

Repeal of the Federal Estate Tax: Unaffordable and Unfair

As the Minnesota Budget Project works to promote a balanced approach to the federal budget, we have been keeping our eye on efforts in Congress to repeal the federal estate tax. Repeal of the federal estate tax is wrong for several reasons:

- At a time of large federal budget deficits, repeal of the estate tax is unaffordable at a cost of \$1 trillion over the first ten years it is in effect.¹ The loss of revenue would further expand the budget deficit and threaten the nation's ability to fund its priorities.
- Repeal of the estate tax is unfair, as it would further shift responsibility for funding our national priorities away from those with the greatest ability to pay.
- Repeal of the estate tax would take away incentives for charitable giving, incentives that have been important in creating and supporting philanthropy in Minnesota and across the country.

Status of the federal estate tax

As part of a 2001 federal tax bill, the estate tax was changed to gradually exempt more of a person's estate from tax as well as lower the tax rate, and then repeal it entirely in 2010. However, to get around Congress's budget rules, the 2001 tax bill was set to expire completely in 2011, and revert back to the law as it was in 2001. Since 2001, there have been ongoing efforts in Congress to repeal the estate tax permanently.

The U.S. House of Representatives has previously passed legislation to repeal the estate tax, and repeal is one of the top tax policy goals of the Bush administration. That means the ultimate fate of the estate tax rests in the U.S. Senate. The U.S. Senate is expected to vote on a bill to repeal the federal estate tax at the end of May or sometime in June. In September 2005, a Senate vote to repeal the estate tax fell two votes short of the 60 votes needed for passage.

It does not appear that the Senate will have the necessary 60 votes to pass repeal of the estate tax this year. Therefore, repeal supporters are expected to offer an alternative they describe as a "reform" of the estate tax. But such reform plans, like the one being offered by Senator John Kyl, are little different from repeal, as they would lose almost as much revenue as repeal and would confer the biggest benefit on the wealthiest estates. The most important vote may well be on Senator Kyl's proposal, which would also require 60 votes to pass in the Senate.

What is the federal estate tax?

The federal estate tax is a tax on the inter-generational transfer of large amounts of wealth. When someone dies, his or her assets (the "estate") are distributed to his or her heirs by an executor of the estate. If the total value of the estate is large enough, an estate tax is imposed on the estate before the assets are distributed to the heirs. The executor of the estate is responsible for paying any taxes due from the estate.

If a married person dies, that person's entire estate can go to the surviving spouse with no estate tax liability at all. However, even where there are heirs other than a spouse, not all of an estate is subject to tax. For example, current law provides for a \$2 million exemption from the estate of each person who dies (or \$4 million for couples). The exemption increases each year, and will

¹ Except where otherwise noted, data in this analysis comes from Center on Budget and Policy Priorities, *The Estate Tax: Myths and Realities*, www.cbpp.org/estatetaxmyths.pdf.

reach \$3.5 million per person by 2009. Charitable donations are also subtracted from the value of the estate before any tax is applied.

Who pays the estate tax?

In 2006, it is estimated that approximately 12,600 estates will be subject to the estate tax, or 0.5% of all estates.² In other words, 99.5% percent of all people who will die in the U.S. this year will be able to pass on 100% of their assets free of any federal estate tax.

In 2006, estates with values over \$5 million will pay an estimated 87% of all estate taxes and estates in excess of \$10 million will pay 64% or nearly two-thirds of all estate taxes.³

Despite rhetoric to the contrary, the estate tax does not threaten small family-owned farms and businesses. The Congressional Budget Office (CBO) has estimated that if the current estate tax levels were in effect in 2000, then only 123 farm estates and 135 family-owned businesses in the entire country would have been subject to the estate tax. As the exemption level rises over time, even fewer family farms and businesses would be affected.

Because of the significant deductions and exemptions available to shield estates from taxation, the actual share of the estate paid in estate taxes is significantly less than the current top estate tax rate of 46%. Those few estates that will pay any estate tax in 2006 will on average pay less than 20% of their assets in estate taxes. This effective tax rate (or percentage of assets paid in taxes) will fall over time as the exemption amounts increase and tax rates fall.

Impact of estate tax repeal

The estate tax is the most progressive component of a federal tax code that is only modestly progressive. The estate tax affects only those most able to pay and the revenues raised by this tax are used to support a broad range of programs and services that benefit all Americans. Repeal of the estate tax would result in a shift in responsibility for funding government services from those with the greatest ability to pay to those with more modest means.

Repeal of the estate tax would also be fiscally irresponsible. Complete repeal of the federal estate tax would cost the federal government approximately \$1 trillion over the first ten years, including increased interest payments on the national debt. Repeal of the estate tax would cost more each year than what the federal government currently spends annually for homeland security, K-12 education, or veterans' medical care.⁴ With federal deficits exceeding \$300 billion per year, repeal or significant reductions in the estate tax would saddle future generations with additional enormous national debt.

The estate tax and charitable giving

Under current law, any part of an estate that goes to a charitable donation is exempt from the estate tax, providing a valuable incentive for charitable giving. Minnesota benefits greatly from private foundation grants made possible by the incentive of the estate tax. In fact, some of Minnesota's largest foundations would not exist but for the estate tax. Repeal of the estate tax would have a devastating impact on foundations and nonprofit organizations that do important work in our communities and that depend upon charitable contributions for their survival.

² Estimate by Center on Budget and Policy Priorities.

³ Tax Policy Center, Table To6-0020, *Current Law: Distribution of Gross Estate and Net Tax By Size of Gross Estate, 2006*, www.taxpolicycenter.org/taxmodel/tmdb/tmtemplate.cfm.

⁴ Center on Budget and Policy Priorities, *Issues Surrounding the Federal Estate Tax: Impact of Repeal vs. Reform*, www.cbpp.org/estatetaxslideshow.htm.

A 2004 study on the effect of the estate tax on charitable giving found that repeal of the estate tax would cause charitable contributions to fall by large amounts. The Congressional Budget Office (CBO) found that in 2000, charitable contributions and bequests totaled \$212 billion. If the estate tax had not been in place in 2000, charitable donations would have decreased by an estimated 6% to 12%, or \$13 billion to \$25 billion nationwide. By way of comparison, corporate charitable donations in 2000 totaled \$11 billion.⁵ Repeal of the estate tax would create a significant disincentive for charitable giving, which would have a deep impact in Minnesota and across the nation.

What happens next?

The U.S. Senate is expected to take a vote on the estate tax by the end of May or early June. However, the Senate may vote not just on repeal, but also on Senator Kyl's reform proposal. Under current law, the estate tax would have a \$3.5 million exemption and a 45% rate in 2009. Only 7,100 estates nationwide — or 0.3% — would be subject to the estate tax. Senator Kyl's proposal would increase the individual exemption to \$5 million and lower the maximum tax rate to 15%, the same tax rate that is applied to capital gains. The effective tax rate — the percentage of assets actually paid in estate taxes — would fall to 6%. Senator Kyl's reform would have a fiscal impact similar to repeal, as it would lose 84% of the revenue that would otherwise be collected by the estate tax.

If the goal of estate tax reform is to reduce the number of estates subject to the estate tax while not greatly increasing the federal deficit, this can be addressed through modest changes to the exemption level. A steep cut to the top estate tax rate is not needed and would, in fact, cause a significant loss of revenues and greatly damage incentives for charitable giving.

For example, an estate tax reform that maintains the parameters in place for 2009 — a \$3.5 million exemption (indexed for inflation) and a 45% rate — costs only 40% as much as repeal while significantly reducing the number of estates subject to tax. This is in contrast to the Kyl proposal, which costs nearly as much as repeal, primarily because of the reduction in the estate tax rate.

The Minnesota Budget Project encourages Minnesotans to express their concerns about repeal of the estate tax as well as irresponsible “reform” plans. For more information about how to get involved in the estate tax debate, contact Steve Francisco at (651) 642-1904, email steve@mncn.org, or visit www.mncn.org/bp/federalissues.htm.

⁵ Center on Budget and Policy Priorities, *New CBO Study Finds That Estate Tax Repeal Would Substantially Reduce Charitable Giving*, www.cbpp.org/8-3-04tax.htm.