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Economic Issues Surrounding the Estate and Gift Tax: A Brief Summary

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Summary

Supporters of the estate and gift tax argue that it provides progressivity in the federal tax system, provides a backstop to the individual income tax, and appropriately targets assets that are bestowed on heirs rather than assets earned through their hard work and effort. Progressivity, however, can be obtained through the income tax and the estate and gift tax is an imperfect backstop to the income tax. Critics argue that the tax discourages savings, harms small businesses and farms, taxes resources already subject to income taxes, and adds to the complexity of the tax system. Critics also suggest death is an inappropriate time to impose a tax. The effect on savings, however, is uncertain, most farms and small businesses do not pay the tax, and complexity could be reduced through reform of the tax. This report will be updated as legislative developments warrant.

The estate and gift tax has been the subject of legislative interest for several years, with increases in the exemption enacted in 1997. Proposals to reduce or eliminate the tax were adopted in the 106th Congress, but were vetoed by the President. President Bush had also proposed eliminating the tax and the Ways and Means Committee reported out a bill, H.R. 6, that would phase out the tax. Similar provisions were included in the Senate bill and the final tax cut bill, H.R. 1836, was signed by the President on June 7, 2001, although this legislation retained a gift tax with a large exemption.[1] The entire bill is to sunset after 2010, but there are proposals to make the change permanent, including H.R. 8 which passed the House on April 13, 2005. Further consideration to making the tax change permanent was originally scheduled for the fall of 2005, but was delayed because Congress was considering legislation relating to Hurricane Katrina.

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[1] For a more extensive discussion of estate and gift tax issues, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues,* by Jane Gravelle and Steven Maguire. See CRS Report RL32818, *Estate Tax Legislation in the 109th Congress*, by Nonna A. Noto for further information on proposals. See also CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law*, by John R. Luckey.

The estate and gift tax is a comparatively small source of federal tax revenue, accounting for 1.2% of federal receipts, an amount which has declined following the reduction in rates and the increase in exemptions enacted in 2001. Estates and gifts to spouses are exempt from tax as are gifts to charity. The first $2 million of the net estate value is exempt from tax. Gift taxes have a $1 million effective exclusion in addition to an annual gift exclusion of $11,000 per donee. Taxable estates are subject to a 46% rate. The exemption from tax is scheduled to rise and the tax rate to fall with the estate tax (but not the gift tax) permanently eliminated in 2010, when a tax on capital gains in excess of an exempt amount will be imposed. The 2001 tax cuts, absent legislation, will sunset after 2010 and the rates and exemptions return to the values prior to the 2001 tax changes. The House recently passed legislation to make the repeal permanent.

Arguments for the Estate and Gift Tax

Perhaps the principal argument in support of an estate and gift tax is its contribution to progressivity in the income tax system. The estate tax is the most progressive of any of the federal taxes. According to the latest data from the Internal Revenue Service (2004), out of the approximately 2.4 million deaths per year, only 1.3 % of decedents' estates paid the estate tax; based on the distribution of gross estate, that share is probably close to 0.5% for 2006 and will drop to about 0.2% in 2009. These numbers can be contrasted with the income tax where about 70% of families and single individuals owe tax. Because the exclusion has been rising, the share of decedents' estates paying estate taxes has been falling. Even prior to the 2001 tax cuts, however, only 2% of decedents paid an estate tax. Progressivity in the tax system, however, could also be altered through changes in the income tax.

Another argument made by proponents of the estate and gift tax is that, to the extent that inherited wealth is seen as windfall to the recipient, such a tax source may be seen by some as fairer than taxing earnings that are the result of work and effort.

Finally, many economists suggest that an important rationale for maintaining an estate tax is the escape of unrealized capital gains from any taxation, since heirs receive a stepped-up basis of assets. Families that accrue large gains through the appreciation of their wealth in assets can, in the absence of an estate tax, largely escape any taxes on these gains by passing on the assets to their heirs. The base of the estate tax is, however, quite different from the base of the capital gains tax, and the rates are higher. The 2001 tax revisions proposed to tax capital gains after allowing a significant exemption.

Arguments Against the Estate and Gift Tax

An important criticism of the estate and gift tax is that it reduces savings and economic growth. However, as is also the case for the income tax, neither economic theory nor empirical evidence clearly indicate that the estate tax reduces savings. For example, while the estate tax may discourage saving for bequests because the cost of making a net bequest (in terms of forgone consumption) increases, the tax also requires a greater amount of saving to achieve a net target. Estate and gift taxes are unlikely to have much effect on assets accumulated for precautionary purposes. Bequests can also reduce saving by heirs because they increase resources for consumption.[2]

A second major argument against the estate and gift tax is that it burdens family businesses and farms and makes it more difficult to pass on these assets to the next generation who can continue the business. However, only a small portion (less than 5%) of businesses and farms are likely to be affected; many of those have sufficient liquid assets to pay the tax. In addition, extensions of time to pay the tax are allowed.[3]

Critics also argue that death is not an appropriate occasion to impose a tax; indeed, the tax is sometimes referred to as a "death tax." Another argument is that wealth has already been taxed through income taxes, though this is not the case for unrealized capital gains. Finally, critics assert that the complexity of the tax not only imposes administration and compliance burdens but undermines the progressivity of the tax.[4] Of course, this latter argument could also be a justification for reforming rather than reducing or abolishing the tax.

Other Issues

Two other economic effects of the tax that might be considered in evaluating changes are the possible negative effect on charitable contributions (because charitable contributions are deducted from the estate and gift tax base) and the effect on state and local estate taxes. A credit has been allowed against estate and gift taxes for state estate taxes in the past, although this credit has now been eliminated; these changes may create pressure on states to reduce these taxes which will now become a more visible burden on their residents.

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[2] For an analysis of these savings effects and indications of a limited and uncertain effect from empirical data, see William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Savings?" and Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on Wealth Accumulation and the Avoidance Behavior of Donors," both in *Rethinking Estate and Gift Taxation*, eds. William G. Gale, James R. Hines, Jr. and Joel Slemrod, Washington, D.C., The Brookings Institution, 2001.

[3] For analyses of the estate tax data, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues* by Jane G. Gravelle and Steven Maguire; CRS Report RS20593, *Asset Distribution of Taxable Estates: An Analysis*, by Steven Maguire; and Estate Taxes, Life Insurance, and Small Business by Douglas Holtz-Eakin, John W. Phillips, and Harvey S. Rosen, National Bureau of Economic Research working Paper 7360.

[4] For a discussion of avoidance methods and an estimate that indicates reasonable compliance and administrative costs, see Charles Davenport and Jay Soled, "Enlivening the Death-Tax Death-Talk." *Tax Notes*, July 26, 1999, pp. 591-629.