CHANGING VIEWS OF THE ESTATE TAX:
IMPLICATIONS FOR LEGISLATIVE OPTIONS

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A Study by the American Family Business Foundation

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February 2009

AMERICAN FAMILY BUSINESS FOUNDATION

The federal estate tax has a substantial impact on family businesses. Eliminating the estate tax would raise the probability of hiring by 8.6 percent, increase payrolls by 2.6 percent and expand investment by 3 percent. A symmetric result is expected for permitting the estate tax to rise with the sunset of the Economic Growth Tax Reduction and Reconciliation Act (EGTRRA) – lower payrolls and capital outlays.

To get a sense of the magnitude of these estimates, recall that roughly 50 million workers are employed in small business. If small business payrolls were to rise by as much as 2.6 percent strictly through additional hiring, this translates to roughly 1.5 million additional small business jobs. Alternatively, a higher estate tax that lowers payrolls by 0.9 percent would translate into a reduction of over 500,000 jobs. Consider that 1.5 million jobs are nearly half of the total jobs that the Obama Administration hopes to "save or create" under its recently announced budget plan. This study suggests that simply killing the estate tax could bring them nearly half way to that goal. The magnitude of these figures illustrates the importance of estate tax policy to economic growth.

Economic Impact of Repealing the Federal Estate Tax, by the Numbers

- Increase small business capital by over $1.6 trillion
- Increase the probability of hiring by 8.6%
- Increase payrolls by 2.6%
- Expand investment by 3%
- Create 1.5 million additional small business jobs
- Slash the current jobless rate by .9%

These facts are especially important at present, as the estate tax faces an uncertain future. In the absence of legislation, the estate tax will be repealed in 2010, only to reappear in 2011 with a rate of 55 percent tax on estates valued over $1 million. Neither full repeal nor statutory rates reaching 55 percent appear to be politically palatable, forcing Congress to act. This study examines the possible policy actions that Congress might take in terms of this tax and estimates their likely impact on entrepreneurial decisions, small and family businesses, and on the U.S. economy as a whole.

In 2004, individuals reported a total of $10.2 trillion in capital on estate tax returns. This study estimates that eliminating the estate tax would raise the capital in estates by over $1.6 trillion. In contrast, allowing the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) to sunset would raise the estate tax and lower capital accumulation by nearly $540 billion.

To estimate the impact of estate taxation on the cost of capital the authors reason that taxing capital via the marginal statutory estate tax is comparable to confiscatory annual taxes on the rate of return to capital. For example, expecting to pay a marginal estate tax rate of 45 percent (current 2009 law) is equivalent to an annual tax of over 150 percent over a 5-year horizon. Over longer periods, the equivalent tax declines – for example, over a 30-year horizon is 26.6 percent – but remains quite substantial.

Eliminating the estate tax, accordingly, has a fairly dramatic impact on the incentives to accumulate capital. Similarly, allowing current law to permit the top effective marginal estate tax rate to reach 60 percent (as would happen if EGTRRA sunsets) would be tantamount to an increase in the annual rate of marginal capital taxation of between 14 percent (over 30 years) to 74 percent (over 5 years). Tax incentives of this magnitude are important policy considerations.

The study concludes that the future path of the estate tax has significant impacts on overall capital accumulation in the United States, and consequent impacts on productivity, economic growth, and the standard of living. Equally significant are the impacts on the composition of economic activity. Decisions by entrepreneurs and family businesses are strongly influenced by tax policy in general and by the rate of taxation on the return to capital in particular. Allowing the tax to revert back to the high marginal tax rates and low exemption of the 1990s would have a crushing impact on businesses, workers, and on the U.S. economy as a whole. Eliminating the estate tax would increase the investment outlays, hiring propensities, and size of family business payrolls. When deciding the fate of the estate tax this spring, policy makers will be wise to consider that killing the tax would be a positive step towards instilling life back into the ailing U.S. economy.

Congress will soon enter another round of debate over the estate tax, which has long been a lightning rod of tax policy. Policy makers have largely viewed the estate tax through the lens of social policy and issues of fairness. However, it has very real effects on capital accumulation, bequests, entrepreneurs, family businesses, the labor supply, and on overall economic efficiency. A better understanding of the strong negative impacts of the estate tax on the economy is crucial for the design of future U.S. tax policy.

INTRODUCTION AND OVERVIEW

The United States estate tax has long been a lightning rod of tax policy. This tax, technically one aspect of the Unified Transfer Tax, taxes wealth accumulation at death. Policymakers have largely viewed the estate tax through the lens of social policy and issues fairness. However, it has potential effects on capital accumulation, bequests, family businesses and entrepreneurs, labor supply and overall economic

efficiency. A better understanding of the economic impacts of the estate tax is crucial for the design of future U.S. tax policy.

These facts are especially important at present, as the estate tax faces an uncertain future, with legislative action likely in the 111th Congress. In the absence of legislation, the estate tax will be repealed in 2010, only to reappear in 2011 with a return to 2000 law. Neither full repeal nor statutory rates reaching 55 percent appear to be politically palatable, forcing Congress to act. This paper examines the possible policy actions that Congress might take in terms of this tax, estimates their likely impact on the overall U.S. economy, small and family businesses[1], and entrepreneurial decisions.

To anticipate the key findings, we conclude that the future path of the estate tax has significant impacts on overall capital accumulation in the United States, and the consequent impacts on productivity, economic growth, and the standard of living. Equally significant are the impacts on the composition of economic activity. Decisions by entrepreneurs and family businesses are strongly influenced by tax policy in general, and the rate of taxation on the return to capital in particular. Eliminating the estate tax – as under current law in 2010 – would increase the investment outlays, hiring propensities, and size of family business payrolls. On the other hand, allowing the tax to revert to the high marginal tax rates and low exemptions of the 1990s would have strong negative impacts.

This paper is organized as follows: We begin with a summary of the policy outlook for the estate tax and other capital income taxes. We then present a catalog of the economic impacts of the estate tax and summarize the research literature to date. Armed with this background, we compute and present the estimated impacts of the likely policy options.

THE POLICY OUTLOOK: CAPITAL TAXES AND THE ESTATE TAX

The federal estate tax is a tax on "your right to transfer property at your death."[2] Property, as defined by the estate tax, includes the fair market value of all assets such as cash and securities, real estate, insurance, trusts, annuities and business interests. As with any tax, the key components are not simply the base, but also exemptions and deductions, the schedule of tax rates, tax credits, and the overall revenue objectives. The basic structure is shown in Table 1.

The estate tax and federal revenue. Table 2 shows annual federal revenue organized according to the collection of specific taxes. (The numbers in parentheses show the percentage of total federal tax revenue in the given year.) These figures indicate the relatively small overall contribution of the estate and gift taxes to overall federal revenues – less than 2 percent. Accordingly, in evaluating policy options it is

important to recall that any changes in estate tax revenue may be relatively easily offset with changes to the remainder of the revenue structure.

Who pays the estate tax? Only a small number of individuals pay the estate tax each year. In 2007, there were 36,458 estate tax filers – out of 235 million total tax filers that same year. Table 3 indicates the distribution of taxable estates across estate size. The numbers show that smaller estates (under $3.5 million) make up the bulk of filers – over 60 percent in years 2002-2007. Large estates (over $10 million), however contributed between 18 and 30 percent of the total revenue in the same time frame, indicating a disproportionate distribution of tax liability.

What is the future of the estate tax? At present, the near-term outlook for all aspects of the tax is highly uncertain. As Table 4 indicates, current law reflects the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, which has steadily increased the amount of estate exempt from tax (and reduced the top rate) until the estate tax is entirely repealed in 2010. The legislation also changed the federal treatment of state-level estate and inheritance taxes by reducing the credit for such taxes paid to 75 percent in 2002, 50 percent in 2003, and 25 percent in 2004. In 2005 the credit was replaced with a deduction.

However, EGTRRA sunsets in 2010. Without extension of the EGTRRA, or new legislation, in 2011 the top statutory tax rate will revert to 60 percent[3] and the exemption will fall to $1 million per individual ($2 million per married couple). The treatment of state-level taxes will revert to a credit, as well.

During the 2008 campaign, President Barack Obama supported permanent extension of the 2009 law – effectively a permanent 45 percent top rate with $3.5 million exemption per individual ($7 million for couples)[4], and his Budget blueprint issued on February 26, 2009 confirmed this agenda. According to the Joint Committee on Taxation, the Obama proposal would reduce federal revenue by $324 billion over the next decade (compared to permitting the sunset to take place).[5] In contrast, the Administration compared keeping 2009 law with repeal and concluded that it would raise $121 billion over 5 years and $288 billion over 10 years.

The impending sunset of EGTRRA also creates uncertainty over other key aspects of the tax code that impact the accumulation of wealth, the incentives to start and operate businesses, and the return to capital investments. As shown in Table 5, the top tax rates for personal income, capital gains, and dividends will shift sharply if policies are permitted to expire in 2011. Again, however, during the campaign, Barack Obama proposed permanent alternatives to these sunsets; these are shown in Table 5 as well.

Research on the estate tax has engendered a dramatic rethinking of the appropriate policy. Traditionally, the estate tax was viewed primarily as an instrument of social justice. By taxing wealth at death, it was deemed to preclude the inappropriate and unjustified concentration of wealth in the hands of a minority. Importantly, at the same time, it was viewed to be an economically benign tax that did not affect the overall path of capital accumulation and generation, productivity growth, innovation, or employment in the economy.

Over time, however, this simple characterization of the estate tax has been steadily reversed. To begin, research suggested that the tax did little in practice to achieve its stated goals of stopping the concentration of wealth, either because it was far too easily legally avoided, or because research indicated that it had the perverse impact of actually increasing the concentration of wealth. George Cooper, in is book *A Voluntary Tax?*, argued that widespread avoidance opportunities were easily available. Douglas Bernheim [1987] raised the possibility that due to the incentives for transfers to children and charities, the estate tax might reduce personal income taxes – perhaps enough to offset any direct estate tax revenue.   And even proponents of the estate tax such as Alan Blinder [1974] and Joseph Stiglitz [1978] – both among former President Clinton's Council of Economic Advisers – suggested that it would have little impact on, or might even increase, wealth inequality because reduced capital accumulation harmed the lifetime earnings opportunities of the relatively less well off. (This is not a universal finding; for a contrary conclusion see Laitner [2001] in *Rethinking Estate and Gift Taxation.*)

The new view of the estate tax is quite different, if not yet universally accepted and fully-documented. In this view, the estate tax affects myriad economic decisions. It provides incentives for legal avoidance through the configuration of assets in trusts and other vehicles. It affects the composition of estates, whether by providing incentives to make charitable bequests at estate or to more extensively hold lightly taxed assets. The estate tax may create disincentives that lower overall wealth accumulation, leading to smaller estates and taxes.

Historically, among the most vociferous opponents of the estate tax have been small and family businesses as well as entrepreneurs – important contributors to U.S. economic vitality. As documented by the Small Business Administration, "…small businesses employ about half of U.S. workers. Of 116.3 million nonfarm private sector workers in 2005, small firms with fewer than 500 workers employed 58.6 million and large firms employed 57.7 million. Firms with fewer than 20 employees employed 21.3 million."[6] Recent research fleshes out the foundations of this opposition – the estate tax has a disproportionate impact on the overall economy precisely because it has such dramatic impacts on these individuals and their enterprises.

These impacts occur on both sides of the generational transactions – lower estate taxes may both engender greater success among those accumulating estates, and provide needed cash flows for those who are recipients of bequests and running a business. And perhaps most importantly, even if one believes that it is appropriate to more heavily tax the return to capital in order to equalize the distribution of wealth, recent evidence suggests that the estate tax is not the most efficient means to this end.

The transformation of the policy view of the estate tax began with the observation that the use of sophisticated lawyers permitted decedents to reduce their tax liability. While the evidence does <u>not</u> suggest that the wealthiest may easily avoid the entire tax[7], for the less affluent there appear to be myriad strategies. Schmalbeck [2001] contains a sophisticated discussion of the ways to use legal strategies to reduce the effective tax rate.

In addition to legal strategies, individuals may modify the composition of their overall estates to reduce the tax liability. Of course, this comes with a cost – a portfolio of wealth that does not clearly meet the objectives of the individual in the absence of tax considerations.

Because charitable bequests at death are fully deductible, greater donations to charity are a potential tax-reducing option. The strength of this incentive is directly related to the expected marginal estate tax rate. In 2010, current law eliminates the estate tax and, thus, the charitable-giving incentives. In contrast, a full reversion to 2000 will provide a tax saving of up to $0.60 per dollar of charitable bequest. Put differently, the "price" of a $1 bequest will fall to $0.40. If 2009 law is made permanent, the incentive lies in between; the top rate of 45 percent implies a price of $0.55 per dollar of giving.

This logic focuses on the impact of incentives that affect the price of charitable giving. An argument in the other direction emphasizes the impact of reducing the overall size of the estate. A successful widowed entrepreneur may wish to leave each of his children $1 million and give the remainder to charity. Without the estate tax, if his estate is $10 million and he had four children, he would leave $6 million to charity. If the tax regime had a 45 percent rate and a $3.5 million exemption, he would leave $2.3 million to charity.

The evidence suggests a considerable impact on the structure of bequests. A large literature finds that charitable gifts rise with the estate tax incentive. Economist David Joulfaian [2000] estimated that eliminating the tax entirely would diminish charitable bequests by about 12 percent. This is equivalent to about $1.3 billion of charitable bequests in 1998.

In this framework, "charity" is a lower-taxed form of asset accumulation. Following the same logic, Poterba and Weisbenner [2003] examine whether similar

incentives affect the portfolios of decedents. In particular, they note that there exists considerable variation in the use of discretion in valuing assets in an estate. For some assets such as conventional securities traded on liquid markets, little discretion is possible. However, for others such as interests in closely-held businesses, family limited partnerships, or real assets or collectibles that do not trade in deep, liquid markets there may be greater ability to undervalue assets and reduce tax liability.

This logic suggests that the effective estate tax burden may be greater on assets that are easily valued than on difficult-to-value assets. Their research finds exactly this result: the mix of assets reported on estate tax returns is consistent with lower relative valuations for difficult-to-value assets.

Altering bequests and portfolios to reduce estate taxes carry a price – wealth accumulation is less solely dedicated to the financial objectives of the individual, whether they are investment in a family business or leaving bequests to children. Not surprisingly, one might suspect that the estate tax might reduce the overall amount of saving in an economy. In a comprehensive and detailed analysis of Internal Revenue Service data dating to 1916, Kopzcuk and Slemrod [2000] find that in aggregate, time-series analysis the estate tax is "generally negatively correlated with the reported net worth of the top estates relative to national wealth." In other words, when the estate tax goes up, the accumulated net worth declines.

This finding stands up to further scrutiny of individual tax return data, where they find that estimated elasticity of reported estates is negative with respect to the tax rate, and statistically significant. Interestingly, Kopzcuk and Slemrod [2000] find that the tax rate that prevailed during one's lifetime (as opposed to the rate at death) has a greater effect on the estimated savings rate. Using the marginal estate tax rate at the age of 45, they find that the estimated elasticity is statistically significant and it implies that an estate tax rate of 50 percent would lower net worth among the wealthiest ½ percent by over 10 percent.

To understand this reduction in net worth as a result of the estate tax, recognize that the tax reduces the lifetime marginal rewards for work, risk-taking, and investment when compared to leisure or consumption. A successful entrepreneur may face a federal top personal federal income tax rate of 35 percent, plus an estimated average state income tax of 10 percent, for a marginal rate of 45 percent. Each additional dollar added to his estate will also be taxed. However, if our entrepreneur facing the estate tax decides instead to buy an around-the-world cruise, he reduces his estate, and lowers his estate tax liability.

These findings echo those by Holtz-Eakin and Marples [2001]. Using a sophisticated analysis of individual-level data, they find the estimated impact of the estate tax is negative, statistically significant, and far stronger than the impact of capital income taxes. Their estimate is comparable to an elasticity with respect to the estate tax rate of roughly –1.4.

These findings are far from conclusive, and the authors in each instance provide substantial caveats regarding their basic findings. However, they are part of a larger trend away from the view that estates are not responsive to economic incentives and the estate tax has little impact in our tax system. This reflects, as well, a more sophisticated view of who is affected by the estate tax. Those with the highest saving propensity are also those most likely to be affected by the estate tax, so it is less surprising that the estate tax is a deterrent to overall capital accumulation. In the same way, those who start businesses are much more likely to be affected by the estate tax (see Holtz-Eakin and Marples [2001]), with the result that entrepreneurship and the estate tax are closely intertwined.

Considerable concern has been raised that the estate tax may lead to the sale or dissolution of business enterprises. However, this is not the only means by which the estate tax affects business growth and success. Poterba [1997] indicates that when translated into an annual-equivalent, the estate tax raises the effective tax rate on capital income. A higher tax rate raises the cost of capital, and leads to lower investment and employment (see Carroll, Holtz-Eakin, Rider, and Rosen [2000]). These incentives are consistent with the results of Holtz-Eakin, *et al.* [1999], who found that those small businesses likely to face the estate tax experienced slower employment growth than otherwise-situated competitors.

The estate tax may affect more than the decedent. In a pair of studies, Holtz-Eakin, Joulfaian and Rosen [1993, 1994] examined the impact of the receipt of bequests on the survival and operation of entrepreneurial enterprises. These studies indicate that the receipt of bequests will improve the survival, capitalization and scale of payroll for entrepreneurial enterprises. While this finding focuses on the mere transmission of cash flows, the findings of Dunn and Holtz-Eakin [2000] indicate that they may be paired as well with the transmission of human capital propensities to engage in entrepreneurial activities. In short, the estate tax has important and significant impacts on the transmission of successful entrepreneurship across generations.

To summarize, recent research has reversed a simplistic view of the estate tax as a social policy without economic consequence. In contrast, a significant estate tax will distort decisions ranging from the legal structure of the estate, to the entrepreneurial ventures to that generate significant wealth. At present, the future of the estate tax faces considerable legislative uncertainty. The range of legislative outcomes corresponds to a range of economic impacts, to which we turn in the next section.

ESTIMATING THE IMPACT OF POLICY OPTIONS

The results of the recent literature may be used to evaluate the economic implications of legislative alternatives. We do so in three steps. First, we examine the

likely impact of changes in the estate tax on the accumulation and distribution of wealth by estate tax payers, and the economy as a whole. Next, we turn to developing a method for comparing changes in estate taxes to revenue-equivalent shifts in taxes on capital income. Finally, we compare the impact of each of these options on the cost of capital and the operation of family businesses.

The results are summarized in Tables 6, 7, and 8. Specifically, we examine the two major alternatives to current law. In 2009, the top marginal tax rate is 45 percent. One possibility is to make permanent the total repeal of the estate tax that will take place in 2010 (when the rate drops to zero) and thereby lower the permanent rate dramatically. The alternative is to permit EGTRRA to sunset, yielding a top statutory rate of 55 percent, and a top effective marginal tax rate of 60 percent.[8]

We begin with the top panel of Table 6, which displays the potential impact of changes in the estate tax on wealth accumulation. Specifically, we use the estimated elasticity of wealth accumulation from Kopzcuk and Slemrod[9] and Joulfaian to translate the impact of increasing (permitting EGTRRA to sunset) and decreasing (eliminating) the estate tax rate.

Consider the first row of the table. Eliminating the estate tax would reduce the top rate from 45 percent to 0 percent. In 2004, individuals reported a total of $10.2 trillion in wealth on estate tax returns.[10] Eliminating the estate tax would raise the wealth reported on estates by over $1.6 trillion. In contrast, allowing EGTRAA to sunset would raise the estate tax and lower estate wealth accumulation by nearly $540 billion.

The second panel of Table 6 estimates the impact of the options on the cost of capital. These estimates are built off of the results contained in Tables 7 and 8. Specifically, Table 7 displays a mechanism for translating each rate of estate taxation (at the <u>end</u> of life) into an equivalent capital income tax (<u>each</u> year of life).[11] Our computations focus on <u>marginal</u> estate tax rates, and their corresponding marginal capital income tax rates, as these are the tax rates that influence decisions to accumulate and deploy more capital. As the table makes clear, taxing capital via the marginal statutory estate tax is comparable to confiscatory annual taxes on the rate of return to capital. For example, a marginal estate tax rate of 45 percent (current 2009 law) is equivalent to an annual tax of over 150 percent over a 5-year horizon. Over longer periods, the equivalent tax declines – for example, over a 30-year horizon it is 26.6 percent – but remains quite substantial.

Eliminating the estate tax, accordingly, has a fairly dramatic impact on the incentives to accumulate capital. Similarly, allowing current law to permit the top marginal estate tax rate to reach 60 percent would be tantamount to an increase in the annual rate of marginal capital taxation of between 14 percent (over 30 years) to 74 percent (over 5 years). Tax incentives of this magnitude are important policy considerations.

The computations in Table 7 overstate the likely consequences of the estate tax by implicitly assuming the individual perceives the estate tax as a <u>certainty</u>. Obviously, not everyone pays the estate tax, and over periods as long as 20 to 30 years, there is no certainty that wealth accumulation will proceed on a pace that guarantees facing an estate tax liability. Table 8 modifies the computations to allow for the substantial probability that no tax liability will accrue, and the corresponding small probability that the marginal tax rates matter.[12] While this adjustment affects the scale of the implicit annual taxes, the basic pattern and message are the same.

Returning to Table 6, we deploy these effective tax rates in two ways. In the middle panel of the table, the final column indicates that in the presence of 2009 law, the "cost of capital" – defined here as the pre-tax return required to pay taxes and depreciation, and still make the post-tax market rate of return – ranges from 15 percent (for long-lived, 20-year investments) to 34.1 percent (for shorter-lived capital).[13]

Eliminating the estate tax (column 1) would lower the cost of capital accordingly. Also shown in column 2 is the impact on the cost of capital of a revenue neutral increase in the top two marginal tax rates. Similarly, columns 3 and 4 of Table 6 show the impact on the cost of capital from allowing the top rate to rise to 60 percent and the corresponding reduction from cutting the top two marginal tax rates.

What is the bottom line for family businesses? The final rows of Table 6 show the impact on these entrepreneurial enterprises of the various policy options. In particular, we use the results from the literature to estimate the impact of policy changes – higher or lower estate taxes – on the probability that a business will be able to increase hiring, the scale of its overall payroll, and the amount of its capital investment.

The table shows substantial impacts. Eliminating the estate tax (column 1) would raise the probability of hiring by 8.6 percent, increase payrolls by 2.6 percent and expand investment by 3 percent. The remaining column tells a symmetric story for permitting the estate tax to rise with the sunset of EGTRRA – lower payrolls and capital outlays.

To get a sense of the magnitude of these estimates, recall that roughly 50 million workers are employed in small business. If small business payrolls were to rise by as much as 2.6 percent strictly through additional hiring, this translates to roughly 1.5 million additional small business jobs. Alternatively, a higher estate tax that lowers payrolls by 0.9 percent would translate into a reduction of over 500,000 jobs. Obviously, these numbers represent only very rough estimates. The exact impacts will depend on details of the estate tax policy, the distribution of wealth and expected longevity among owners, and many other factors. But the magnitudes are illustrative of the importance of estate tax policy to economic growth.

SUMMARY AND CONCLUSIONS

The 111th Congress will likely wrestle with the future of the estate tax. Recent research has revised the traditional view of the estate tax as a benign act of social redistribution. Instead, the tax is now understood to have important impacts on the startup and survival of small businesses, their capital accumulation and employment patterns, and the overall wealth of the United States. We have documented some of the potential magnitudes involved in the broad policy options facing the Congress, emphasizing the basic point that good tax policy can support growth, employment and a higher standard of living.

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About the American Family Business Foundation

The American Family Business Foundation (AFBF) is the research and education voice of America's family business owners and farmers. Established in 2008, the Foundation publishes reports that examine critical policy questions about the impact the estate tax has on capital accumulation, family businesses, employment, income mobility and wealth disparity, federal revenues and the general economy. In addition to academic research, the Foundation hosts educational events designed to drive the public debate about the estate tax. Finally, the Foundation's principals are policy experts that are frequently called upon to provide insight on estate tax issues.

Endnotes

1   The term "small business" is defined for the purposes of this paper by the size standards of the Small Business Administration (SBA) and Internal Revenue Service (IRS). The SBA and IRS defines a small business as one with less than 500 employees. Data is not readily available regarding tax returns for family-owned businesses, however most meet small business standards.

2   See IRS [2008].

3   The top effective rate is considered 55 percent in the tax code, however a 5 percent surtax applies to estates valued between $10,000,000 and $17,184,000.

4   Barak Obama's Comprehensive Tax Plan: http://www.barackobama.com/pdf/taxes/ Factsheet _Tax_Plan_FINAL.pdf.

5   "Obama Plans to Keep Estate Tax," *Wall Street Journal*, January 12, 2009.

6   See www.sba.gov.

7   It is certainly possible to avoid taxation to an extent, as efforts by more famous estate holders indicate.

8   We do not explicitly model the impact of changing from stepped-up basis at death to carryover basis; instead focusing on the impact of rates.

9   Kopzcuk and Slemrod estimate the elasticity with respect to the "tax price" – one minus the tax rate. We transform the elasticity to apply directly to the tax rate in each case.

10   Internal Revenue Service, "Personal Wealth, 2004", *Statistics of Income Bulletin*, 2008.

11   That is, the effective capital income tax rate, t, that is equivalent to the estate tax, e, is defined by: $(1+r)^N(1-e) = (1+r(1-t))^N$, where N is the expected lifetime of the individual.

12   The computations assume that the probability of a liability is 5 percent. There can be no single number that fits all situations. This choice reflects the overall probability is low – only about 1.5 percent of the overall population pays the estate tax. However, entrepreneurial business owners are more likely than the population as a whole to pay the estate tax, so a higher estimate is appropriate for examining their incentives.

13   These computations assume a market return of 8 percent and an expected life of 20 years prior to having an estate tax liability (with probability 5 percent). Although the absolute numbers will change, the basic pattern is not sensitive to the assumed rate of return.

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Appendix

Table 1

Recent Structure of the Estate Tax

Taxable Estate	Tax Liability
Not over $10,000	18 percent of such amount
Over $10,000 but not over $20,000	$1,800 plus 20 percent of excess over $10,000
Over $20,000 but not over $40,000	$3,800 plus 22 percent of excess over $20,000
Over $40,000 but not over $60,000	$8,200 plus 24 percent of excess over $40,000
Over $60,000 but not over $80,000	$13,000 plus 26 percent of excess over $60,000
Over $80,000 but not over $100,000	$18,200 plus 28 percent of excess over $80,000
Over $100,000 but not over $150,000	$23,800 plus 30 percent of excess over $100,000
Over $150,000 but not over $250,000	$38,800 plus 32 percent of excess over $150,000
Over $250,000 but not over $500,000	$70,800 plus 34 percent of excess over $250,000
Over $500,000 but not over $750,000	$155,800 plus 37 percent of excess over $500,00
Over $750,000 but not over $1,000,000	$248,300 plus 39 percent of excess over $750,000
Over $1,000,000 but not over $1,250,000	$345,800 plus 41 percent of excess over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300 plus 43 percent of excess over $1,250,000
Over $1,500,000 but not over $2,000,000	$555,800 plus 45 percent of excess over $1,500,000
Over $2,000,000 but not over $2,500,000	$780,800 plus 49 percent of excess over $2,000,000
Over $2,500,000 but not over $3,000,000	$1,025,800 plus 53 percent of excess over $2,500,000
Over $3,000,000	$1,290,800 plus 55 percent of excess over $3,000,000
Over $10,000,000 but not over $17,184,000	Additional 5 percent surtax

Source: U.S. Tax Code

Note: Over the life of EGTRAA, successive lower brackets have been removed. Depending on the tax code and year, various combinations of exemption amounts and rates exist. In 2009, for example, the only rate is 45 percent on the excess of $3.5 million, and in 2010, no rate applies. For 2011 (should EGTRAA expire), the first dollar taxed is $1,000,001, at a rate of 41 percent, and the subsequent rates apply. For example, with an estate valued at $2,750,000, the total liability would be $1,157,500.

Table 2

The Role of the Estate Tax in Federal Revenues
(Millions of Dollars)

Year	Total federal collections	Individual Income Tax	Estate Tax	Gift Tax
1995	1,375,731 (100%)	675,779 (49.1%)	13,326 (1.0%)	1,818 (0.1%)
1996	1,486,546 (100%)	745,313 (50.1%)	15,350 (1.0%)	2,241 (0.2%)
1997	1,623,272 (100%)	825,020 (50.8%)	17,595 (1.1%)	2,761 (0.2%)
1998	1,769, 408 (100%)	928,065 (52.5%)	21,314 (1.2%)	3,316 (0.2%)
1999	1,904,151 (100%)	1,002,185 (52.6%)	23,627 (1.2%)	4,758 (0.2%)
2000	2,096,916 (100%)	1,137,077 (54.2%)	25,618 (1.2%)	4,103 (0.2%)
2001	2,128,831 (100%)	1,178,209 (55.3%)	25,289 (1.2%)	3,958 (0.2%)
2002	2,016,627 (100%)	1,037,733 (51.5%)	25,532 (1.3%)	1,709 (0.1%)
2003	1,952,929 (100%)	987,208 (50.6%)	20,887 (1.1%)	1,939 (0.1%)
2004	2,018,502 (100%)	990,248 (49.1%)	24,130 (1.2%)	1,449 (0.1%)
2005	2,268,895 (100%)	1,107,500 (48.8%)	23,565 (1.0%)	2,040 (0.1%)
2006	2,518,680 (100%)	1,236,259 (49.1%)	26,717 (1.1%)	1,970 (0.1%)
2007	2,691,537 (100%)	1,366,241 (50.8%)	24,557 (0.9%)	2,420 (0.1%)

Source: IRS and author computations

Table 3

Number and Revenue by Size of Estate

Size of Taxable Estate	2007		2005		2003	
	Number	Amount (Millions)	Number	Amount (Millions)	Number	Amount (Millions)
< $2.0 million	3,681	4,586	17,792	21,889	47,598	46,171
$2.0 < $3.5	18,953	36,324	13,462	23,571	12,463	19,474
$3.5 < $5.0	5,718	14,687	4,084	9,993	3,982	9,077
$5.0 < $10.0	5,265	19,832	3,836	14,098	3,591	12,796
$10.0 < $20.0	1,844	12,455	1,264	8,434	1,247	7,966
> $20.0 million	997	18,817	719	18,223	695	13,606
Total	36,458	106,701	41,158	96,209	69,576	109,091

Source: IRS

Table 4

Current Law – Death Tax Exemption and Top Marginal Rate

Year	Exemption (Millions)	Top Marginal Rate
2008	$2	45%
2009	$3.5	45%
2010	--	0%
2011	$1	60%

Table 5

Top Tax Rates under Current Law and Obama Proposal

	Top Tax Rate 2009-2010	Top Tax Rate 2011	Top Tax Rate Obama Proposal
Personal Income	35%	39.6%	39.6%
Capital Gains	15%	20%	20%
Dividends	15%	39.6%	20%

Table 6

Economic Impacts of Policy Alternatives		
	Eliminate Estate Tax	Allow EGTRAA to Sunset
Wealth Accumulation		
Estate Wealth	$1,632 billion	-$539 billion
Cost of Capital		
5-year Life	-0.4 pct. points	0.1 pct. points
10-year Life	-0.2 pct. points	0.1 pct. points
20-year Life	-0.1 pct. points	0.1 pct. points
Family Business		
Probability of Hiring	8.6%	-2.9%
Payroll Size	2.6%	-0.9%
Investment	3.0%	-1.0%

Table 7

Policy Option		Expected Life					
Annual Capital Income Tax Rates Equivalent to Death Tax (Percent)							
		5	10	15	20	25	30
Eliminate Death Tax (0%)	Level	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Change from 2009	-152.1%	-78.3%	-52.7%	-39.8%	-31.9%	-26.6%
2009 Law Permanent (45%)	Level	152.1%	78.3%	52.7%	39.8%	31.9%	26.6%
Current Law (60%)	Level	226.1%	118.2%	80.0%	60.5%	48.6%	40.6%
	Change from 2009	73.9%	39.9%	27.3%	20.7%	16.7%	14.0%

Table 8

Policy Option		Expected Life					
Annual Capital Income Tax Rates Equivalent to Expected Death Tax (percent)							
		5	10	15	20	25	30
Eliminate Death Tax (0%)	Level	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Change from 2009	-6.1%	-3.1%	-2.0%	-1.5%	-1.2%	-1.0%
2009 Law Permanent (45%)	Level	6.1%	3.1%	2.0%	1.5%	1.2%	1.0%
Current Law (60%)	Level	8.2%	4.1%	2.7%	2.1%	1.6%	1.4%
	Change from 2009	2.1%	1.0%	0.7%	0.5%	0.4%	0.3%