

The Estate Tax

Background

In the United States, the estate tax—“death tax” to its critics—is a charge imposed on the transfer of the taxable estate of a deceased person. The tax is not only levied on liquid assets like cash, stocks and bonds, but also hits fixed assets like small businesses and family farms – assets that sometimes must be sold or heavily borrowed against to pay the tax.

The estate tax was originally established in 1797 to help the United States build its navy. It was repealed in 1802, and re-enacted only during the Civil War and the Spanish-American War. The estate tax became a permanent part of the federal tax code in 1916 on estates larger than \$50,000 (about \$950,000 in 2010 dollars); its top rate was 10 percent. The revenue yield from the early form of this tax was low because the people who would have been subject to it simply gave away their assets without penalty during their lifetimes. To close this loophole, a gift tax was established in 1924 to augment the estate tax. Since 1976, the estate tax and the gift tax have been unified into one tax system.ⁱ

Since the Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted, the amount allowed to be excluded from estates increased from \$675,000 to \$3.5 million in 2009, while the maximum top rate fell from 55 percent in 2001 to 45 percent, before both were repealed for one year in 2010.ⁱⁱ As of 2011, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the exclusion amount at \$5 million and a top tax rate of 35 percent for 2011 and 2012.ⁱⁱⁱ

The phase-out of the death tax from 2001-10 represents Congress’ recognition of the economic damage it causes.

ISSUE SNAPSHOT

As of 2011, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the exclusion amount at \$5 million and a top tax rate of 35 percent for 2011 and 2012.

It is long past time for Congress to permanently repeal the estate tax. It serves none of the original purposes Congress intended in 1916, and it presents a significant danger for family-owned businesses.

Even though the new estate tax laws for 2011-12 have a relatively high exclusion amount and a lower top tax rate, they still possess the ability to hurt businesses, workers, and the economy. Specifically, the estate tax:

- **Discourages savings and investment:** If a family believes that they are making enough income to be required to pay an estate tax, they might well conclude that it would be better spend their earnings now instead of investing and making more money in the future.
- **Undermines job creation:** Because the estate tax discourages savings and investment, it reduces capital that would otherwise be available for businesses to expand their operations and add new workers.
- **Suppresses wages:** Because the estate tax reduces the capital needed for businesses to upgrade their tools, workers’ productivity cannot increase as it could if they had newer technology.
- **Stifles entrepreneurship:** The estate tax keeps some entrepreneurs from starting new businesses because it threatens to take a portion of his or profits upon

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their death; income that could have otherwise gone to the entrepreneur's family.

- Hurts family-owned businesses: Because the value of the portion of a business owned by a deceased person is counted as part of their estate, it can raise the value of the estate to the point that the deceased's family must pay estate taxes. Unfortunately, this is often hard to do, as assets must be sold which would otherwise be used to employ workers and keep the business going. Even in the best of scenarios, families that are able to pay estate taxes with cash may see the growth of their business slowed.

Ironically, the estate tax creates little revenue, as those who can afford to do it spend considerable time and effort moving their wealth into low- or no-tax havens and instruments. In 2008, for example, the estate tax raised only \$24 billion in revenue for the government, slightly more than 1 percent of all federal tax collections.^{iv}

Policy Consideration

Several econometric models show that repealing the estate tax would lead to the generation of hundreds of thousands of jobs. As early as 1993, economic simulations showed that repealing the estate tax would create 228,000 jobs. By comparison, the most recent study, which was conducted Douglas Holtz–Eakin and Cameron Smith and completed in 2009, found that repealing the estate tax would create 1.5 million jobs. This number is significantly larger than earlier studies because it was done during the current recession.

A large increase in employment is not the only benefit the economy would enjoy if Congress repealed the death tax. Additional benefits from full repeal of the estate tax include:

- Increasing small business capital by more than \$1.6 trillion;
- Increasing the probability of hiring by 8.6 percent;
- Increasing payrolls by 2.6 percent; and
- Expanding investment by 3 percent.^v

Recommendation

It is long past time for Congress to permanently repeal the estate tax. It serves none of the original purposes Congress intended in 1916, and it presents a significant danger for family-owned businesses.

Further Reading

- Curtis Dubay, "The Economic Case against the Death Tax." The Heritage Foundation *Backgrounder* #2440, July 20, 2010. Available at <http://tinyurl.com/4c54bue>. Access verified January 24, 2011.
- "Brief History of the Death Tax." American Family Business Institute, 2009. Available at <http://tinyurl.com/4g8bbvv>. Access verified January 26, 2011.

ⁱ William W. Beach, "Now is (Still) the Time to Permanently Repeal Federal Death Taxes." The Heritage Foundation *WebMemo* #720, April 12, 2005. Available at <http://tinyurl.com/4ljp95t>. Access verified January 24, 2011.

ⁱⁱ Chris Edwards, "Tax Policy under President Bush." The Cato Institute, August 14, 2006. Available at <http://tinyurl.com/6mmevu>. Access verified January 24, 2011.

ⁱⁱⁱ "Tax Cuts, Unemployment Insurance and Jobs." The White House, December 17, 2010. Available at <http://tinyurl.com/4feh3rw>. Access verified January 24, 2011.

^{iv} Curtis Dubay, "The Economic Case against the Death Tax." The Heritage Foundation *Backgrounder* #2440, July 20, 2010. Available at <http://tinyurl.com/4c54bue>. Access verified January 24, 2011.

^v Douglas Holtz–Eakin and Cameron T. Smith, "Changing Views of the Estate Tax: Implications for Legislative Options," American Family Business Foundation, February 2009. Available at <http://tinyurl.com/22vunlt>. Access verified January 26, 2011.