Estate Tax Options

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Summary

The Economic Growth and Tax Relief Act of 2001 (EGTRRA; P.L. 107-16), among other tax cuts, provided for a gradual reduction and elimination of the estate tax. Under EGTRRA, the estate tax exemption rose from $675,000 in 2001 to $3.5 million in 2009, and the rate fell from 55% to 45%. In 2010, the estate tax was eliminated. As with other provisions of EGTRRA, however, the estate tax changes will sunset in 2011; the exemption will become $1 million (as scheduled in pre-EGTRRA law) and the tax rate will return to 55%.

There is general agreement that some sort of estate tax will be retained. A proposal to make the 2009 rules ($3.5 million exemption and 45% rate) permanent was included in President Obama's 2010 and 2011 budget outlines and was passed by the House in December 2009 (H.R. 4154). Senate Democratic leaders have indicated a plan to enact the 2009 rules permanently (and make them retroactive to 2010). The Senate Republican leadership has proposed a $5 million exemption and 35% rate.

With any of the exemption levels, few estates are affected by the tax. In 2011, the shares of estates taxed are projected by one study to be 1.76%, 0.25%, and 0.14% for the exemption levels of $1 million, $3.5 million, and $5 million, respectively. These numbers would grow to 3%, 0.46%, and 0.23% by 2019. The revenue yield in 2011 is projected to be $34.4 billion, $18.1 billion, and $11.2 billion for the $1 million exemption/55% rate, $3.5 million exemption/45% rate, and the $5 million exemption/35% rate. The estate tax accounts for a small share of revenue.

The estate tax is a highly progressive tax; it not only applies to the largest estates, but within the distribution of estates a large share is concentrated in the over $20 million estate level: 62% for the $3.5 million exemption/45% rate and 73% for the $5 million/35% rate. Because of various exemptions and deductions, the effective tax rates on estates are much smaller than the statutory rate, with an average 16% rate on estates over $20 million for the $3.5 million exemption/45% rate and 12% for the $5 million exemption/45% rate. When distributed with respect to income, 96% falls in the top quintile of the income distribution, 72% in the top 1%, and 42% in the top 0.1%, under the $3.5 million exemption/45% rate.

Although concerns have been raised about the effects of the tax on small businesses and farmers, estimates indicate that the share of estate taxes paid by small business estates under the proposed revisions would be small (16% to 18%) and the share of estates of small business owners taxed is small (about 0.2% of decedents with at least 50% of their assets in businesses). Evidence suggests that the number of returns with inadequate liquid assets to pay the estate tax is negligible.

Other effects are likely small. The effects on savings are uncertain but likely small relative to the economy because the tax is small. Moving to either the $3.5 million plan or the $5 million plan would be projected to decrease charitable contributions by a small amount: 1% to 2%. Recent evidence suggests that the costs of administration and compliance are around 7% of revenues.

Structural reforms that might be considered are inheritance of spousal exemptions, and some reforms directed at abuses. A provision to restrict Grantor Retained Annuity Trusts (GRATS), which can be used to virtually eliminate estate tax by providing an annuity with a remainder, is contained in H.R. 4849. Other provisions in President Obama's budget outline include restricting discounts for estates left to family partnerships and conforming fair market value for purposes of the estate tax and future capital gains realizations for heirs.

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Introduction

The Economic Growth and Tax Relief Act of 2001 (EGTRRA; P.L. 107-16), among other tax cuts, provided for a gradual reduction in the estate tax. The estate tax applies to wealth transferred at death and had, at that time, a unified exemption for both lifetime gifts and the estate, of $675,000.

Under EGTRRA, the estate tax exemption rose from $675,000 in 2001 to $3.5 million in 2009, and the rate fell from 55% to 45%. Although combined estate and gift tax rates are graduated, the exemption is effectively in the form of a credit that eliminates tax due at lower rates so there is a flat rate on taxable assets. The gift tax exemption was, however, restricted to $1 million.

For 2010, EGTRRA scheduled the elimination of the estate tax, although it retained the gift tax and its $1 million exemption. EGTRRA also provided for a carryover of basis for assets inherited at death, so that, in contrast with prior law, heirs who sold assets would have to pay tax on gains accrued during the decedent's lifetime. This provision has a $1.3 million exemption for gain (plus $3 million for a spouse).

As with other provisions of EGTRRA, the tax revisions expire in 2011, returning the tax provisions to their pre-EGTRRA levels. The exemption would revert to $1 million (a value that had already been scheduled for pre-EGTRRA law) and the rate to 55%. The carryover basis provision effective in 2010 would be eliminated (so that heirs will not be taxed on gain accumulated during the decedent's life when they inherit assets).

Most agree that the 2010 provisions will not be continued, and, indeed, may be repealed retroactively. President Obama proposed a permanent extension of the 2009 rules (a $3.5 million exemption and a 45% tax rate), and the House provided for that permanent extension on December 3, 2009 (H.R. 4154). The Senate Democratic leadership has indicated a plan to retroactively reinstate the 2009 rules for 2010 and beyond. Senate Minority Leader McConnell proposed an alternative of a 35% tax rate and a $5 million exemption.[1] A similar proposal for a $5 million exemption and a 35% rate, which also includes the ability of the surviving spouse to inherit any unused exemption of the decedent, is often referred to as Lincoln-Kyl after the two Senators who have supported it. Others have argued for a permanent estate tax repeal.[2]

To address abuses and tax avoidance, President Obama has included proposals in his 2011 budget outline. One of these proposals, to reform the Grantor Retained Annuity Trust (GRAT), is included in H.R. 4849. This provision is discussed in detail below.

After a brief description of the estate and gift tax and of options, this report compares the alternatives, focusing largely on a $1 million exemption and 55% rate, a $3.5 million exemption and a 45% rate, and a $5 million exemption and a 35% rate. Several policy effects and issues are analyzed: the share of decedents subject to tax, revenue effects, distributional effects, and effects on savings, charitable contributions, and compliance and administration. The report also

[1] See Chuck O'Toole, "Estate Tax Expiration Imminent After Congress Fails to Complete Action," *Tax Notes Today*, December 17, 2009, 2009TNT 240-4. For a discussion indicating that there would not be a legal issue with a retroactive tax, see Jay Starkman, "Can an Estate Tax be Retroactive?" *Tax Notes*, February 22, 2010, pp. 972-974.

[2] In addition to H.R. 4154, numerous bills have been introduced in the 111th Congress to address the estate tax. See CRS Report R40964, *Estate Tax Legislation in the 111th Congress*, by Nonna A. Noto.

considers other aspects of the proposals, such as whether the exemptions are indexed for inflation, a proposed inheritance of the exemption for spouses, and proposals to address perceived abuses.

Brief Description of the Estate Tax

This section describes the estate tax as it existed in 2009 and will exist in 2011 absent legislative change. For 2010, there is no estate tax, although the gift tax remains and there is a tax on gains accumulated during the decedent's lifetime when assets are sold by heirs (with a $1.3 million exemption plus $3 million for a spouse). As mentioned above, few expect this treatment to continue.

Basic Structure

The estate and gift tax is a unified tax, so that assets transferred as gifts during a person's lifetime are combined with those transferred at death (bequests) and subject to a single rate schedule.[3] The tax is imposed on the decedent's estate and the rate structure applies to total bequests and gifts given; heirs are not subject to tax. In the past, a single effective exemption applied, but under the 2001 tax revisions effective in 2009, the gift tax exemption was more limited than the combined exemption for both estate and gift taxes. Thus, while a unified rate schedule applies to both bequests and gifts, the exemptions differed in 2009. The combined exemption was $3.5 million, while the exemption for gifts was $1 million. In 2011, the combined exemption will be $1 million, absent change.

Although the rates of the tax are graduated, the exemption is applied in the form of a credit and offsets taxes applied at the lower rates. Individuals are also allowed to exempt annual gifts of $13,000 per recipient, which are not counted as part of the lifetime exemption. The annual gift tax exemption is indexed for inflation in $1,000 increments. A generation skipping tax is also imposed, to address estate tax avoidance through gifts and bequests to a later generation.[4]

Exemptions and Deductions

Estates are allowed to exempt some assets from the estate tax and take a deduction for selected other transfers. Transfers between spouses are exempt. Estates are also allowed to take deductions for charitable contributions and administrative expenses. Currently estates are also allowed a deduction for taxes paid on estates and inheritances imposed by states. Prior to 2001, a credit was allowed, subject to a cap, for state estate taxes, but the credit was phased out and replaced by a deduction in that legislation. (Should EGTRRA provisions expire, the state credit would reappear.)

[3] CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law,* by John R. Luckey provides a detailed description of the estate tax.

[4] For example, parents may directly skip a generation by leaving some assets to grandchildren, or they may set up a lifetime trust for their children, with the assets subsequently inherited by the grandchildren. The generation skipping tax is imposed in these circumstances, although it also has an exemption.

Special Provisions for Small Businesses, Farms, and Landowners

A series of provisions benefit small businesses, including farms or landowners. These include the ability of family businesses to pay the tax in installments with only interest payments during part of the installment period, special use valuation, conservation easements, and, if the law reverts to its 2001 rules, a deduction for family owned business assets. Minority discounts, although granted by courts rather than specifically in the law, may also benefit small businesses.

Although the estate tax return is due within nine months of the death, small businesses are allowed to defer payment (except for interest) for the next five years, and pay the remaining installment payments over 10 years. Since the last interest payment and the first installment coincide, the overall delay in full payment is 14 years. The benefit is allowed only for the business portion of assets and only if 35% of the estate is in a farm or closely held business.

Small businesses are also allowed to value their assets at use as a farm or business. This provision is particularly beneficial to farms and allows a reduction in the estate value of up to $1 million. It means, for example, that the value of the farm will be what it could be sold for if restricted to farm use rather than, for example, to be subdivided for development. Heirs are required to continue use as a farm or business for 10 years.

Farmers and other landowners may also benefit from conservation easements, a perpetual restriction on the use of the land where, in addition to the reduction in value due to the easement itself, an exclusion of up to 40% of the restricted value of the land, capped at $500,000, is allowed.

In prior law, another provision benefitting small businesses was the Qualified Family Owned Business Income (QFOBI) deduction. This provision allowed estates with at least half of their assets in a family business to take a deduction for these business assets. This provision originally allowed up to $675,000 of business deductions at a time when the basic estate tax exemption was $625,000, and imposed an overall cap of $1.3 million on the total of both deductions. Once the regular exemption passed the $1.3 million level, the provision was no longer relevant. If the 2001 tax cuts sunset, the exemption will become $1 million and QFOBI will be relevant again, allowing an additional $300,000 exemption. If the $3.5 million exemption is reinstated for 2011, this provision would again become ineffective, unless revised. To qualify for the QFOBI deduction, heirs must continue the business for 10 years or the tax saving must be repaid.

Step Up in Basis for Appreciated Assets

Heirs take as their basis (the amount to be deducted from the sales price) for purposes of future capital gains the value of the asset at the date of the decedent's death. This treatment is referred to as step-up in basis and means that no capital gains tax is paid on the appreciation of assets during the decedent's lifetime. For example, if decedent purchased stock for $100,000 and the value of the stock at the time of death is $200,000, if the heir sells the property for $250,000 a gain of $50,000 ($250,000 minus the stepped-up basis of $200,000) is recognized. The $100,000 of gain that accrued during the decedent's lifetime is never taxed. The step up rules do not apply to gifts, where carryover basis is applied. In that case, the original basis of $100,000 would be carried over and the gain would be $150,000 ($250,000 minus $100,000). Both the gain accrued by the donor and the gain accrued by the donee are taxed. The step-up rules do not apply to bequests for 2010, where carryover basis, with an exemption, applies, as noted above.

Differences in the Treatment of Bequests and Gifts

Aside from the different exemption levels, there are other differences between the taxation of gifts and bequests. As noted above, gifts do not benefit from the step up in basis. The donor takes the basis in the hands of the donor, generally the original cost of acquiring the assets. The basis cannot be less than the fair market value at the time of the gift if a loss is realized.

At the same time, the gift tax is tax exclusive (the tax is imposed on the gift net of the tax) whereas the estate tax is tax inclusive (the tax is applied to the estate inclusive of the tax). To illustrate, consider a 50% tax rate. Assuming the exemption is already used, to provide a gift of $1 million costs $1.5 million: the tax rate of 50% is applied to the gift of $1 million for a $0.5 million tax. To provide a net amount of $1 million for a bequest, $2 million is required: a tax of $1 million (50% of $2 million) and a net to the heir of $1 million. Another way of stating this is that the gift tax rate, if stated as a tax inclusive rate like the estate tax, would be 33%. Thus for the 55%, 45%, and 35% estate tax rates, the gift tax rate equivalents are 35%, 31%, and 26%.[5]

Options for Revision

The principal components of any policy that continues the estate tax are the amount of the exemption and the tax rate.[6] As indicated earlier, the estate tax will revert to an exemption of $1 million, absent a change in the statute, and while any level of exemption might be considered, the two most common levels mentioned are $3.5 million and $5 million. The level of the exemption affects not only the revenue but the number of estates that are subject to the tax.

The second principal component of a continued estate tax is the rate, which will return to 55% absent legislative change; rates of 45% and 35% are most frequently discussed, although some proposals would apply the capital gains tax rate (currently 15% but scheduled to go to 20% in 2011) or some multiple of it.

Another issue is whether to index the exemption for inflation. Some components of the income tax, such as rate brackets and standard deductions, are indexed, while others (such as child credits) are not. Over time, as prices rise, a fixed exemption causes more estates to be subject to tax. Without indexation, Congress may return from time to time to reconsider the exemption.

A final issue is the potential carryforward of an unused estate tax exemption to the surviving spouse. The provision, contained in the Lincoln-Kyl proposal, would allow spouses to inherit unused estate tax exemptions. Since bequests to the spouse are excluded from the estate, the couple together can have a larger total exemption if the first spouse to die leaves assets to the children or other heirs large enough to absorb his or her estate exemption. This action will reduce the size of the estate subject to tax when the second spouse dies. There are reasons, however, that

[5] To convert the statutory tax inclusive rate into an equivalent rate for a tax exclusive application, the formula is $t/(1+t)$, where t is the tax inclusive rate.

[6] Leaders of both parties have indicated an intention to continue an estate tax, although some bills propose its permanent elimination. If the estate tax is eliminated, the main options are whether or not to continue the gift tax and the carryover basis for appreciated assets. In the absence of an estate tax, a gift tax can limit certain abuses that can arise from the transfer of assets between taxpayers with differing tax rates. These issues are not discussed in detail in this report.

the taxpayer may prefer to leave more assets to a spouse (for example, if there are concerns about having enough assets to live in comfort or cover emergencies). The proposed change is to permit the second spouse to inherit any unused exemption and add it to his or her own future exemption.

Proposals have also been made to increase the percentage or dollar limits of special use valuations and conservation easements. At the same time, there are proposals, including those in President Obama's budget, to restrict practices considered as abuses. One proposal, relating to a certain type of trust (a Grantor Retained Annuity Trust or GRAT) is being considered in H.R. 4849, the Small Business and Infrastructure Jobs Tax Act of 2010. Another proposal would restrict minority discounts for estates that are sometimes allowed by courts when no one heir has a controlling interest in the property. A third provision would require estates and heirs use the same fair market value in determining the valuation for purposes of the estate tax and for determining basis in the hands of the heir.

An Introduction to the Issues

Data, other empirical evidence, and economic theory can help address proposals to revise the estate tax. Relevant economic issues include the scope and effect of the tax on the total population and the distribution of the tax, the revenue yield, and the potential effects on family businesses, savings, administration and compliance, and charitable giving. To the extent possible, different options are compared in the context of these issues.

Other issues are perhaps more philosophical or, as Gale and Slemrod discuss in their article on the estate tax, rhetorical.[7] For example, some people oppose the estate tax because they hold a philosophical view that the estate tax is a death tax and death should not be taxed. Arguments are also made that estate taxes result in a double tax, because assets have already been taxed under the income tax and should not be taxed again. Gale and Slemrod do point out, however, the complexity of the rhetorical questions. For example, they point out that for the vast majority of people (at the time they were writing, 98%) death actually brings potential tax benefits through the forgiveness of tax on accrued but unrealized gains (gains on assets that have not been sold). They also note that income from unrealized appreciation in assets is not taxed during the lifetime and so is not subject to double taxation. They indicate that 36% of estate assets and 80% of the wealth in closely held business and farm estates is from unrealized appreciation.

Supporters of the estate tax may believe it is important to constrain the accumulation of wealth generation after generation. While empirical evidence can demonstrate that the estate tax is highly progressive, the degree to which taxes should be applied to large amounts of wealth in pursuit of reducing inequality in society, much like the question of whether it is wrong for death to trigger a tax, is a value judgment.

Coverage of Decedents

The estate tax has never affected more than a small fraction of decedents. **Table 1** indicates that if the law reverts to the $1 million exemption, less than 2% of decedents would pay an estate tax.

[7] William G. Gale and Joel Slemrod, "Rhetoric and Economics in the Estate Tax Debate," *National Tax Journal*, vol. 54, September 2001, pp. 613-627.

Table 1 also indicates that restoring the $3.5 million exemption leads to a quarter of 1% of decedents paying the tax. Moving to a $5 million exemption reduces the share to 0.14%. The column for 2019 illustrates the effects of indexing the $3.5 million and the $5 million for inflation, starting from 2009. Note that even with indexing for inflation, real asset growth leads to an increased share of decedents paying the estate tax. With or without indexing, the $3.5 million option will affect less than ½ of 1% of decedents and the $5 million option will affect less than ¼ of 1% of decedents. If the main focus of legislation is to exclude all but a small fraction of estates from the tax, the $3.5 million exemption and the $5 million exemption accomplish that goal, and indexing does not matter very much over short time horizons.

Table 1. Percentage of Decedents Subject to Estate Tax

Exemption Level	2011	2019
$ 1 million	1.76	3.00
$3.5 million	0.25	0.46
$3.5 million, indexed for inflation	0.24	0.32
$5 million	0.14	0.23
$5 million, indexed for inflation	0.14	0.18

Source: Based on data in Urban Brookings Tax Policy Center, Table T09-0431, http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2506&topic2ID=60&topic3ID=66&DocTypeID=

Note: For proposals that are indexed, the indexation begins from 2009.

Liabilities and Revenue Loss

An issue in the choice of estate tax provisions is the revenue cost. Although the estate tax accounts for a small share of total federal revenues, 1.3% in 2012 if the $1 million exemption/55% rate provisions are retained, concerns remain about revenue losses.

Revenue costs are normally estimated against a current law baseline. Thus, the cost of keeping the 2009 rules in place retroactively to 2010, with a $3.5 million exemption and a 45% tax rate, would be compared to no estate tax in 2010; therefore there would be a revenue gain compared to no estate tax. In subsequent years, where current law reverts to a larger estate tax (a $1 million exemption and 55% rate) the smaller estate tax will lead to a revenue loss. Receipts are also measured when they flow into the Treasury and there is a delay in the filing of estate tax returns. The Joint Committee on Taxation (JCT) in 2009 estimated a gain of $0.5 billion in FY2010, then a loss, rising to $38 billion in FY2019 for a total of $234 billion over the 10-year period (FY2010-FY2019). Treasury's estimates are smaller, with a $3 billion and a $1 billion gain respectively in the first two fiscal years, becoming a $28 billion loss by FY2019, and losing $171 billion over a 10-year period.[8]

Another way to examine the alternatives is to look at the estimated yield for alternative proposals, that is, the liability rather than the flow of revenue to the Treasury. **Table 2** provides data from the Urban Brookings Tax Policy Center for the three exemption levels. In 2011, the scheduled rules

[8] These Treasury and JCT numbers are reported on a year by year basis in CRS Report R40964, *Estate Tax Legislation in the 111th Congress*, by Nonna A. Noto, p. 10.

($1 million exemption, 55% rate) are estimated to produce a liability of $34.4 billion; the $3.5 million exemption, 45% rate a revenue of $18.1 billion, and the $5 million exemption/35% rate a revenue of $11.5 billion. Thus, in 2010, the reduced liability from moving to a $3.5 million exemption with a 45% rate is $16.3 billion, whereas moving to the $5 million exemption with a 45% rate loses an additional $6.9 billion, for a total of $26.2 billion. The cost increases over time as the real and nominal value of wealth grows, so that, for example, the reduction in tax from moving to a $3.5 million exemption and 45% rate increases from $16.3 billion in 2011 to $30.7 billion in 2019.

Table 2. Estate Tax Liability Under Alternative Proposals ($billions)

Exemption Level/Rate	2011	2019
$ 1 million, 55% rate	34.4	62.2
$3.5 million/45% rate	18.1	31.5
$3.5 million, indexed for inflation/ 45% rate	17.9	28.9
$5 million/ 35% rate	11.2	20.9
$5 million, indexed for inflation/ 35% rate	11.2	17.9

Source: Based on data in Urban Brookings Tax Policy Center, Table T09-0431, http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2506&topic2ID=60&topic3ID=66&DocTypeID=

Notes: For proposals that are indexed,, indexation begins from 2009.

Table 2 also contains estimates of estate tax liability if exemptions are indexed (assuming indexing back to 2009). Indexing does not make a great deal of difference over this time period. Real growth in wealth is more important. For example the difference between revenues in 2011 and 2019 for the $3.5 million exemption/45% rate is $13.4 billion but only $2.6 billion of the difference is due to lack of indexing for inflation.

As indicated above, the two proposals generally discussed are the $3.5 million exemption and 45% tax rate, and the $5 million exemption and 35% tax rate. However, various combinations of rates and exemptions could be considered. **Table 3** reports the estimates of estate tax liability for each of the three exemption levels at different rates. It shows that, compared with the default $1 million exemption, a larger amount of the revenue loss results from moving to the $3.5 million exemption rather than the 45% rate. Similarly, in moving from the $1 million to the $5 million exemption, the cost of the exemption increase is smaller than lowering the rate to 35%. However, once the exemption is set a $3.5 million and the rate at 45%, the cost of moving to a $5 million exemption ($14.2 billion) is about the same as the cost of moving to a 35% tax rate ($14.1 billion).

The rate reductions tend to benefit, relatively, a wealthier group of estates than exemptions, and thus reduce progressivity of the estate tax. However, rate reductions also reduce the average marginal tax rate more than exemption increases, which could matter for economic efficiency. These distributional issues are discussed more fully in the next section.

Table 3. Estate Tax Liability 2011: Exemption and Rate ($ billions)

Exemption Level	55% rate	45% rate	35% rate
$1 million	34.4	28.1	21.8
$3.5 million	22.1	18.1	14.1
$5 million	17.4	14.2	11.2

Source: Based on data in Urban Brookings Tax Policy Center, Table T09-0431, http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2506&topic2ID=60&topic3ID=66&DocTypeID=

Distributional Issues

One of the rationales for an estate tax is to impose a tax on high income and high wealth taxpayers, and contribute to the progressivity of the tax system. As indicated in the discussion of coverage, all of the proposals fall on a small proportion of decedents and thus, due to the size of the exemption level, on those with the greatest wealth. The alternative proposals have different effects on the size of estates covered and the distribution of taxes.

As indicated in **Table 4**, the number of estates is concentrated in the smaller estates. With the $1 million exemption, about half of the estates subject to tax have assets of under $2 million and almost 80% have assets of under $3.5 million and these estates would be eliminated from estate tax coverage with either the $3.5 million or the $5 million exemption. With a $3.5 million exemption, the share of taxable estates under $5 million is smaller than the share falling between $5 million to $10 million group. Of the returns taxed under the $3.5 million exclusion, 23% are less than $5 million in assets and would not be taxed under the $5 million exclusion.

Table 4. Percentage Distribution of Taxable Estate Tax Returns by Size of Estate, 2011

Size of Estate ($millions)	$1 Million Exemption, 55% Rate (44,230 returns)	$3.5 Million Exemption, 45% Rate (6,420 returns)	$5 Million Exemption, 35% Rate (3,560 returns)
1-2	52.2	0.0	0.0
2-3.5	26.0	0.0	0.0
3.5-5	9.1	23.7	0.3
5-10	7.6	44.7	45.2
10-20	2.8	18.7	31.7
Over 20	2.2	12.8	22.5
Total	100.0	100.0	100.0

Source: Based on data in Urban Brookings Tax Policy Center, Tables T09-0396, T09-0398, T09-0398
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2471&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2473&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2474&topic2ID=60&topic3ID=66&DocTypeID=

As shown in **Table 5**, revenue from the estate tax is more concentrated in larger estates. The largest share of revenue is in the $20 million and above class regardless of the exemption. With a return to the $1 million exemption that class would pay one-third of the revenue; with a $3.5

million exemption it would pay over 60% and with a $5 million exemption it would pay almost three-quarters of the estate tax. These estimates indicate that the estate tax not only applies to high wealth families, but with either the $3.5 million or the $5 million exemption more than half the revenue is collected from estates with $20 million or more in assets.

Table 5. Percentage Distribution of Estate Tax Revenue by Type of Return, 2011

Size of Estate ($millions)	$1 Million Exemption, 55% Rate ($34.4 billion total)	$3.5 Million Exemption, 45% Rate ($18.1 billion total)	$5 Million Exemption, 35% Rate ($11.2 billion total)
1-2	7.5	0.0	0.0
2-3.5	15.9	0.0	0.0
3.5-5	10.8	2.4	0.0
5-10	18.3	16.1	9.5
10-20	13.9	18.3	18.0
Over 20	33.7	62.3	72.5
Total	100.0	100.0	100.0

Source: Based on data in Urban Brookings Tax Policy Center, Tables T09-0396, T09-0398, T09-0398
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2471&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2473&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2474&topic2ID=60&topic3ID=66&DocTypeID=

Although the statutory marginal tax rates are often criticized as being very high, the average share of the estate paid in tax is much lower. Part of the reason for the lower effective tax rate is the exemption. For example, even if a $10 million estate has no other deductions and exemption, a $3.5 million exemption means only $6.5 million is taxed. The tax of $2.95 million (45% of $6.5 million) is a tax of 29.5% on the $10 million.

As shown in **Table 6**, the effective tax averages less than 20% for estates up to $20 million and the average rate on those estates is less than 20%. The effective tax rate also rises, generally, with estate size, which would be expected as the exemption is a smaller share of the estate. With the $1 million exemption, the tax is 16.5% in the highest class, while it is 16% under the $3.5 million exemption and 11.5% under the $5 million exemptions. Important reasons for lower effective tax rates are the exemption, spousal transfers, and charitable contributions. The decline in effective tax rate at the very highest estate size for the $1 million exemption may reflect the greater likelihood of charitable contributions and the lesser importance of the exemption.

Table 6. Effective Estate Tax Rate (Tax as Percentage of Assets), 2011

Size of Estate ($millions)	$1 Million Exemption, 55% Rate	$3.5 Million Exemption, 45% Rate,	$5 Million Exemption, 35% Rate
1-2	2.6	0.0	0.0
2-3.5	10.1	0.0	0.0
3.5-5	12.9	1.5	0.0
5-10	15.5	7.2	2.6
10-20	18.6	13.6	7.9

Size of Estate ($millions)	$1 Million Exemption, 55% Rate	$3.5 Million Exemption, 45% Rate,	$5 Million Exemption, 35% Rate
Over 20	16.5	16.0	11.5

Source: Based on data in Urban Brookings Tax Policy Center, Tables T09-0396, T09-0398, T09-0399
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2471&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2473&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2474&topic2ID=60&topic3ID=66&DocTypeID=

Most distributional analyses of taxes are reported relative to income. As shown in **Table 7**, the Tax Policy Center has estimated the distribution by income class of the tax for the $1 million exemption /55% rate and the $3.5 million exemption/45% tax rate. As this table indicates, the estate tax is highly concentrated in the higher income classes. For the $1 million exemption, 83% of the tax falls in the top quintile and 45% of the tax in the top 1%. For the $3.5 million exemption, 96% of the tax is imposed on the top quintile and 72% on the top 1%. These results indicate that the estate tax is a highly progressive feature of the federal tax system.[9]

Table 7. Distribution of Estate Taxes by Income Class

Income Share	$1 Million Exemption, 55% Rate	$3.5 Million Exemption, 45% Rate
Bottom Quintile	0.3	0.1
Second Quintile	0.9	0.2
Middle Quintile	5.2	0.4
Fourth Quintile	8.9	0.4
Top Quintile	83.1	96.2
80-90th Percentile	8.6	2.0
90-95th Percentile	6.0	1.3
95-99th Percentile	23.4	20.8
Top 1%	45.0	72.0
Top 0.1%	22.6	42.1

Source: Based on data from Urban Brookings Tax Policy Center, Tables T10-0073 and T09-0402
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2664&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2477&topic2ID=60&topic3ID=66&DocTypeID=

Notes: Distribution for the $1 million exemption is based on combined data with distributions for 2009 and 2012, weighted by 2010 revenue effects. Distribution for the $3.5 million exemption is for 2009.

9 The corporate tax is estimated to have a similar amount of concentration at higher income levels as the estate tax at the $1 million exemption level; the $3.5 million level is more concentrated. The individual income tax is more progressive at the lower end of the distribution, however, because it provides subsidies. For comparisons of taxes see Urban Brooking Tax Policy Center Table T09-0373 http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2448&topic2ID=40&topic3ID=81&DocTypeID=.

Effects on Small Businesses and Farmers

An issue that has played an important role in the debate over the estate tax is the possible impact on small businesses and farms. The role played by the small business issue in the original 2001 legislation is detailed by Graetz and Shapiro.[10] Arguments were made that the estate tax causes families to have to sell businesses to pay the estate tax because there are not enough liquid assets to pay the tax.

According to aggregate data for 2008, farm assets account for 2.4% of assets reported on estate tax returns, and business assets constitute 17.9%.[11] These shares include assets of estates where business or farm assets may be a minor part of the estate.

Evidence on the effect of the tax on small business suggests that the taxable business estates are a small share of all taxable estates and a small share of estates of all business decedents. **Table 8** provides estimates for the coverage of the estate tax reported or derived from the Urban Brookings Tax Policy Center of estates with at least half of their assets in business. As shown in the table, these estates are less than 10% of taxable estates, and, as with other estates, only a small fraction of business estates pay the estate tax (0.2% for the $3.5 million and $5 million exemption).

Table 8. Coverage of Estates with At Least Half of Assets in a Business, 2011

Exemption	Taxable Estate Returns	Percentage of all Taxable Estate Returns	Estimated Taxable Estates of Businesses as a Percentage of Decedents with Business Assets
$1 million	3030	6.9	1.6
$3.5 million	440	6.9	0.2
$5 million	350	9.8	0.2

Source: Based on data from Urban Brookings Tax Policy Center. Data on Taxable Estates of with Half of More of the Estate in Business Assets from Tables T09-0196, T09-0i98, and T09-0199. http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2270&topic2ID=60&topic3ID=66&DocTypeID= http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2272&topic2ID=60&topic3ID=66&DocTypeID= http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2273&topic2ID=60&topic3ID=66&DocTypeID= Data on total number of estates and total decedents from Table T09-0431 http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2506&topic2ID=60&topic3ID=66&DocTypeID= Data on the share of tax returns with at least half of income from business is from Table T09-0426. http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2501&topic2ID=60&topic3ID=73&DocTypeID=

Notes: To estimate the share of decedents with business assets, the share of income tax returns with more than half of income from small business (7.5%) was multiplied by the total number of decedents.

As shown in **Table 9**, data indicate that returns with business assets account for a somewhat higher share of the estate tax than they do of the number of taxable estates, suggesting some larger concentration of business assets in larger estates. (Note that in this case, the tax paid

[10] Michael J. Graetz and Ian Shapiro, *Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth,* Princeton, N.J. Princeton University Press, 2005.

[11] See CRS Report RS20593, *Asset Distribution of Taxable Estates: An Analysis*, by Steven Maguire. Assets counted as business include closely held stock , real estate partnerships, other limited partnerships, farm assets, and other non-corporate business assets. If real estate and limited partnerships are excluded, the share is 14%.

reflects total estate tax, and thus includes tax on business and non-business assets.) However, the effective tax rates (taxes paid as a percentage of the assets of all estates of $1 million or more) are somewhat lower for these small business returns, suggesting the use of discounts may be important.

Table 9. Taxes Paid on Small Business Estates, 2011

Exemption/Rate	Estate Tax Liability ($billions)	Share of Estate Tax Liability	Effective Tax Rate, Business Estates	Effective Tax Rates, All Estates
$1 million, 55%	3.7	10.8	10.4	10.8
$3.5 million, 45%	2.9	16.0	9.3	10.8
$5 million, 35%	1.8	18.0	7.8	8.1

Source: Based on data from Urban Brookings Tax Policy Center. Data on Taxable Estates of with Half of More of the Estate in Business Assets from Tables T09-0196, T09-oi98, and T09-0199. http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2270&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2272&topic2ID=60&topic3ID=66&DocTypeID=
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2273&topic2ID=60&topic3ID=66&DocTypeID=

Although the Urban Brookings Tax Policy Center did not separately estimate farmer estates or consider questions of whether these estates had adequate liquid assets to pay the tax, a study done by the Congressional Budget Office (CBO) did examine these issues. This CBO study likely defined farmers more broadly than the Tax Policy Center criterion. At the same time, it examined the subset of estates that took the QFOBI exemption, which would be both small business and farm estates where the heirs expected to continue the business and where more than half of the estate was in the family business. The analysis was for 2000. Column 2 of **Table 10** reports those values at an average annual growth rate of 3.5% for 11 years (for 2000 to 2011), to project the distribution across estate sizes for 2011. (This measure increases the value by the average annual growth rate of the economy minus growth in the labor force for 2000-2009, applied over 11 years, thus taking into account real wealth growth as well as inflation).

Table 10 indicates that the number of farm estates, using their measure of farms subject to the tax, would be less than 123 estates at the $3.5 million exemption and about 65 at the $5 million exemption. These estates are about 2% of all estates owing tax. The number of returns claiming QFOBI are also small, accounting for 2% to 2.5% of all taxable estate returns.

Table 10. Number of Farm Estates or Estates Claiming QFOBI Deductions with Estate Tax Liability at Different Exemption Levels

2000 Exemption Level ($millions)	Level Adjusted for 2011 ($ millions)	Number of Farm Estates	Percentage of Total Estates	Number of QFOBI Estates	Percentage of Total Estates
0.675	1.0	1659	3.2	485	0.9
1.5	2.2	300	2.2	223	1.6
2.0	3.0	123	1.9	135	2.1
3.5	5.1	65	1.8	94	2.5

Source: Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses*, July 2005. http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf.

Table 11 shows results the study found for a second question: how many estates of these types are likely to have insufficient liquid assets in the estate to pay the tax liability? While there were 138 farm estates in these circumstances for the $1 million exemption, there were only about 15 for the larger exemptions. These returns account for 0.2% and 0.4% of returns paying estate tax. For estates claiming the QFOBI deduction there were 62 at the $3.5 million exemption and 41 at the $5 million exemption. These returns accounted for about 1% of taxable estates.

Table 11. Number of Farm Estates or Estates Claiming QFOBI with Insufficient Liquid Assets to Pay the Tax

2000 Exemption ($millions)	Level Adjusted for 2011 ($millions)	Number of Farm Estates with Insufficient Liquidity	Percentage of Total Estates	Number of QFOBI Estates with Insufficient Liquidity	Percentage of Total Estates
0.675	1.0	138	0.3	164	0.3
1.5	2.2	27	0.2	82	0.5
2.0	3.0	15	0.2	62	0.9
3.5	5.1	13	0.4	41	1.1

Source: Congressional Budget Office, Effects of the Federal Estate Tax on Farms and Small Businesses, July 2005. http://www.cbo.gov/ftpdocs/65xx/doc6512/07-06-EstateTax.pdf.

A different survey of farmers performed by the Department of Agriculture estimated that farm estates would pay $683 million in estate taxes in 2009, which would be just under 4% of total estate tax liability, and that 1.6% of farms decedents would pay the estate tax under the 2009 provisions.[12] This share is much larger than the share for businesses overall reported by the Tax Policy Center and is also about twice as large as the estimates implied by the CBO study.[13]

Regardless of the data source used, the evidence suggests two important characteristics of businesses and the estate tax: businesses pay a small fraction of the estate tax and a tiny fraction of total estates of businesses and farmers are liable for the tax. If estate tax policy decisions are driven by these concerns, a more target-efficient alternative would be to provide additional benefits for business assets, such as an expanded QFBOBI deduction.[14]

Effects on Savings and Output

Some claims have been made that the estate tax causes a significant reduction in savings. This effect may be alleged to be so damaging that it justifies eliminating the tax. However, there is no clear basis for this claim. Economic theory does not provide a clear guide. If the bequest motive is primarily to leave a bequest to one's heirs because of concerns about their welfare, the estate

[12] Ron Durst, *Federal Tax Policies and Farm Households*, U.S. Department of Agriculture, Economic Information Bulletin 54, Mau 2009, http://www.ers.usda.gov/Publications/EIB54/EIB54.pdf

[13] The number of farms reported in the USDA study are 2.022 million, and if the average death to population ratio (about 0.008) were applied, the number of total farm decedents would be about 17,000. The 123 returns reported by CBO are about 0.7% of this number.

[14] See CRS Report RL33070, *Estate Taxes and Family Businesses: Economic Issues*, by Jane G. Gravelle and Steven Maguire for a discussion of business deduction options.

tax could lead to less saving (because a gift to one's children is made more costly relative to one's own consumption, the substitution effect), or it could lead to more savings to retain a larger amount after the estate tax is paid (the income effect). These offsetting income and substitution effects create an ambiguous theoretical prediction about the effect of the estate tax on savings. If the main purpose of accumulating assets is to provide a precautionary savings amount (to account for catastrophic illness, for example), the estate tax does not matter, since it is irrelevant to that purpose.

With theoretical uncertainty, the issue becomes an empirical one. Here, however, there is virtually no empirical evidence. In the single study of the wealth elasticity of estates (the percentage change in wealth divided by the percentage change in taxes), Kopczuk and Slemrod characterized their results as fragile, meaning that the results depended on model specification.[15]

A study by Holtz-Eakin and Smith used an elasticity from one of the specifications in the Kopczuk and Slemrod study to estimate that the estate tax caused a decrease in wealth of $1.6 trillion.[16] Although this estimate was based on total projected wealth associated with those filing estate tax returns (in 2004), the report indicated the increase in capital was an increase in small business capital (although, as noted above small businesses account for only a fraction, about 16%, of the estate tax). That estimate was, in turn, used to project increases in hiring by small businesses.

The effect projected in the Holtz-Eakin and Smith study appears quite large.[17] As a simple illustration, consider that the effect of estate taxes on savings should be similar to the effect of capital income taxes in general. In 2007, the last year for which data on sources of income in the income tax were available, the estate tax accounted for only 4% of capital income tax revenue at the Federal level.[18] This ratio implies that eliminating capital income taxes would increase wealth by $40 trillion ($1.6 trillion dividend by 0.04). This amount would be an approximate doubling of the total U.S. capital stock.[19] Even the most generous model with infinitely elastic savings responses tends to produce an increase of about a third that size, and estimates based on the higher end of empirically estimated time-series savings rates would suggest a result only a tenth of that size. Some effects from dynamic models, depending on how the revenue loss is offset, are negative or negligible.[20]

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[15] Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," Working Paper 7960, National Bureau of Economic Research, October 2000.

[16] Douglas Holtz-Eakin and Cameron T. Smith. "Changing Views of the Estate Tax: Implications for Legislative Options," American Family Business Foundation, February 2009.

[17] Unfortunately, the study did not spell out the methodology used in detail, including not identifying precisely what elasticity was used or how the price and income effects were measured.

[18] Based on CBO data the estate tax collected $26 billion in that year, while the corporate tax collected $370 billion and capital gains $126 billion (Congressional Budget Office, The Budget and Economic Outlook for FY2010-FY2019, January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf). From individual tax return data an additional $121 billion is estimated from the individual income tax (a 15% tax on qualified dividends, a 20% tax on other income including interest, rent, and business income). The estimate assumes that 25% of business income is a return to capital. Data from Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, located at http://www.irs.gov/taxstats/.

[19] Based on a typical rule of thumb that the capital stock is 3.5 times output, the capital stock would be around $40 billion. Note that a different functional form, such as a constant elasticity function, could alter the projection but not the general magnitude.

[20] See Eric Engen, Jane Gravelle, and Kent Smetters, "Dynamic Tax Models: Why They Do the Things They Do" *National Tax Journal* , vol. 50, September 1997, pp. 657-682. Results from eliminating capital income taxes ranged (continued...)

One problem with the estimate in the estate tax study is that it did not take account of feedback effects from the economy, particularly the decline in pre-tax return when the capital stock expands.[21] That feedback effect is the reason that an infinitely elastic response leads to a limited effect: the capital stock expands only enough to drive the after tax return back to its original value.

Given lack of theoretical and empirical evidence it is not possible to precisely determine what the effect of repealing the estate tax on savings, but it is likely to be small, simply because the yield of the tax is small. Any effect on the stock of capital in small business should only be a fraction of that amount.

The tax rate is more important than the exemption in determining any positive effects of reducing the estate tax on savings, since that rate is more important for the marginal rate that drives the substitution effect. Exemptions affect the substitution effect by pushing some income into a zero marginal tax rate, but are more important for the average rates that determine the income effect, so that higher exemptions are less likely to increase savings than higher rates.

Effect on Charitable Contributions

Unlike the effect of the estate tax on savings, there is an extensive empirical literature on the response of charitable bequests in the estate tax, and the evidence indicates a significant response of bequests. Nevertheless, according to a recent CRS study, the effect on overall charitable giving is likely to be small: moving from the $1 million exemption with a 55% tax rate to the $3.5 million exemption with a 45% tax rate would be projected to lower charitable giving by 1%; moving to the $5 million exemption with a 35% rate would be projected to reduce giving by 2%.[22] These relatively small effects occur largely because only 4% to 6% of giving is affected by the estate tax. The effects would be larger for foundations and certain types of organizations (such as higher education) that are more likely to receive bequests.

Administrative and Compliance Cost

Another issue is the degree to which the estate tax causes excessive compliance and planning costs for taxpayers, and administrative costs for the IRS. Some arguments have been made that these costs, particularly for estate planning, are as large as the estate tax itself. Gale and Slemrod, however, review the limited evidence and conclude that the cost of administration and

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(...continued)

from a 1% fall in the capital stock to a 34% rise.

[21] In technical terms, the estimate appears to have been made solely from looking at the supply curve and did not take account of the demand curve. The elasticity of the demand curve for capital with respect to the rate of return is the factor substitution elasticity divided by the labor income share of output, and multiplied by the rate of return, divided by the rate of return plus depreciation. The factor substitution elasticity is generally one or less in absolute value (the elasticity is negative), the labor share about two thirds, and the ratio of return to return plus depreciation about 0.7 making the absolute value of the demand elasticity of capital 1.05 or less. Since the total elasticity is the demand elasticity times the supply elasticity, all divided by the sum of the absolute value of the two elasticities, and the calculations imply that the supply elasticity is about 2.22, the inclusion of demand effects would have reduced the projection by over two thirds.

[22] CRS Report R40518, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, by Jane G. Gravelle and Donald J. Marples.

compliance is probably in the neighborhood of 7% of revenues, with almost all of that cost due to planning and compliance.[23]

Other Design Issues

This section briefly discusses proposals to revise certain features of the estate tax. These include portability of the spousal exemption, changing the rules on certain trusts, restricting minority discounts, and conforming definitions of fair market value for estates and heirs.[24]

Portability of the Spousal Exemption

Because transfers between spouses are exempt from the estate tax, the estate exemption is of no value to a person who transfers all of his or her estate to a spouse. For example, if the estate tax exemption is $3.5 million and a couple jointly owns assets of $8 million ($4 million each), if the first spouse to die leaves $4 million to the second spouse, and the second spouse then leaves $8 million to children, $4.5 million of the estate will be subject to tax. If the first spouse to die left $3.5 million to the children directly, then the second spouse would have an estate of $4.5 million, with only $1 million subject to the estate tax.

There are estate planning options (such as credit shelter trusts) that can address this issue. However, these options (which may also require an initial transfer of assets between spouses) not only require complicated estate tax planning but also may cause taxpayers to dispose of their assets in a way that they would not prefer.

Simply allowing a spouse to inherit any unused portion of the exemption is an alternative. In the example above, all of the assets could be left to the remaining spouse on the death of the first spouse, and the second spouse to die would be able to claim a total exemption of $7 million (the sum of both exemptions). Portability can also be valuable with assets, such as pension rights, that cannot be transferred.

Although there are some advantages to this provision in both equity and simplified planning, there are problems as well. First, the portability provision will cost increasing amounts of revenue in the future. The JCT provided estimates suggesting that the number of estates benefitting from portability will increase by 14 times over ten years.[25] Thus, allowing portability is likely to substantially decrease revenues in the long run. However, it may be more likely to benefit smaller estates where it may be more difficult to engage in the types of transfers and planning needed to absorb the credits.

There are some complications as well for designing and administering this provision, some of which are detailed in the JCT study.[26] Second (and more) marriages raise an issue. Should the

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[23] William G. Gale and Joel Slemrod, "Rhetoric and Economics in the Estate Tax Debate," *National Tax Journal*, vol. 54, September 2001, pp. 613-627.

[24] These issues do not exhaust the possible reforms that might be considered. See CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Donald J. Marples and Jane G. Gravelle, pp. 22-24.

[25] Joint Committee on Taxation, *Taxation of Wealth Transfers Within A Family: A Discussion of Selected Areas for Possible Reform*, JCX-23-08, http://www.jct.gov/publications.html?func=startdown&id=1317

[26] See also William J. Turnier, "Three Equitable Taxpayer-Friendly Reforms of Estate and Gift Taxation," *Tax Notes*, April 10, 2000, pp. 269-279.

inheritance be allowed for future marriages or should it be inherited only once? That is, suppose a widow remarries, and then dies leaving all her assets to a second spouse: does the second spouse inherit two exemptions or one? Is there a possibility for deathbed marriages to terminally ill low income individuals to generate an additional deduction (and how can that be distinguished from "legitimate" marriages with a tragic early death)?

Another question is: should the value of the inherited exemption be limited to the value of the spouse's estate. That seems to be a reasonable rule. Otherwise, if the second spouse continues to accumulate wealth, the portability would effectively increase the exemption over the amount available had each spouse absorbed the exemption in their own estate. Such a rule, however, would require the filing of estate tax returns and valuation of the estate when they would not otherwise be subject to tax. There would also be issues about how to reconstruct fair market value, if the portability were allowed if the first estate tax return were not filed. As with many solutions that seem simple, complications remain.

Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust (GRAT) is a trust that allows the grantor to receive an annuity, with any remaining assets transferred to the trust recipient. The value of the gift is reduced by the value of the assets used to fund the annuity. If the assets in the trust appreciate substantially, then virtually all of the gift can be reduced by the value of the annuity, while still providing a substantial ultimate gift to the recipient. If the grantor dies during the annuity period the remaining value of the annuity is included in the estate. Thus for this trust approach to be a method of transferring assets roughly tax free, the assets must appreciate at a rate faster than the discount rate used to value the annuity, and the grantor needs to survive over the period of the annuity. To assure the latter will be likely to occur, many of these trusts have very short annuity periods, as short as two years. The GRAT proposal contained in H.R. 4849 and in the President's budget proposals[27] would impose a minimum annuity term of ten years, disallow any decline in the annuity, and require a non-zero remainder interest. The Administration estimates this proposal would raise $3 billion over 10 years.

Minority Discounts

There are existing restrictions to keep estates from engaging in artificial actions designed to reduce the value of estates (such as freezes on assets). As discussed above, courts sometimes allow estates to reduce the fair market value when assets are left in family partnerships where no one has a majority control. These discounts have even been allowed when assets are in cash and readily marketable securities, and the setting up of these family partnerships has become an estate tax avoidance tool. A provision in the Administration's proposal would set up a category of disregarded actions that could not be used to allow discounts. The estimated revenue gain is $18.7 billion over 10 years.

[27] For a discussion of these and other proposals, see the "Green Book": *General Explanations of the Administrations Fiscal Year 2011 Revenue Proposals.* February 2010, http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf.

Consistent Valuation

There is no explicit rule preventing a low valuation of fair market value for an estate and a high valuation of the asset for purposes of stepped up basis in the hands of the heir. A provision in the Administration's budget proposals would require this value to be the same and is projected to raise $3 billion over ten years.

Conclusion

The analysis indicates that the estate tax is relatively small, in revenues, in coverage, and in its effects on family businesses, savings, charitable contributions, and tax administration and compliance. One-fourth of 1% or less of all estates and of family businesses are expected to be subject to tax under an exemption of $3.5 million or $5 million. This share would grow slightly over the 10-year budget horizon, but indexing the exemption would not be very important over this short time period.

The estate tax is a small, but highly progressive, element of the tax system. Under the proposals under consideration (the $3.5 million exemption and the $5 million exemption), the majority of the tax falls on estates of $20 million or more, which in turn constitute only three-hundredths of 1% of decedents. For the $3.5 million exemption, 45% rate effective in 2009 and under consideration as a permanent treatment, 96% of the tax falls on the top quintile of the income distribution, 72% falls in the top 1%, and 42% in the top 0.1%.

Effects on savings are uncertain in direction but likely small. Based on empirical evidence, a decline of 1% to 2% in charitable contributions from increasing the estate tax relative to the current law baseline of a $1 million exemption with a 55% rate would be expected. Costs of estate planning and administration are relatively small as a percent of estate tax revenue.

Because transfers between spouses are exempt, allowing spouses to inherit the exemption can increase the combined couples' exemption, and simplify estate planning. This change could cost increasing amounts of revenue over time, however, and lead to certain administrative complications.

Several provisions to deal with perceived abuses might be considered, with the most important one relating to the use of discounts when assets are left to a family partnership and no one heir controls the property.

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