The Economic Consequences Of Repealing The Estate Tax Law

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Abstract

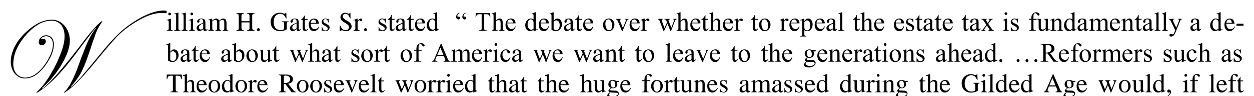
The federal estate tax has been a part of our tax structure since the founding of the country. It is the federal government's only tax on accumulated transfers of wealth. From its inception in 1916, it has been applied only to very large estates. The transfer of wealth can take place during the individual's life (gift) or at the time of death (estate). Both types of transfer are combined and taxed according to the Taxpayer Relief Act of 1976. The Taxpayer Relief Act of 1976 was an important legislation affecting the structure of both the federal estate and gift taxes. In this Act, a unified system of taxation was established which treats both transfers of wealth, either during the life of the owner (gift) or at his or her death (estate) uniformly.

The recent legislation of 2001 made drastic changes to the tax rates and the level of exemptions of the 1976 federal estate tax. According to this legislation, the maximum estate tax rate will drop gradually during the period of 2002-2010. Beginning in 2002, the maximum unified tax rate is reduced from 55% to 50%. This drop will reach to 45% by the year 2007 and will remain unchanged till 2009. The limit of exemption for a taxable transfer of wealth will increase from $1,000,000 to $1,500,000 by the year 2004, to $2,000,000 by 2006, to $3,500,000 by 2009, and to infinity by 2010 (estate tax will be repealed). This original version of federal estate tax will come back in 2011, unless the Congress decides differently and changes the law.

Like other social, economic, and tax issues, the transfer of wealth tax (estate and gift) is subject to debate and disagreements. The opponents of the estate tax support their views by referring to the immorality aspect of the tax and its undesired economic consequences. The supporters of the estate tax present their arguments on the basis of fairness and the ability of the tax to encourage charitable contributions. In addition, they believe that the economic consequences of repealing the estate tax would ripple through our economy and reduce federal revenues. Consequently, it could bring inequity and unfair distribution of wealth among the citizens and eventually could culminate in high difference in the class level of citizens.

In our view, the federal estate tax is a tax worth fighting to keep and attempting to improve. If it were repealed, the burden of taxes would be felt more by those who have no wealth and had paid their income taxes on their earned income once before. Consequently, the lawmakers should keep the federal estate tax and fixing it by adjusting the amount of exemptions and the tax rates to reasonable, effective, and fair levels.

1. Introduction



William H. Gates Sr. stated " The debate over whether to repeal the estate tax is fundamentally a debate about what sort of America we want to leave to the generations ahead. …Reformers such as Theodore Roosevelt worried that the huge fortunes amassed during the Gilded Age would, if left

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untaxed, evolve into a dangerous, permanent aristocracy."[1] Furthermore, the repeal "would be bad for our democracy, for our economy, and our society [and]…enrich the heirs of…millionaires while hurting families who struggle to make ends meet."[2]

The current federal estate tax only applies to estates worth $1 million+1; thus, repeal of this tax will only help the extremely wealthy few. Furthermore, repeal will cost the nation nearly $100 billion over the next decade and $850 billion over the next 20 years, according to Congress's Joint Committee on Taxation released February 6, 2001. Thus, at a time of budget deficits and so many unmet needs, does it make sense to pass this extremely regressive tax break? Certainly the answer is no, because the repeal of the federal estate tax law would slow the economic growth, reducing social mobility and waste productive activity.

The main purpose of this paper is to explain the economic consequences of repealing the federal estate tax law. To accomplish this objective, we will briefly explain: (a) the history of the federal estate tax, (b) the federal estate, gift, and generation-skipping transfer (GST) taxes and their calculations, (c) arguments for and against the repeal of the federal estate tax law, and (d) the economic consequences of the repeal of the federal estate tax law.

2. History Of The Federal Estate Tax

Benjamin Franklin said 200 years ago that "in this world two things may indeed be inevitable: death and taxes"[3.] The federal estate (death) tax[4] is neither a property tax nor an inheritance tax. It is a tax imposed on the transfers of the entire taxable estate at the *holder's death*. The estate taxes have taken on several different forms in the United States, at both the federal and state level. In the history of this great republic, a federal estate tax has been imposed three times only to be repealed shortly thereafter. The intention in each situation was to generate revenue on a short-term basis to finance U.S. military action.

The first federal estate tax was enacted in 1797 to help naval rearmament in response to heightened tensions with France, and it was terminated four years later. The second federal estate tax was imposed in 1862 during the Civil War, and was abolished in 1870. Thirdly, in 1898, another federal estate tax was enforced to pay for the Spanish –American War, and then was repealed in 1902.The United States fourth federal estate tax was enacted in 1916 because of World War I, and has existed in various forms ever since.[5]

The **unified transfer tax**, which passed in 1976, was an important legislation affecting the structure of both the federal estate and gift taxes. In this Act, a unified system of taxation was established which treats both transfers of wealth, either during the life of the owner (gift) or at his or her death (estate) uniformly. Because of the massive impact of the 1976 Act and the presence of two additional components designed to close "loopholes", namely the gift tax and a generation – skipping transfer (GST) tax, a brief explanation is in order. [6]

3. What Are Estate, Gift, And Generation-Skipping Transfer Taxes And How Are They Calculated?

Estate and gift taxes are used to tax large transfers of wealth between individuals. Gift taxes are imposed on transfers made during an individual's lifetime, and estate taxes are imposed on transfers made at the time of death. Although before 1976 the gift and estate taxes were computed and paid separately, since the passage of the Unified Transfer Act of 1976, they are ***unified*** in the sense that a single graduated rate schedule applies to the cumulative total of taxable transfers made through gifts and estates combined.[7]

The concept of taxation of gifts and estates may seem complicated at first glance. However, the calculation of these taxes is actually quite similar to the calculation of personal income taxes. As with the computation of the personal income tax, in the computation of the estate and gift some *exemptions* and *credits* are available before the application of the progressive tax rates. One of the readily available exemptions is that each taxpayer is allowed to give $10,000 ($20,000 for married joint filers) in gifts to any single individual in the course of a year tax-free. This amount has been raised to $11,000 for the year 2002 and will remain at this level until cumulative inflation indexing raises it to the next lowest rounded multiple of $1,000. Other *exemptions* are: (a) gifts to a spouse, (b) gifts of paying tuition or medical expenses, (c) gifts to political organizations, and (d) gifts to charity.

It should be noted that the transfer of wealth through gifts and estates *above* the fore mentioned $10,000 annual exemptions may not be subject to the transfer tax either permanently or immediately. This is because each taxpayer is allowed a lifetime *credit* against transfer of wealth via gifts and/or at death. Tables 1 and 2 in the Appendix show the original amount of credit and the changes since the Taxpayer Relief Act of 1976 and the Tax Relief Reconciliation Act of 2001.

The estate and gift taxes are, however, different from personal income tax in one important way. For *estate and gift tax* purpose, the amount of gift above the annual exemption limit of $10,000 ($11,000 for 2002 and later as indicated above) is calculated and reported annually. But the related gift tax is not paid at that time. The amount of the annual taxable gifts is accumulated overtime and combined with the final transfer of wealth at death, when the actual gift and estate taxes are computed and paid. In contrast, for *personal income tax*, the annual income tax is both calculated and paid year by year. For example, the *personal income tax* computation and payment for an individual for year 2002 is based on the total taxable income earned from January 1 to December 31 of 2002. It doesn't matter how much that individual had earned in 2000, or 2001. On the other hand, for *estate and gift tax* purposes, it does matter how much a taxpayer has given away in the past through gifts above the $10,000 annual exemption. Consequently, the amount of gift tax and the related tax rate depend on the total amount of taxable transfers of wealth the individual taxpayer has made since 1976 (when the estate and gift taxes were unified).

To finalize the process of gift and estate tax, form 706 needs to be completed within nine months after death. The requirements may differ when the decedent has made taxable gifts after 1976 or has utilized any of the $30,000 specific gift tax exemptions after September 8, 1976.[9]

Because of some tax planning devices, such as the creation of a trust, large transfers of wealth can be structured with a skip in the transfer tax. To overcome such a weakness and unfairness in taxation, the tax law imposes an additional tax called *generation skipping transfer tax* (GST). The GST tax captures the transfers of wealth from a grandfather and/or grandmother to their grandchildren that "skip" a generation via creation of a trust.

According to the Taxpayer Relief Act of 1976, the value of the *net taxable estate* of each individual transferred via various forms (gifts, inheritance, and the GST) are aggregated and taxed together at rates effectively ranging from 41 to 50 percent. Net taxable estate is defined as the gross value of estate assets and lifetime gifts, minus allowable deductions and credits.

3.1. Calculating the estate tax:[8]

Any gift or estate value left over when all exemptions and credits are taken into account is taxable according to The Taxpayer Relief Act of 1976. The tax rate for different levels of taxable transfers is shown in Table 3 of the Appendix. As can be noted, the tax rate ranges from 18 percent on the first $10,000 of taxable gifts and estates to 55 percent on taxable gifts over $3,000,000. However, because of the current exclusion of $ 1 million of taxable gifts and estates, the lowest rate that is ever applied is the 41 percent rate. This exclusion is scheduled to remain at $1 million during the years of 2002 and 2003, and then rises gradually to $3.50 million by 2009 and finally the entire federal estate tax law repealed in 2010. Even though, the estate tax itself will disappear in 2010, it will come back in its entirety in 2011 with $1 million exemption—unless Congress decides differently and changes the law.

In contrast to the gradual increases in the amount of the exemption, the maximum estate tax rate will drop gradually during the period of 2002-2010. Beginning in 2002, the maximum unified tax rate is reduced from 55% to 50%. This drop will reach 45% by the year 2007 and thereafter till 2009 (see Table 4 in Appendix).

Finally, the 5 percent surtax imposed on taxable transfers of wealth between $10, 000,000 and $21,040,000 has been abolished starting in 2002.

4. Arguments For And Against The Repeal Of The Estate Tax[10]

Generally speaking, the income earned in America is subject to income taxation. The objectives for this taxation are, to generate revenue for the government, create equity, fairness, and growth in the economy, as well as encouraging certain social and benevolent activities among taxpayers. In short, there are two ways that an individual can avoid this taxation and defeat its objectives, namely *tax evasion* or *tax avoidance*. The former one is illegal, but the latter is legal and is called tax planning. Tax planning is usually nothing more than arranging the timing of collection of revenues, payment of expenses, or recognition of the income over a taxpayer's life. The logical consequence of tax planning, therefore, should be a postponement of the income tax, rather than a permanent avoidance of the tax. Now the vital and controversial issue concerning the federal gift and estate taxes is related to: (1) the earned income that has been taxed before should be taxed again at the time of transfer? (2) the earned income and its accumulation throughout the years that have not been taxed and postponed should be taxed at least once at the time of its transfer? Or if it was taxed before, should it be taxed again at the time of transfer?

The opponents of the estate tax support their views by referring to the immorality aspect of the tax and its undesired economic consequences.

Taxing at death is immoral: These groups often view death as an undesirable time to impose taxes at best, and a morally repugnant one at worst. Because the estate tax is imposed at the most inappropriate time, the death of a loved one, the federal government worsens the pain by seeking to confiscate one-half of all the decedent's wealth accumulated during his or her lifetime.

Economic growth: The estate tax adds heavy taxation on the accumulated savings and investments of individuals at the time of death. As a result, it reduces the transferability and mobility of the capital in the economy, causing the slow down of the economic growth and prosperity.

Double taxation: The opponents of the estate tax believe the income should be taxed one time, and that is when it is earned. The earning after tax that is accumulated throughout the individual's life and became his or her wealth should not be taxed again. This double taxation is not fair and could effect negatively the motivation of thrift and savings among wealth holders.

The estate tax hurts families who own businesses and farms: In conjunction to the pervious reason the opponents of the estate tax claim that a large proportion of the American businesses and farmers never make it to the second generation. They argue that the main reason for such a discontinuity in family trades and businesses is the breakdown of businesses due to the estate taxation. Usually, after the death of a family head, successful and on going businesses is liquidated to pay the estate taxes.

The estate tax discriminates unfairly against savers: Opponents also claim that the tax inequality of the estate tax burdens families that want to accumulate savings and pass them to their children without expensive tax planning. In short, it punishes those who fail to engage in sophisticated tax planning techniques.

On the other hand, the supporters of the estate tax present their arguments on the basis of the equality and fairness of taxation and on the ability of the estate tax for encouraging charitable contributions.

The American Way: Like the individual income taxes, the federal estate tax does more than raise revenue for the government. The objectives of taxation, in addition to raising revenues, are creating equity, fairness, economic growth and control, encouraging certain activities, industries, and charitable giving by individual taxpayers and more. Some of these objectives can be incorporated well in the estate taxation. It is believed that well-designed estate taxation could help reduce concentrations of power and wealth among a few. Consequently, it could promote the equity of economic opportunity for the majority of Americans and improve the social system for the nation.

Simple fairness: It is worth noting that the bulk of the largest wealth accumulations have never been touched by the income tax because they are mainly realized but unrecognized capital gains and life insurance

proceeds. The main examples of unrecognized capital gains are the appreciation of wealth because of favorable economic conditions or property exchanges without cash involvement. Usually the legitimate earnings through salaries, interests, and dividends would not accumulate to a significant size over the annual exemption of the estate tax. Without the estate tax, therefore, those gains would remain untaxed forever. With the absence of well-designed estate tax, those deferred taxes at death are forgiven, causing inequity in taxation and less fairness in the social and economic systems. For a fairer system, however, the annual exemption should be raised and adjusted periodically to prevent double taxation of earned and saved salaries, interest, and dividends throughout a taxpayer's life.

***Encourage charitable giving**:* According to the Treasury's Office of Tax Analysis, there is overwhelming evidence that estate taxes stimulate charitable bequests ranging from educational institutions to faith-based organizations that assist the poor and disadvantaged families. The absence of estate taxation could hamper or discourage such charitable bequests and contributions.

***Continuation of family businesses and farms**:* The opponents of the estate tax have raised the question that the imposition of the estate tax at the time of death could cause hardships and the breakdown of successful family businesses or farms. With proper estate planning and inclusion of adequate life insurance, this problem can be mitigated and family businesses can continue their operations in the hands of decedent's heirs. Additionally, the heirs benefit from a step-up in the basis of the property providing significant income tax advantages through increased depreciation deductions and smaller capital gains on dispositions. These estate tax law benefits can, with proper planning be obtained at little or no estate tax costs.

5. Tax Planning Devices And Recent Observation[11]

It is not uncommon for wealthy families to benefit from the expertise of sharp accountants and attorneys to reduce the pain of taxation during life or at the time of death. Estate planning with the use of life insurance proceeds is one of the devices that assist wealthy families to ease the burden of gift and estate taxes. Recently, the appealing feature of this device has reached to a level that the wealthiest older Americans have been shopping not for the cheapest rates for life insurance, but for the highest possible rate they can find. The reason is the tax avoidance consequences of life insurance premiums, which appears unbelievably desirable, especially for very wealthy and older taxpayers. The new technique that was invented by a lawyer in New York and a chemical engineer in California offers wealthy taxpayers a $9 reduction in the federal estate tax for each dollar spent on the life insurance. Because of this tax-planning device, more wealthy taxpayers are buying this type of insurance all over the USA. For instance, "In Alaska, premiums for such insurance totaled just $1.1 million in 1999, but ballooned to more than $80 million last year."

The reasons for such a boom in the sales of life insurance to very wealthy and older Americans are three. The first is related to the 1913 tax legislation that made proceeds from the life insurance tax exempt in order to help widows and orphans of deceased taxpayers. The second is the presence of an annual $11,000 ($10,000 before year 2002) gift exclusion in the federal gift tax. The third is due to the weakness in the law and the manipulation in reporting correct facts and information about the annual life insurance premiums. Related to the latter, as one insurance company agent stated, "The insurance companies offer many different rates for the same policy. And the buyer is allowed to declare on his tax return the insurance company's lowest premium for the amount of insurance, even if that person could never qualify for that rate because of his age and health, and even if no one has actually ever been sold a policy at that rate."

The combination of the above three reasons has enabled wealthy taxpayers to bypass, if not entirely, a significant part of the federal gift and estate taxes. As one insurance agent stated "a customer paid a $550,000 premium for the first year alone, the highest price offered by the insurance company, for a policy that was also offered at $50,000, the lowest price. So $550,000 can be passed on to heirs tax-free. Yet the gift tax is only $25000---- 50% of the lowest premium, instead of $275,000, which is 50 percent of the highest premium." It is interesting to note that even the $25,000 of the tax in this example could be lower in some cases, when the annual exclusion of $11,000 is applied.

The above tax planning technique has shaken IRS and other authorities. As a result, in a formal notice, the Treasury Department and the Internal Revenue Service has recently stated that such a scheme "is not permitted in any published guidance". On the same line, the chief tax policy official at the Treasury Department, Pamela F. Olsen, stated that under the new regulation issued recently " any scheme to understate the value of benefits for income or gift-tax purposes won't be respected" in audits. Furthermore, as Representative Lloyd Doggett, a Texas Democrat has said recently: "I am encouraged that this particular tax shelter has been shut down."[12]

Nonetheless, it appears that those who have developed and applied the scheme, as well as the insurance companies and their agents who have sold such polices, will be embroiled for years in litigation with the IRS.

6. Summary

The federal estate tax has been a part of our tax structure since the founding of the country. It is the federal government's only tax on accumulated transfers of wealth. From its inception in 1916, it has been applied only to the very large estates. It is one of the oldest and most common forms of taxation on transfer of wealth held by individuals till the time of their death. The transfer of wealth can take place during the individual's life (gift) or at the time of death (estate). Both types of transfer are combined and taxed according to the Taxpayer Relief Act of 1976. The gift tax is imposed to prevent complete tax avoidance by individuals. The federal estate tax is integrated with the gift tax so that large estates cannot skip transfer tax at lifetime giving or time of death.

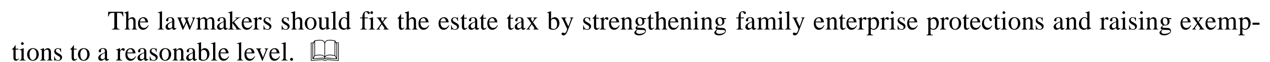
The economic consequences of repealing the estate tax would ripple through our economy and reduce federal revenues. Furthermore, it could decimate the charitable sector and devastate nonprofit organizations ranging from educational institutions to faith –based organizations. Finally, it could bring inequity and unfair distribution of wealth among the citizens. Such a factor could eventually cause high difference in the class level of citizens and could cause social problems.

7. Conclusion

Compared to the other ways of paying for government services, who could quarrel with a tax that raises a good deal of money without bothering almost 99 percent of citizens and also encourages charitable giving which promotes America's core economy and helps build a more equitable society and democratic values? The federal estate tax is, indeed, a tax worth fighting to keep and attempting to improve upon. If it were repealed, the burden of taxes would be felt more by those who have no wealth.

8. Recommendation

The lawmakers should fix the estate tax by strengthening family enterprise protections and raising exemptions to a reasonable level.



Endnotes

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2. Francis, David, R. *The Christian Science Monitor*, Feb. 26, 2001.
3. Bartlett, John, " Familiar Quotations", 16th ed. (Boston .Ma: Brown And Company, 1972), P 310.
4. The term death tax refers to all forms of taxing transfers of wealth between generations. Some forms impose a tax on wealth as the heirs (an inheritance or accessions tax) receive it, while others forms impose a tax as it leaves the possession of the decedent (an estate tax).
5. Hoffman, William, H, and etal. *West's Federal Taxation: Corporations, Partnerships, Estates & Trusts* (South-Western Publishing Company, 1994) p.17-2. Also, see John R. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," (Washington, DC: Congressional Research Service—CRS Report for Congress 95-444, March 16,1995)
6. Internal Revenue Code Sections 2601—2663.
7. The Federal Estate Tax is set forth beginning in Section 2001 of Internal Revenue Code. *26 U.S.C. 2001.*

The Federal Gift Tax is set forth beginning in *26 U.S.C.2501.* See Code of Federal Regulations: *26 C.F.R., Chapter 1, Subchapter* B--Estate and Gift Taxes.
8. Internal Revenue Code Sections 2053—2056 & Section 2056A.
9. Hoffman, William, H, and etal. *West's Federal Taxation: Corporations, Partnerships, Estate, and Trusts* (Thomson Publishing Co. 2003) p17-40.
10. Jim Saxton, Chairman, *Joint Economic Committee Study*, (United States Congress, December 1998) and William G. Gale & Joel Slemrod, "Resurrecting the Estate Tax," Policy Brief, The Brookings Institution, June 2000.
11. David Cay Johnston, "Scheme Helps Rich Dodge Their Taxes", The New York Times, reprinted in *Valley Daily News,* July 15, 2002, PP 1&17.
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Appendix

Table 1
Estate Credit And Exemption Amounts Schedule (Act Of 1976)

Tax Year	Credit Amount	Exemption Amount
1997	$192,800	$ 600,000
1998	202,050	625,000
1999	211,300	650,000
2000	220,550	675,000
2001	220,550	675,000
2002	229,800	700,000
2003	229,800	700,000
2004	287,300	850,000
2005	326,000	950,000
2006	345,800	1,000,000

Table 2
Unified Transfer Tax And GST Transfer Exemptions (Act Of 2001)[1]

Tax Year	Gift Tax Exemption	GST and Estate Tax Exemption
2002-3	$1 million	$1 million
2004-5	$1 million	$1.5 million
2006-8	$1 million	$2 million
2009	$1 million	$3.5 million
2010	Estate tax repealed	

[1] IRC Section and Reference: 2010 and 2505

Table 3
Estate And Gift Tax Rate Schedule (Act Of 1976)

Total gifts and estate subject to tax	Marginal tax rate
$0 - $10,000	18%*
10,000 - 20,000	20%*
20,000 - 40,000	22%*
40,000 - 60,000	24%*
60,000 - 80,000	26%*
80,000 - 100,000	28%*
100,000 - 150,000	30%*
150,000 - 250,000	32%*
250,000 - 500,000	34%*
500,000 - 750,000	37%*
750,000 - 1,000,000	39%*
1,000,000 - 1,250,000	41%
1,250,000 - 1,500,000	43%
1,500,000 - 2,000,000	45%
2,000,000 - 2,500,000	49%
2,500,000 - 3,000,000	53%
3,000,000 and over55%	

*The 2002 exemption level of $1,000,000 means that these rates are not currently applicable.

Table 4: Maximum Unified Transfer Tax Rate[2]

Tax Year	Maximum Unified Transfer Tax Rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2009	45%
2010 and later	Estate tax repealed. Highest individual rate (35%) applies to gift tax.

[2] IRC Sections Reference: 2001 and 2502