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CONGRESS SHOULD NOT WEAKEN ESTATE TAX BEYOND 2009 PARAMETERS

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Senate Finance Committee Chairman Max Baucus reportedly plans to unveil a proposal in coming weeks to make permanent key features of the estate tax that are in place in 2009.[1] This will launch a major congressional debate. Under current law, the tax has been phasing down for several years and is scheduled to end entirely in 2010, only to return in 2011 under the parameters that were in place in 2001. To avoid such roller-coaster changes, Congress is expected to consider estate-tax legislation this year.

Some in Congress have proposed going beyond the 2009 rules and further weakening the estate tax. This would be unwise, for the following reasons:

- Making the 2009 parameters permanent would be very expensive, costing $609 billion over the first decade in which its effects would be fully felt (2012-2021). Going further would not be fiscally responsible.

- Under the 2009 parameters, the estates of fewer than three of every 1,000 people who die will owe any estate tax whatsoever; there is no need to shrink this tiny fraction further.

- While going beyond the 2009 rules would benefit only a very small number of wealthy individuals, millions of middle- and low-income Americans likely would eventually bear a significant share of the costs, in the form of higher taxes and lower government benefits. Millions of ordinary Americans could end up with a lower standard of living so that some of the nation's wealthiest individuals could escape much or all of the estate tax.

- The few estates that are taxable under the 2009 rules would be taxed much more lightly than is commonly understood. In 2011, taxable estates would owe less than one-fifth of their value in tax, on average.

- Under the 2009 estate tax parameters, almost no small business and farm estates would owe any estate tax — just 140 such estates in the entire nation would be taxable in 2011, for example. Moreover, it is extremely unlikely that *any* taxable estates would have to be liquidated to pay the tax under the 2009 estate tax parameters.

[1] Jay Heflin, "Baucus Drafting Bill to Freeze Estate Tax, Cut AMT," CongressNow, Jan. 12, 2009.

- A meaningful estate tax is an important incentive for charitable giving. Shrinking the tax beyond its 2009 level would weaken this incentive, likely producing a drop in donations.

What will happen under current law if no estate tax reform is enacted?

The Economic Growth and Tax Relief Reconciliation Act of 2001 sharply reduced the number of estates affected by the estate tax over nine years, by gradually increasing the value of an estate that is exempt from the estate tax. It also gradually decreased the maximum estate tax rate. In 2008, only estates worth more than $2 million — effectively more than $4 million for a couple — owed any estate tax. In 2009, the exemption rises to $3.5 million (effectively $7 million for a couple). In both years, the maximum tax rate for the portion of an estate subject to the tax is 45 percent.

The estate tax is scheduled to be repealed entirely in 2010, for one year. It then is slated to revert to its 2001 parameters starting in 2011, with a $1 million exemption and a top tax rate of 55 percent. (See Table 1.)

TABLE 1:
Estate Tax Parameters Under 2001 Law

Year	Per-Person Exemption (Effective Per-Couple Exemption)	Top Rate
2001	$675,000 ($1.3 million)	55%
2002	$1 million ($2 million)	50%
2003	$1 million ($2 million)	49%
2004	$1.5 million ($3 million)	48%
2005	$1.5 million ($3 million)	47%
2006	$2 million ($4 million)	46%
2007	$2 million ($4 million)	45%
2008	$2 million ($4 million)	45%
2009	$3.5 million ($7 million)	45%
2010	*Repeal*	
2011	$1 million ($2 million)	55%

What to Do Now

In his campaign, President Obama called for addressing this matter by making the 2009 estate-tax parameters permanent. There are six reasons why it would be unwise to go farther than that.

1. Making the 2009 parameters permanent itself would be very costly; going farther would not be fiscally responsible.

Estimates from the Urban Institute-Brookings Institution Tax Policy Center show that *repealing* the estate tax would cost nearly $1.3 trillion from 2012 through 2021 (the first ten years in which the effect of repeal would be fully felt[2]) — about $1 trillion in forgone tax revenue and an additional $277 billion in increased interest payments on the debt. (See Figure 1; note: Appendix 1 provides descriptions of the various proposals.)

Making the 2009 estate tax parameters permanent itself would cost $609 billion over this

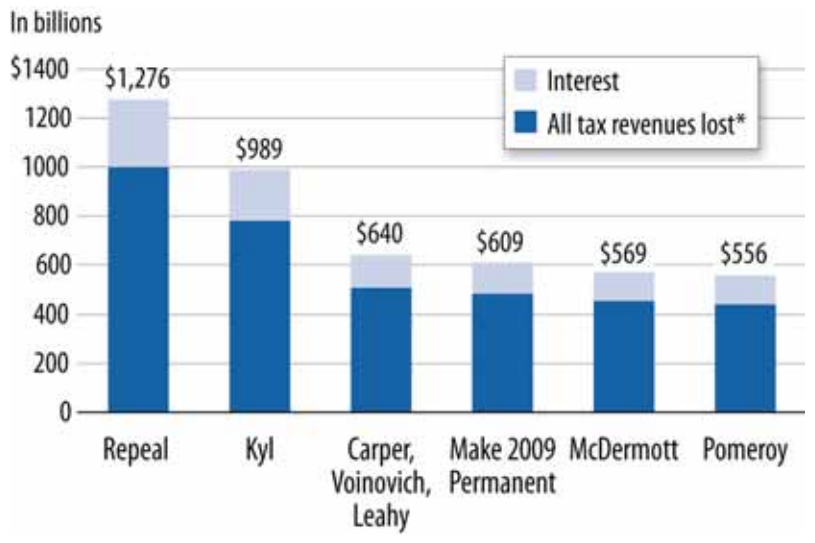
[2] Under current law, the estate tax would be repealed in 2011 but return in calendar year 2011, so full repeal would be first felt for deaths in calendar year 2011. Revenues from 2011 estates would be generally expected to show up in the *following* fiscal year, fiscal year 2012.

period, or about half as much as repeal — $485 billion in revenue losses and $124 billion in added interest costs. Making the 2009 parameters permanent thus would be quite expensive. But it would cost $667 billion less than repeal.

Acting to make the 2009 rules permanent would be more fiscally responsible than various other proposed estate-tax changes, as well. One so-called "compromise" proposal, advanced by Senator Jon Kyl (R-AZ), for example, would set the estate-tax exemption level at $5 million (effectively $10 million for a couple) and the top tax rate at 15 percent. Senator Kyl, an advocate of complete repeal of the tax, has commented that an estate tax along these lines "would be almost as good as full repeal." That is an apt description of its budgetary effects as well; the proposal would cost 84 percent as much as repeal, adding nearly $1 trillion to deficits over the next 10 years.

FIGURE 1:

Cost of various estate tax proposals compared to current law, 2012-2021



*Includes lost estate, gift, and income tax revenues.
Source: Urban-Brookings Tax Policy Center

The Kyl proposal would cost $380 billion more over the 2012-2021 period than making the 2009 estate-tax parameters permanent. And the added costs would benefit the estates of only about the wealthiest three of every 1,000 Americans.

Moreover, while the added cost of the Kyl proposal in 2012 (relative to the cost of making the 2009 estate-tax rules permanent) would benefit only an infinitesimal fraction of Americans, it would be equal to about *half* of everything the federal government is expected to spend on veterans' medical care that year for the millions of Americans who have fought for their country.

2. The large costs of further weakening the estate tax would ultimately have to be paid by someone — most likely, in large part, by middle- and low-income Americans.

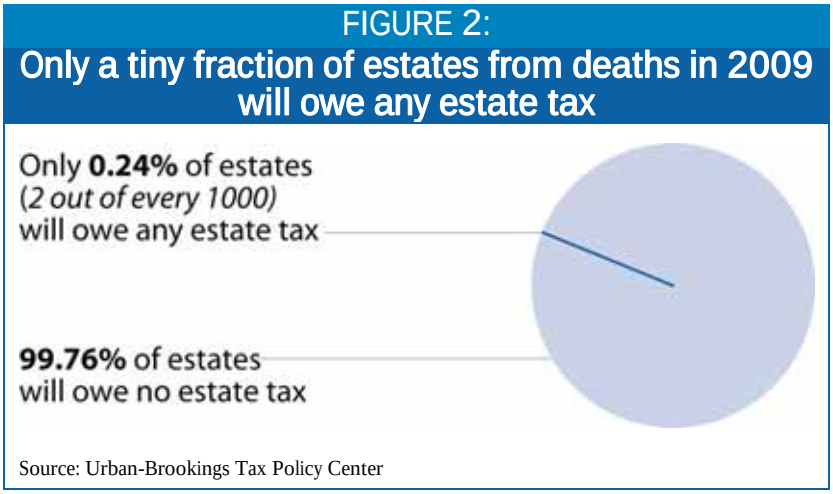
The costs of losing such substantial amounts of revenue cannot be avoided indefinitely. Although those costs could be financed by additional federal deficits and debt in the short run, the federal budget already is on an unsustainable path under current policies, so significant increases in taxes and cuts in programs will eventually be required to keep deficits and debt from exploding and seriously damaging the economy in coming decades. Any increase in the debt to pay for further weakening the estate tax would simply add to the amount of tax increases and budget cuts that ultimately must be enacted to avoid that outcome. The additional budget cuts and tax increases required would likely mean larger future reductions in benefits and services and/or increases in taxes for middle-and low-income households, possibly including households with seniors, veterans, and

people with disabilities, among others.[3]

Those ordinary Americans whose benefits were cut or taxes raised would end up having a lower standard of living so that the estates of the wealthiest individuals in the country could escape the estate tax or be taxed more lightly.

3. Under the 2009 estate-tax parameters, only a tiny fraction of estates would owe any tax; there is no need to shrink this fraction further.

Under the *2008* estate tax law, only 0.6 percent of all estates — the estates of 6 out of every 1,000 people who died in 2008 — were expected to owe any estate tax, according to the Tax Policy Center. Under the more generous $3.5 million exemption level (effectively $7 million per couple) in effect for 2009, the percentage of estates facing any estate will be cut by more than half to just 0.24 percent this year (and 0.3 percent of all estates in 2011). (See Figure 2.)



If the 2009 parameters are made permanent, 85 percent of all estates that would owe tax in 2011 if the estate tax reverted to its 2001 parameters would be entirely free from the estate tax, as would 50 percent of the estates that would owe tax if the *2008* parameters were continued.

4. The few estates that are taxable under the 2009 rules would be taxed much more lightly than is commonly understood.

Under the 2009 parameters, the amount that a taxable estate owes in estate tax equals far less than 45 percent of the value of the estate. Although the top tax rate is 45 percent, the estate-tax exemption and other favorable deduction and valuation rules substantially reduce an estate's actual tax liability.[4]

- Tax Policy Center analyses show that if the 2009 parameters are made permanent, the small number of estates that will be taxable in 2011 will owe, on average, an amount equal to *less than one-fifth* of the value of the estate.

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[3] See generally, William G. Gale, Peter R. Orszag, and Isaac Shapiro, "The Ultimate Burden of the Tax Cuts: Once They are Paid For, Low- and Middle-Income Households Likely to be Net Losers, On Average," Urban-Brookings Tax Policy Center and Center on Budget and Policy Priorities, June 2, 2004.

[4] For more information see Aviva Aron-Dine and Joel Friedman "New Estate Tax Anecdotes Dredge Up Old Myth that the Estate Tax Claims Half of an Estate": http://www.cbpp.org/6-14-06tax.htm

- Moreover, taxable estates with a value of between $3.5 million and $5 million will, on average, owe tax equal to just 7 percent (or one-fourteenth) of the value of the estate, while taxable estates worth between $5 million and $10 million will owe tax equal to an average of 15 percent (about one-seventh) of the estate's value. (See Figure 3.)

The preponderant share of the estate tax under the 2009 parameters will be paid by the very largest estates. If the 2009 parameters were made permanent, then in 2011 some 62 percent of all of the tax owed would be paid by estates worth more than $20 million. These estates would comprise just three out of every 10,000 estates in the country (including both taxable and non-taxable estates). Even these extremely large estates would face taxes that, on average, equal less than one-quarter of an estate's value.

FIGURE 3:

The average taxable estate will owe less than 20% of its value in estate tax in 2011 under the "Make 2009 Permanent" proposal

Source: Urban-Brookings Tax Policy Center

5. Under the 2009 estate tax parameters, only a tiny fraction of small business and farm estates would owe any estate tax.

Very few taxable estates consist primarily of small business or farm assets. Those estates that do owe only very modest amounts of tax under the 2009 parameters.

- The vast majority of farm and business estates already escape the tax. The Tax Policy Center estimates that estates in which a small business or farm valued at up to $5 million makes up the majority of the estate accounted for fewer than 2 percent of all estates subject to tax in 2009.[5] The estates of only five of every *100,000* people who die fall into this category.

- In addition, those very few small business or farm estates that owe any tax generally will face only a modest tax burden. The Tax Policy Center estimates that the tiny number of small business or farm estates that will be taxable in 2009 will owe tax equal to an average of 14.3 percent of the value of the estate, compared to the 19.4 average rate that taxable estimates overall will pay.

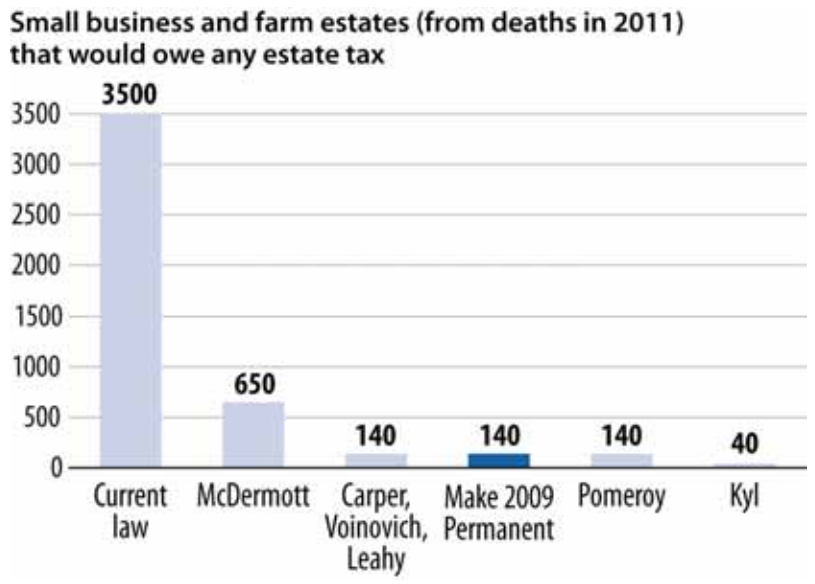
[5] We follow the Tax Policy Center definition of a "small-business estate." TPC defines such an estate as one in which more than half of the value of the estate is in a farm or business and the farm or business assets are valued at less than $5 million.

- The Tax Policy Center also estimates that making the 2009 parameters permanent would eliminate the estate tax for *96 percent* of the small business and farm estates that would owe some tax if the estate tax returned to its 2001 parameters. If the 2009 parameters are made permanent, only 140 small business or farm estates in the nation will owe any estate tax in 2011 (see Figure 4).

Furthermore, a Congressional Budget Office study of the estate tax found that of the few farms and small businesses that would owe any tax under the 2009 parameters, all but a handful would have sufficient liquid assets on hand (such as bank accounts, stocks, bonds, and insurance) to pay the tax without having to touch the farm or business.[6] The few with any liquidity problems would have other options available to them such as spreading their estate-tax payments over a 14-year period that generally would allow them to pay the tax without having to sell off any of the farm or business assets.

FIGURE 4:

Under the 2009 parameters, only 140 farm and small business estates will owe any estate tax



Note: A small farm or business estate is defined as an estate with farm and business assets that represent at least half of the gross estate and total no more than $5 million.
Source: Urban-Brookings Tax Policy Center

There are a number of reasons why, under the 2009 rules, nearly all small business and farm estates would be exempt from the tax and those few that would face it would generally be taxed lightly. First, small business and farm estates tend to have a smaller gross value than other taxable estates; since the first $3.5 million of any estate ($7 million for a couple) is entirely exempt under the 2009 rules, most small business and farm estates escape the tax entirely. This also is a key reason why the few small business or farm estates that would be taxable would be taxed lightly — due to the generous exemption level, they would be subject to tax only on a small share of their value. Finally, the estate-tax law contains a number of special provisions targeted to farm and business estates that allow such estates to further reduce the amount of tax they pay. (See box on page 7 for examples of additional estate-tax protections targeted to farms and other small businesses.)[7]

[6] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

[7] The provisions targeted to small business and farm estates include the qualified family-owned business-interest deduction, valuation of assets based on current use, minority discounts, and the payment of estate taxes owed over 15 years.

Farm and small business estates enjoy existing protections

Under current estate tax law, farm estates benefit from four forms of targeted estate tax relief.

- **Special use valuation.** This year's $3.5 million estate tax exemption really amounts to a nearly $9 million exemption for farm couples. Each member of a farm couple is allowed to reduce the value of farmland and certain other assets in their estate by up to $960,000 in 2008 (indexed for inflation) through a provision that allows farmers to value these assets based on their current use (farming) rather than on their most profitable use. According to a leading study of this matter conducted by USDA economists during the Bush administration, special use valuation can reduce the value assigned to the component of farm estates that consists of real property (as distinguished from the part that consists of financial assets) by 40 to 70 percent of the market value of those assets.

- **Payment of tax over 15 years.** Farm and small business estates are generally eligible to defer payment of estate tax (paying only interest) for five years and then may pay the tax in up to ten annual installments. The first $1.33 million in estate tax is subject to an interest rate of only 2 percent. In addition, the interest rate on the remainder owed is still only 45 percent of the rate generally levied on late tax payments. This provision prevents farmers with large estates but few liquid assets from having to sell their farms to pay the estate tax.

- **Conservation easements.** Farmers may deduct from the value of the estate up to 40 percent of the value of land subject to a qualified conservation easement. (A conservation easement is essentially an enforceable promise not to develop the land for uses other than farming; typically, conservation easements are donated to environmental groups or municipalities.)

- **Minority and marketability discounts.** Estate tax law allows a lower valuation for property that is held by multiple heirs, each of whom has a minority interest, or that is otherwise difficult to sell. Farm and small business estates are especially likely to qualify for these discounts. According to the Congressional Budget Office, minority discounts reduced the taxable value of undeveloped land and farmland for which these discounts were claimed by an average of 51 percent in 2000.**

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* Ron Durst, James Monke and Douglas Maxwell, "How Will the Phaseout of Federal Estate Taxes Affect Farmers?" USDA Agriculture Information Bulletin No. 751-02, February 2002. http://www.ers.usda.gov/publications/aib751/aib751-02/aib751-02.pdf.
** Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses."

False Claims about the Estate Tax and Farms

Even under the lower estate-tax exemption levels of the past, the often-repeated claim that the estate tax causes the widespread liquidation of farms and small businesses was spurious. Despite the claim that the estate tax has dire consequences for family farms, the American Farm Bureau acknowledged to the *New York Times* several years ago that it could not cite a single instance of a farm being sold to pay the estate tax.[8] On an analytic basis, the Congressional Budget Office exploded the myth that family farms and businesses must be sold to pay the tax.[9]

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[8] Johnston, David Cay. "Few Wealthy Farmers Owe Estate Tax, Report Says." *New York Times*, July 10, 2005. http://www.nytimes.com/2005/07/10/politics/10tax.html

[9] Congressional Budget Office, "Effects of the Federal Estate Tax on Farms and Small Businesses," July 2005.

Proposals are likely to emerge in Congress, however, to expand the current estate tax preferences for farms and small businesses. Such measures may be portrayed by their sponsors as being both modest and necessary. Such proposals could, however, be extremely costly, as they can create lucrative opportunities for wealthy individuals who are not small business or farm proprietors to shift large amounts of their assets late in life in order to escape the estate tax.[10] Such measures could end up being exploited by clever tax attorneys and accountants at the expense of the federal Treasury and open up large, unintended loopholes. The dangers of such proposals are illustrated by a recent Tax Policy Center analysis of one such proposed measure to exempt farmland from the estate tax:[11]

- The Tax Policy Center concluded that "an unlimited exemption for farm assets could create a giant loophole from the estate tax" because wealthy individuals who expect to pay the estate tax could use much or all of their wealth to buy farms before they died. A special preference such as this would "make the estate tax essentially voluntary for the very wealthy," because "the wealthiest people would have a strong incentive to convert most of their assets into qualifying farms, and thus skirt the estate tax."

- TPC also noted that, "Ironically, this could endanger many existing small farms, as wealthy people would bid up the price of such properties to claim their tax benefits. (How much of Iowa could Bill Gates buy with his fortune?)."

- TPC pointed out, as well, that such preferences can create serious economic consequences, stating, "it is unlikely that a billionaire's heirs holding tens of thousands of acres of farmland for tax purposes would manage the resources as effectively as the professional farmers they would displace….and how committed would the heirs be to continuing to farm the land (rather than develop it) after the required holding period expires?"

- Finally, the Tax Policy Center warned that although some versions of this proposal include measures intended to limit the potential for estate-tax avoidance, it is unclear that such measures would be effective.

Furthermore, additional measures to enlarge special estate-tax preference for farms and other small businesses are not needed. As the foregoing discussion illustrates and the data cited above demonstrate, small business and farm estates already would be very well protected under the 2009 parameters and the current estate-tax preferences for farms and small businesses.

6. A meaningful estate tax is an important incentive for charitable giving.

Retaining a meaningful estate tax would preserve a major incentive for charitable giving.[12]

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[10] Aviva Aron-Dine, "An Unlimited Estate Tax Exemption For Farmland Unnecessary, Open to Abuse, and Likely to Hurt, Rather than Help, Family Farmers," Center on Budget and Policy Priorities, October 1, 2007, http://www.cbpp.org/10-1-07tax.htm.

[11] Leonard E. Burman, Katherine Lim, and Jeff Rohaly, "Back from the Grave: Revenue and Distributional Effects of Reforming the Federal Estate Tax", Urban-Brookings Tax Policy Center, October 20, 2008, http://www.taxpolicycenter.org/UploadedPDF/411777_back_grave.pdf, pp 32-33.

[12] See also Aviva Aron-Dine, "Estate Tax Repeal — Or Slashing the Estate Tax Rate — Would Substantially Reduce Charitable Giving," Center on Budget and Policy Priorities, June 7, 2006, http://www.cbpp.org/6-7-06tax.htm.

- The Congressional Budget Office estimated in 2004 that if there had been no estate tax in 2000, charitable donations by individuals and estates would have been *$13-25 billion lower* than they were that year. The loss would have exceeded the total amount that all corporations in the United States donated to charity in 2000.[13]

- Retaining the estate tax but lowering the top estate tax rate below the current 45 percent rate also would produce a decline in charitable giving. The estate tax serves as a strong incentive for giving because it makes charitable donations much more economical than they otherwise would be. For example, if taxable assets are subject to the estate tax at a 45 percent rate, then a charitable donation of $100 costs the donor only $55, because the other $45 would otherwise have been paid in estate tax. Under a lower estate tax rate, a $100 charitable donation would cost the donor more. Brookings economist and noted tax expert William Gale has testified that "reducing the top estate tax rate would have a significantly negative effect" on charitable giving.[14]

Conclusion

The estate tax affects only the wealthiest Americans. Just 0.3% of estates are now subject to the tax, and despite opponents' claims, nearly all small businesses and farms are exempt. The estate tax also serves as an incentive for charitable giving and is a critical source of revenue for a federal budget already deeply in debt.

Estate-tax legislation is necessary and is likely to be considered in 2009. Repeal of the estate tax would be fiscally irresponsible, costing $1.3 trillion over the decade from 2012 through 2021. Making the 2009 estate tax parameters permanent would be very costly itself but would be a much more responsible approach. Under it, the estates of 997 of every 1,000 Americans who die would be entirely tax free in 2011; for 99.7 percent of Americans who die, there would be no estate tax at all. Going farther than this, especially in the face of the grave long-term fiscal problems the nation faces and the array of significant unmet needs, would be exceedingly difficult to justify.

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[13] Congressional Budget Office, The Estate Tax and Charitable Giving, July 2004. The CBO report is discussed in more detail in David Kamin, "New CBO Study Find that Estate Tax Repeal Would Substantially Reduce Charitable Giving," Center on Budget and Policy Priorities, August 3, 2004, http://www.cbpp.org/8-3-04tax.htm.

[14] William Gale, "Charitable Giving and the Taxation of Estates," Testimony Submitted to the United States Committee on Finance, September 13, 2005.

Appendix One: Summary of Various Estate Tax Proposals

APPENDIX TABLE 1:
Various Estate Tax Options Compared to Repeal

Proposal	Per Couple Exemption	Rate	State Estate Taxes	Cost* 2012-2021 ($ billions)	Cost as percentage of cost of repeal
Repeal	-	-	-	**$1,276**	**100%**
Kyl Proposal	$10 million	20% from $5m to 5m 30% above $25m	Deduction	**$989**	**77%**
Carper, Voinovich, Leahy (S.3284)	$7 million (inflation indexed)	45%	Deduction	**$640**	**50%**
Make 2009 Permanent	$7 million	45%	Deduction	**$609**	**48%**
McDermott (H.R. 6499)	$4 million (inflation indexed)	45% from $2m to 5m 50% from $5m to 10m 55% from above 10m	Credit	**$569**	**45%**
Pomeroy (H.R. 4242)	$7 million	47% 52% on estates between $10 million and $46 million	Deduction	**$556**	**44%**

* Cost compared to current law; includes the cost of forgone estate tax revenues, forgone income and gift tax revenues, and interest on the public debt, assuming that the legislation is deficit financed.

Source: Urban-Brookings Tax Policy Center and Center on Budget and Policy Priorities calculation.