifts given during a person's life, but it is mainly focused on wealth passed through inheritance after death. This has led opponents of the estate tax to refer to it as the "death tax."

All individuals have a lifetime tax credit, currently \$1 million, which can be applied against the estate tax.⁸ This means that the first \$1 million in value of an estate is exempt from taxation. After that, the tax is applied at a marginal rate of between 37-50%, depending on the value of the estate. However, the estate tax does not apply to wealth transfers between spouses, and funeral costs and the legal costs of settling an estate are deducted from the pre-tax value of the estate. Because of these and various other deductions, credits, and estate planning strategies, the effective tax rate is usually far below the marginal rate.⁹ This means that while it may appear that up to half a person's estate may be taxed after death, the actual percentage of an estate subject to the tax is generally much less than that.¹⁰

The current estate tax was enacted in 1916, on the eve of American entry into World War I, and was a valuable source of revenue for the war. The use of an estate tax to finance a war effort was not unprecedented in American history; similar measures were passed during the Civil War and the Spanish-American War but were later repealed. In 1916, however, one of the stated aims of the estate tax was to break up large concentrations of wealth, which were seen as threatening to democracy.¹¹

For much of American history, taxes were viewed primarily as a means of generating revenue for the government. On rare occasions when the federal government levied a tax for purposes other than the creation of revenue, it became a cause of great controversy. Americans in the 19th century were not opposed to paying taxes, necessarily, but they wanted to know they were getting something concrete for their money. They were suspicious about "unnecessary" taxation, and there was little patience for government meddling in private economic affairs, unless that meddling was intended only to help those affairs prosper.¹²

By the turn of the 20th century, however, the increasing concentration of wealth and its perceived political consequences led to a conflict between the long-cherished American values of individualism and equality. The individual pursuit of wealth and economic success with minimal

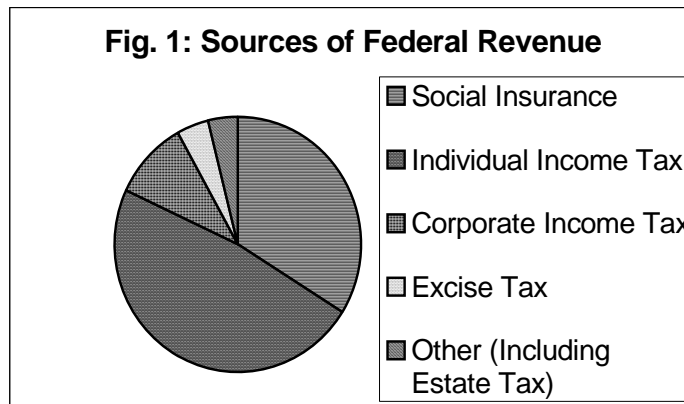
government interference was set against a desire to promote political equality through redistribution of resources.¹³ Up through the start of World War I, the federal government obtained 75% of its revenue from measures like tariffs on imports and excise taxes on “sin” items like tobacco and alcohol, taxes that placed the heaviest burden on those least able to pay. By the end of the war, however, 75% of the federal government’s revenue came from the far more progressive income and estate taxes, shifting a greater share of the burden to the wealthy.

The idea that the rich should pay a greater share of the tax burden had been gaining popularity for some time, and the Wilson administration used the crisis of the war, with its tremendous cost, to shift federal tax policy along those lines.¹⁴ When the estate tax was proposed in Congress, Representative Cordell Hull of Tennessee specifically cited the growing inequality between the rich and the poor and the dangers this imbalance posed to American society as its justification. While the tax passed, critics immediately claimed it was a thinly veiled attempt by the federal government to unlawfully confiscate private property.¹⁵

In 1976, the estate tax was combined with the federal gift tax to form the unified transfer tax. The lifetime credit that can be applied to the estate tax is also applied toward any gifts in excess of \$10,000 per year per recipient, reducing the amount of an estate that is exempt from taxation after death. Gifts to spouses are exempt from taxation. Under the proposed estate tax repeal, a reduced gift tax would remain in force, but this would only apply to wealth transferred during one’s lifetime.¹⁶

Under the 2001 tax law, the lifetime credit was raised from its 2001 level of \$675,000 to \$1 million for 2002, and will continue to rise over the next several years, until it reaches a high point of \$3.5 million in 2009, one year before the tax is repealed. However, unless Congress acts to alter the schedule or make the repeal permanent, in 2011 the estate tax will return with its 2001 credit of \$675,000.¹⁷ In June of 2002, the House passed a bill that would have made the repeal permanent, but it failed narrowly in the Senate. Nevertheless, support for permanent repeal remains strong, and the issue will undoubtedly come before Congress again over the next several years.

Overall, federal revenues totaled \$2.019 trillion in 2001, and over 90% of that was collected through income and social insurance taxes. Individual income taxes made up 48% of all revenue, with social insurance taxes (mainly Social Security and Medicare payroll taxes) totaling another 34%. An additional 10% came from corporate income taxes, with the remaining 8% coming from a variety of smaller sources such as customs duties, excise taxes and the estate tax.¹⁸ In 2001, the estate tax generated roughly \$32 billion in revenue for the federal government, representing less than 2% of total federal revenues.¹⁹

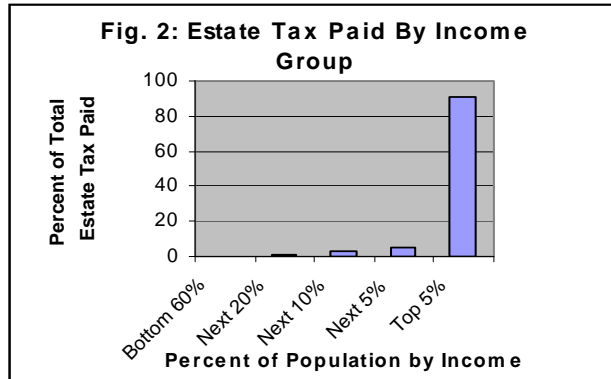


Source: Office of Management and Budget

However, the estate tax is a significant source of revenue for state governments. Most states collect estate taxes in the form of a credit against the federal estate tax. This is called a “pick-up tax,” and means basically that a portion of the federal estate tax is shared by the states, allowing most states to avoid enacting their own separate inheritance taxes that would further burden the taxpayer. In 35 states, there is no estate tax above the level of the pick-up tax. The federal estate tax generates significant revenue for these states, which in 2000 was equivalent to \$5.5 billion.²⁰ If the estate tax is repealed, New York State, for example, would lose roughly 3% of its total revenue, while some states, such as New Hampshire, would lose 4.5% or more.²¹

In 1998, roughly half of all estate taxes were paid by estates valued at \$5 million or more. While opponents of the estate tax argue that it forces heirs to sell small businesses or farms to meet the tax costs, only 3% of all taxed estates had a small business or farm comprising the majority of the value of the estate.²² In addition, under existing estate tax law, those estates in which a family-owned business or farm does comprise a large percentage of the estate value can effectively double the value of their estate tax credit. (See Appendix) Only 2% of all taxpayers

ever pay any estate tax at all, and 91% of all estate taxes are paid by people in the top 5% of the population by income.²³



Source: Center for Budget and Policy Priorities. Based on Data from U.S. Dept. of Treasury Office of Tax Analysis

How can we evaluate taxes?

Is it fair and reasonable to tax wealth? Is the estate tax worth keeping? A short look at how taxes are evaluated may help with these questions.

There are several criteria used by economists to evaluate tax policy. Among these are equity, efficiency, and simplicity. A brief discussion of each of these should be helpful in discussing the estate tax.

Economists generally agree that a tax system should have what is called **vertical equity**. This means the burden of taxation should be distributed fairly according to the ability of people to pay.²⁴ Of course, the definition of a “fair distribution” varies greatly from one person to another.

Taxes are frequently referred to as being progressive or regressive. A progressive tax places a larger relative burden on those with higher incomes, while a regressive tax is more burdensome to those with lower incomes. The federal income tax is a progressive tax, as the tax rate increases according to income. A sales tax is an example of a regressive tax, because sales taxes paid as a share of income are higher for lower income individuals. The estate tax is a progressive tax, since it affects those with large concentrations of wealth, and the rate of tax increases incrementally according to the value of an estate. The estate tax shifts the federal tax

burden toward the wealthiest Americans, who have a greater ability to pay, and therefore could be said to make the federal tax system more progressive than it would be otherwise.²⁵

Another equity concept used to evaluate taxes is **horizontal equity**, meaning that people at the same condition or level of income should pay the same tax. In the case of the estate tax, horizontal equity would mean that two people with an estate valued at \$1 million should pay the same tax. Critics of the estate tax argue that with estate planning and various other avoidance strategies, two estates of the same value could pay very different taxes.²⁶

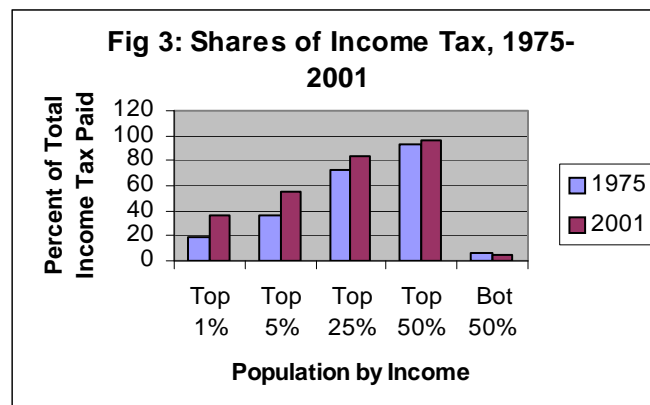
Efficiency has to do with the ability of a tax to generate enough revenue to justify the cost to the taxpayer. In this context, *cost* refers to more than just the amount of tax paid, but also changes in the behavior of the taxpayer to avoid or reduce that amount. If a tax is levied on a popular item, and rather than pay the tax people stop buying the item and substitute another good, the tax would not generate much revenue, yet it would still have a cost to the people who adjusted their buying behavior. The cost, in this case, is not just the tax revenue, but also the loss in well being caused by changing consumer behavior. This cost is referred to as the *excess burden* of a tax.²⁷

As will be discussed below, much of the argument for repeal of the estate tax centers on the idea that it causes people to alter their behavior during life to avoid the tax, by reducing savings and investment and increasing consumption so that less of an estate remains at death. These behaviors, by reducing work effort and investment, may have a cost that outweighs the revenues collected by the tax.

Simplicity is a fairly straightforward concept. How easy is a tax to understand and administer? Is it difficult or costly for the government to collect the tax, and is it easy for people to avoid paying the tax? In the case of the estate tax, another important criticism is that it lacks simplicity. According to the Internal Revenue Service, the average amount of time it takes to complete the estate tax return is 36 hours, or roughly one work week.²⁸ In addition, there are a variety of tax avoidance strategies that are rather complicated and frequently involve complex estate planning over a period of years, but which allow many of the wealthiest estate holders to avoid or significantly reduce their share of the tax.

The Federal Tax System and the Role of Taxes on Wealth

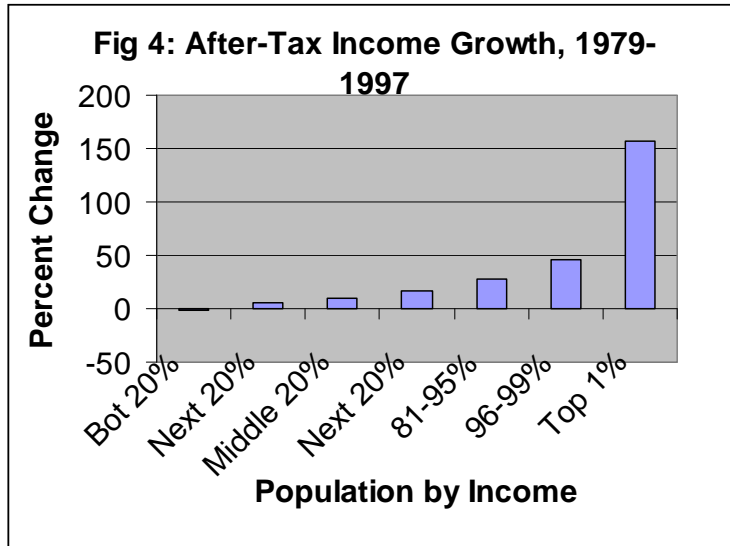
As noted above, individual income taxes comprise nearly 50% of total federal revenues. According to data released by the IRS, the richest 1% of Americans pays 36.18% of all federal income taxes, and the richest 5% of Americans (on whom most of the estate tax burden falls) pays 55.45% of federal income taxes. The richest 25% pays over 83%, and the top 50% of the population pays a whopping 96% of total individual income taxes. The poorest half of Americans, therefore, pays only 4% of all federal income taxes.²⁹



Source: Congressional Joint Economic Committee and National Center For Policy Analysis

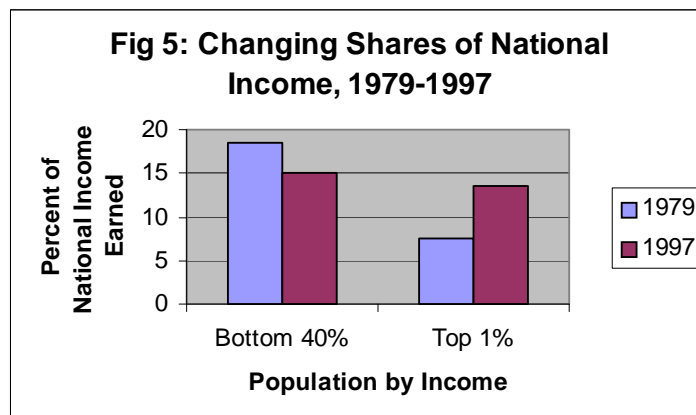
These numbers have risen sharply since the 1970s. In 1975, the top 1% of the population paid only 18.7% of income taxes, and the top 5% paid 36.6%.³⁰ The increasing share of the tax burden paid by the richest Americans, according to the Congressional Budget Office (CBO), is more a result of the skyrocketing wealth of that segment of the population than any increase in taxes, however.³¹ The richest Americans are richer than ever before, and therefore pay a larger share of the federal income tax.

The debate over the estate tax occurs at a time when the gap between rich and poor has been rapidly increasing. According to a 2001 study by the Congressional Budget Office, between 1979 and 1997 the richest 1% of Americans saw their after-tax income increase by 157%. The middle 20% saw their income grow by only 10% in the same period, and the poorest 20% of the population actually saw their after-tax income decline by 1%.³²



Source: Center for Budget and Policy Priorities

After-tax income disparities in 1997 were the largest ever recorded by the CBO. In 1979, the richest 1% of the population received 7.5% of the national income, while the bottom 40% received 18.5%. In 1997, the richest 1% received 13.6% of the national income, while the share of the bottom 40% of the population declined to 15%.³³



Source: Center for Budget and Policy Priorities

Taxing wealth helps the tax system meet certain overall objectives, and may reduce some of these disparities. For example, the estate tax is one way to compensate for certain weaknesses in the income tax. Capital gains, or the growth in the value of investments over time, are a form of income, yet they are not taxed unless an investment is sold. When an investment is sold a capital gain is realized and is taxed under the capital gains tax. Neither the capital gains tax nor the income tax, however, covers unrealized capital gains.³⁴ Unrealized capital gains may form a

significant part of a person's estate. For example, if someone purchased Microsoft stock in the early 1980s, and held on to it as its value skyrocketed over the next two decades, the value of that stock could form part of his or her estate, but would never have been subject to taxation.

A wealth tax, like the estate tax, partially compensates for this by taxing assets at their value at the time of death. So while the person in the example above never paid taxes on the wealth they gained through their Microsoft stock during life, their heirs would pay taxes on the value of those assets at the time of the original holder's death. By some estimates, unrealized capital gains comprise as much as 37% of the value of estates worth more than \$1 million and as much as 56% of the value of estates worth more than \$10 million.³⁵

Furthermore, taxing wealth increases the progressive nature of the tax system. Individuals with large concentrations of wealth have a greater ability to pay a significant share of the tax burden. Taxing wealth is one more way of shifting some of that burden from the poor to the rich.

Another argument for the taxation of wealth is that wealth-holders benefit from certain services provided by the government. One of the goals of national defense, for example, may be to preserve property and protect wealth from enemies. Investments in infrastructure such as roads and highways similarly benefit the wealthy by promoting economic growth and activity, creating opportunities for them to expand their wealth.³⁶

Finally, taxing wealth is one way of reducing the gap between the rich and poor by redistributing income. In a democratic society, a highly unequal distribution of wealth and income may be viewed as undesirable. If it is true that the wealthy are better able to exercise political power and influence, then having a large proportion of a society's wealth concentrated in the hands of a very few raises important questions about political equality.³⁷

Because the vast majority of the estate tax is paid by the wealthiest 5% of Americans, and over 50% of the wealth of the largest estates is in the form of unrealized capital gains, estate tax repeal would benefit a segment of the population that has already experienced a dramatic increase in its share of the national wealth. Citizens for Tax Justice, a liberal tax lobbying group, calculates that the 2001 tax cuts will be worth an average of \$44,800 a year for the wealthiest 1% of Americans. By contrast, the average figure for the bottom 60%, according to their numbers, is \$95.³⁸

Arguments for Repeal of the Estate Tax

One of the criticisms of the estate tax is that few of the wealthiest Americans actually pay their full share of the tax. Estate planning strategies, which generally require the assistance of a lawyer and can be very expensive, make it possible for large estates to greatly reduce their estate tax liability. It is possible for two estates of roughly equal value to pay vastly different estate taxes because of estate planning, which raises questions regarding the tax's equity.³⁹

Opponents of the estate tax often refer to it as the "death tax." They call it a "virtue tax" that penalizes hard work and discourages saving. Rather than save money throughout their lives only to have the government take a large share of it when they die, wealthy Americans may be more inclined to consume their wealth during their lifetimes.⁴⁰ This loss of savings and investment ultimately has a negative impact on the federal income tax, increasing the overall cost of the estate tax.⁴¹ If true, this would suggest that the estate tax is inefficient, conferring an excess burden on the taxpayer that has negative economic consequences.

Since income that otherwise would have been saved or invested is consumed to avoid the estate tax, the tax has had the effect of reducing the capital generated by the economy, inhibiting economic growth. The Heritage Foundation, a conservative think tank that favors repeal of the estate tax, has estimated that immediate repeal of the estate tax could raise the output of the U.S. economy by \$11 billion over the next 10 years, creating thousands of new jobs in the process.⁴²

In addition, opponents argue the estate tax does not actually generate revenue. Filing an estate tax return is a very time consuming affair, and it is very costly for the government to administer the tax. The complexity and cost of administering the estate tax, combined with the other costs incurred through reduced savings and investment, more than equal the total revenue collected by the tax.⁴³

The estate tax lacks horizontal equity, then, because the level of tax liability is depends more on the ability of the estate holder to plan carefully than on the value of the estate. It is not efficient because it leads to changes in behavior that limit the revenue collected by the tax and that have negative consequences elsewhere in the economy. And it is not simple because estate planning is very time consuming and the filing of estate tax returns even more so, usually requiring the expensive services of a lawyer, and administering the tax is complex and costly to the government.⁴⁴

The estate tax is also unfair, argue its opponents, because it represents “double taxation.” The wealth that it taxes was already taxed once as income. This is true in some cases, but as stated above, a significant portion of the value of the largest estates is in the form of unrealized capital gains, which have not been previously taxed.

The most frequent and popular argument in favor of estate tax repeal, however, is that the estate tax hurts farmers and small business owners. It is nearly impossible, according to this theory, for farms and small businesses to remain in families after the death of the owner, because they are forced to sell in order to pay estate taxes.⁴⁵ However, the American Farm Bureau Federation, a lobbying group that favors estate tax repeal, has been unable to find an example of a single farm that was sold due to estate taxes.⁴⁶ In 1998, farm assets made up a majority of only 1.6% of all farms that had any estate tax liability. Farms and family businesses represented only 4% of the assets of all taxed estates worth less than \$5 million.⁴⁷ In addition, there are a variety of legal protections for farms and small businesses to protect them from being sold off to pay estate taxes. (See Appendix.)

To summarize, then, those who favor repeal of the estate tax argue that it is a misguided attempt to redistribute income that the wealthiest Americans can avoid, that it has a number of negative effects on the economy, fails to generate any revenue, and is harmful to the interests of farmers and family-owned businesses. It wrongly penalizes behavior that has always been highly valued in America, namely hard work, saving and investment, and it represents a form of double taxation. The economy and society would be better off if the government would just leave wealth in the hands of those who earned it, to invest and pass on to their children as they see fit.

Arguments against Repealing the Estate Tax

Supporters of the estate tax argue that it is one of the fairest and most progressive taxes on the books. It does not affect 98% of all taxpayers at all, and the 2% that do pay estate taxes are among the richest members of society. Less than 1% of estate taxes are paid by people in the bottom 80% of the population by income.⁴⁸ Thus, the estate tax has significant vertical equity.

In addition, even among those who do incur estate tax liability, the tax burden is not terribly high. After various deductions, exemptions, and the effect of estate planning, only an

average of about 6% of the value of an estate is actually paid in taxes.⁴⁹ While it may be true that many wealthy people manage to avoid much of the estate tax, this is an argument for strengthening it and reducing loopholes, not repealing it.

The estate tax may also encourage saving, rather than discourage it. If a parent wants to leave an estate of a particular size to their child, they must save above that amount to compensate for the estate tax.⁵⁰ This suggests the estate tax promotes positive changes in behavior, rather than negative, weakening any excess burden argument against the estate tax. Included in this positive behavior is the incentive toward charitable giving provided by the estate tax, as discussed below.

Furthermore, it is the heirs who ultimately pay the estate tax, and inheritance is an accident of birth. The estate tax could in this sense be considered a tax on “luck,” and therefore helps promote equality of opportunity.⁵¹ Inheritance by itself may also discourage hard work and promote laziness, as heirs can live off the wealth accumulated by their parents.⁵²

Revenue is a secondary consideration to the estate tax if its primary function is to redistribute income and reduce inequality. Nevertheless, argue its supporters, it *does* generate income, especially for state governments, many of which are now preparing to enact their own estate taxes to make up for their lost share of the federal tax.⁵³ The Congressional Joint Committee on Taxation has estimated that immediate repeal of the estate tax would cost the federal government \$660 billion over a 10-year period, in part by encouraging new forms of income tax avoidance.⁵⁴ In fairness, opponents of the estate tax point out that this figure ignores any positive economic and behavioral effects repeal might have.⁵⁵

One of the most important points made by supporters of the estate tax, however, is that it encourages charitable giving. Because charitable donations are tax deductible, many wealthy people leave sizable bequests to charity at their death, which reduces the value of their estate that is subject to taxation. For the largest estates, those valued at over \$20 million, every \$1000 given to charity reduces their tax liability by \$500. In 1997, estates in this category gave \$7.5 billion in charitable bequests, averaging over \$41 million per estate.⁵⁶ A study by the U.S. Treasury department in 2000 estimated that charitable bequests would decline anywhere from 0 to 31% if the estate tax is repealed, and former President Clinton used the projected impact on charitable donations as justification for vetoing a repeal of the estate tax near the end of his second term.⁵⁷

Supporters of the estate tax suggest that even if the tax by itself is not an effective means of directly redistributing wealth, it has significant distributive effects through its impact on charitable giving. The taxpayer ultimately has “a choice between giving his or her wealth to charity or giving it to the government.” In this sense, the estate tax encourages the private sector to provide services for the poor that the government might otherwise have to provide.⁵⁸

As things currently stand, the debate over the estate tax takes is an all-or-nothing contest between permanent repeal or restoration of the estate tax. However, there are options short of outright repeal that might serve some of the needs of both sides.

Alternatives to Repeal

There are a number of ways that the estate tax might be reformed to correct many of its flaws. Several protections already exist for family-owned businesses and farms, for example, but expanding exemptions for these categories of assets and raising the lifetime credit could increase these protections. In addition, the various loopholes that allow many of the wealthiest estates to reduce or avoid the tax could be removed.

One proposal for accomplishing this would be to combine the estate and gift tax with the income tax. When a person receives an inheritance under such a system, it would be taxed as part of their overall income.⁵⁹ This would serve to emphasize the fact that the estate tax is meant to be a tax on the recipient, not the donor.

Another alternative would be to lower the top marginal rates for the estate tax from its current level of 50% to bring it more directly in line with the top income tax rate. At the same time, the lifetime credit could be raised to further focus the tax on the very wealthy.⁶⁰ The 2001 tax law actually incorporates both of these strategies, but goes on to ultimately eliminate the estate tax before gauging their effectiveness.

Some opponents of the estate tax have also proposed changes to the capital gains tax in order to ensure that unrealized gains would be taxed even if the estate tax were repealed. Basically, these changes would make certain that if an heir sells an investment, they pay a capital gains tax based on the change in value of the investment from the time the original owner purchased it, rather than from the point that they inherited it from that owner. This was actually part of the 2001 tax bill, but it is unclear how it will be administered, and it requires extensive

records to be kept by the investor over long periods of time. Because of these difficulties, the Joint Committee on Taxation estimated that this change to the capital gains tax will only recoup 13% of the taxes on unrealized gains that the estate tax would collect over the next 10 years.⁶¹

Appendix

The Federal Unified Transfer Tax

The tax has three components: The Estate Tax, the Gift Tax, and the Generation-skipping Transfer Tax. It is usually collectively referred to as the Estate Tax or the Death Tax.

Gift Tax: Tax on all transfers of wealth between individuals during life, in excess of \$10,000 per individual per year. All amounts over \$10,000 applied to lifetime unified credit. Couples can effectively give up to \$20,000 per recipient per year in tax-free gifts.

Estate Tax: Tax on inherited wealth. The value of any estate over the level of the lifetime unified credit (currently \$1 million) is taxed at a marginal rate ranging from 37% to 50%, depending on the size of the estate.

Generation-Skipping Transfer Tax: This is a tax on wealth transferred through trust funds designed to skip a generation. For example, if a grandparent establishes a trust fund for their grandchildren, that fund is subject to the GST. The value of the fund is also applied to the lifetime unified credit. This tax was created to eliminate one means of avoiding the estate tax, by creating generation-skipping trust funds that would reduce the effective size of an estate left at death while allowing the decedent to pass on much of that value to their heirs tax-free.

It has been noted that the effective tax rates under the estate tax are generally lower than the marginal rates, due to deductions allowed for charitable contributions, funeral costs and other estate expenses, and estate tax planning strategies. Table 1 lists effective vs. marginal rates in one year.

Table 1: Marginal vs. Effective Estate Tax Rates in 1997

Estate Size	Marginal Rate	Effective Rate Paid
\$600,000-\$1 million	37%-39%	5.45%
\$1 million-\$2.5 million	41-49%	16.47%
\$2.5 million-\$5 million	53-55%	25.13%
\$5 million-\$10 million	55%	26.81%
\$10 million-\$20 million	55%	24.28%*
\$20 million+	55%	14.06%*

Sources: Center for Budget and Policy Priorities and Citizens For Tax Justice

* Estates upwards of \$10 million pay a lower effective rate than estates between \$5 million and \$10 million due to a combination of estate tax planning and charitable deductions. According to Citizens for Tax Justice, up to 40% of the value of estates over \$20 million is donated to charity, greatly reducing their estate tax liability.

Estates that Receive Special Treatment Under the Estate Tax⁶²

Estates consisting of farms or family-owned businesses receive a number of special protections from the estate tax. These include:

If family members have been involved in the operation of the farm or business for a number of years before the decedent's death, and if they remain involved for 10 years after the decedent's death, the farm or business's value is calculated well below its market value for the purposes of the estate tax, reducing tax liability.

The lifetime deduction that can be applied to estates in which the majority of the value is a family business or farm is approximately double that applied to other estates. In 2001, for example, instead of a credit of \$675,000, such estates received a credit of \$1.3 million.

If a farm or family business accounts for more than 35% of the total value of an estate, the estate is eligible for tax deferral. Estate tax payments can be stretched out over 14 years, including 5 years' deferred interest, to protect such estates. The deferred tax payments receive preferential interest rates beginning at 2%, dependent on the value of the farm or business.

All of these measures are designed to prevent family businesses or farms from being sold to meet estate tax payments.

The 2001 Economic Growth and Tax Relief Reconciliation Act

Details of the 2001 Tax Bill, From the *New York Times*, May 26, 2001

2001 Tax Rebate: \$300 for individuals, \$600 for married couples mailed out in 2001

Income Tax Changes: All income tax rates above 15% to fall 1 point in 2001

New 10% tax rate applies to first \$6,000 taxable income for singles, \$12,000 for couples

Top income tax rate of 39.6% falls to 36% by 2006

36% rate falls to 33%

31% rate falls to 28%

28% rate falls to 25%

15% rate remains the same

Income limits on itemized deductions revised upward beginning 2006

Child tax credit rises from \$500 to \$600 in 2001, will continue to rise gradually to \$1000 by 2010

Standard deduction for married couples rises gradually until it is twice that of single taxpayers

15% tax bracket expanded to include more of a couple's income

Income limit for Earned Income Tax Credit expanded by \$3000 by 2008

Estate Tax Changes: Top marginal rate drops from 55% to 50% in 2002, and will hit 45% by 2009

Lifetime credit of \$675,000 rises to \$1 million in 2002, \$1.5 million in 2004, \$2 million in 2006, \$3.5 million in 2009

Estate Tax is repealed in 2010, although it would automatically return in 2011 unless Congress makes repeal permanent

Gift Tax is retained on some gifts but at a reduced rate

Other Changes: Raises tax-favored or deferred contribution limits to several types of retirement planning accounts, including Roth IRA's and 401(k) plans.

Reduced deduction for higher education tuition among high income groups (over \$130,000 a year)

Contribution limits for tax-favored education accounts raised from \$500 to \$2000

Limits on deductibility of student loan interest removed.

Notes

¹ *The Hill*, April 26, 2001.

² *Washington Post*, February 16, 2001.

³ Bush Inaugural Address, Jan. 20, 2001.

⁴ Iris J. Lav and Joel Friedman, "Estate Tax Repeal: A Costly Windfall for the Wealthiest Americans," Memo from the Center on Budget and Policy Priorities (February 6, 2001), 4.

⁵ *New York Times*, May 26, 2001. See Appendix for details on the tax cut.

⁶ *Ibid.*

⁷ See appendix for more details on the components of the unified transfer tax.

⁸ This was formerly \$675,000, but was raised to \$1 million as part of the 2001 tax law.

⁹ Lav and Friedman, "Estate Tax Repeal," 7.

¹⁰ See Appendix.

¹¹ Barry W. Johnson and Martha Britton Eller, "Federal Taxation of Inheritance and Wealth Transfers," Internal Revenue Service Report (2001), 10.

¹² Robert H. Weibe, *Self-Rule: A Cultural History of American Democracy* (Chicago: University of Chicago Press, 1995), 69.

¹³ *Ibid.*, 223.

¹⁴ Nell I. Painter, *Standing at Armageddon: The United States, 1877-1919* (New York: W.W. Norton & Co., 1987), 315-317. The rise of a new class of super-rich industrialists at the end of the 19th century, and the increasing demands placed on the federal government by a modern industrialized society, helped give rise to the notion that the burden of the government's increasing expenses should be born by the rich.

¹⁵ Johnson and Eller, 10.

¹⁶ See appendix.

¹⁷ *New York Times*, May 26, 2001.

¹⁸ "A Citizen's Guide to the Federal Budget: Budget of the United States Fiscal Year 2001," Office of Management and Budget Publication. <http://w3.access.gpo.gov/usbudget/fy2001/guide02.html> June 18, 2002.

¹⁹ Patrick M. Rooney and Eugene R. Tempel, "Repeal of the Estate Tax and its Impact on Philanthropy," *Nonprofit Management and Leadership* 12 (Winter 2001), 201.

²⁰ Lav and Friedman, 13-15.

²¹ Citizens for Tax Justice Press Release, June 19, 2001. Most states would lose between 1-3% of their total revenue.

²² Rooney and Temple, 197.

²³ Lav and Friedman, 6.

²⁴ Harvey S. Rosen, *Public Finance*, Second edition (Homewood, Ill.: Richard D. Irwin, Inc, 1988), 321.

²⁵ Robertson Williams, G. Thomas Williams, and Richard Kasten, "Options to Cut Taxes," Congressional Budget Office Memo, June 2000, 14.

²⁶ Dan Miller, "The Economics of the Estate Tax," Report by the Congressional Joint Economic Committee, (2000), 22.

²⁷ Rosen, 292.

²⁸ Miller, 23.

²⁹ "New IRS Data On Income Shares Now Available," Congressional Joint Economic Committee Press Release (January 14, 2002)

³⁰ Bruce Bartlett, "Tax Yield Curve Shows Progressivity of Tax System," National Center for Policy Analysis Opinion Editorial (Jan 21, 2002) <http://www.ncpa.org/edo/bb/2002/bb012102.html> (May 22, 2002)

³¹ Isaac Shapiro, Robert Greenstein, and Wendell Primus, "Pathbreaking CBO Study Shows Dramatic Increases in Income Disparities in 1980s and 1990s: An Analysis of the CBO Data," Center on Budget and Policy Priorities Report (May 31, 2001), 8.

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- ³² Shapiro, Greenstein and Primus, 1.
- ³³ *Ibid.*, 5
- ³⁴ Rosen, 480.
- ³⁵ Lav and Friedman, “Can Capital Gains Carry-Over Basis Replace the Estate Tax?” Center for Budget and Policy Priorities Report (March 15, 2001)
- ³⁶ *Ibid.*, 481.
- ³⁷ *Ibid.*, 480.
- ³⁸ Citizens for Tax Justice Press Release, April 18, 2001.
- ³⁹ Miller, 23.
- ⁴⁰ Miller, 1.
- ⁴¹ William W. Beach, “A Scorecard on Death Tax Reform,” *Heritage Foundation Backgrounder* (June 25, 1998), 1
- ⁴² *Ibid.*
- ⁴³ Miller, 22-23. It is not clear whether the estate tax actually generates revenue or not, as studies on both sides of the debate have reached different conclusions. Rooney and Tempel argue that more research on this point is necessary. Rooney and Tempel, 203-204.
- ⁴⁴ *Ibid.*
- ⁴⁵ Beach, 2.
- ⁴⁶ Rooney and Tempel, 197-198.
- ⁴⁷ Lav and Friedman, “Estate Tax Repeal,” 2-3.
- ⁴⁸ *Ibid.*, 6.
- ⁴⁹ Rooney and Tempel, 202.
- ⁵⁰ Williams, Woodward and Kasten, 13.
- ⁵¹ Rooney and Tempel, 197.
- ⁵² Citizens for Tax Justice Estate Tax FAQ. <http://www.ctj.org/html/estbob.htm> (May 15, 2002)
- ⁵³ “Some States Avoiding Estate Tax Phase-out,” *Daily Policy Digest*, National Center for Policy Analysis (January 30, 2002)
- ⁵⁴ “The Effects of the Bush Tax Cuts on State Revenues,” Citizens for Tax Justice Memo, May 2001. There are a variety of ways in which the repeal of the estate tax could open new loopholes in the income tax, such as allowing temporary tax-free transfers of assets during life to low- or no-tax entities, and after interest, dividends and capital gains have been realized, recovering the proceeds. These strategies assume that the gift tax will have been greatly reduced or repealed along with the estate tax. Under current law the gift tax is reduced but would remain in effect.
- ⁵⁵ Michael Schuyler and Stephen J. Entin, “Faulty Revenue Scoring: Life Support for the Death Tax,” *Institute for Research on the Economics of Taxation Congressional Advisory* (April 30, 2001), 1-2. These positive behavioral changes would be projected increases in savings, investment and capital development conservatives expect would follow the repeal of the estate tax.
- ⁵⁶ Lav and Friedman, “Estate Tax Repeal,” 14.
- ⁵⁷ Rooney and Tempel, 203.
- ⁵⁸ *Ibid.*, 202.
- ⁵⁹ Rosen, 498.
- ⁶⁰ “The Estate Tax: Mend it, Don’t End It,” *Business Week* (March 5, 2001)
- ⁶¹ Lav and Friedman, “Can Capital Gains Carry-Over Replace the Estate Tax?”
- ⁶² All information from this section taken from Lav and Friedman, “Estate Tax Repeal,” 8.