



To: Interested Parties

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Re: Repeal/Reform of the Estate Tax

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## Background

Recently, the House of Representatives passed legislation to permanently repeal the estate tax and the Senate is likely to take up the issue in the coming months. Repeal or near-repeal of the estate tax represents a massive tax cut for the heirs of the wealthiest at the expense of working Americans. Including the interest payments on additional debt, full and permanent repeal of the estate tax would cost nearly \$1 trillion over the first ten years of implementation.<sup>1</sup> Many of the supposed “compromises” under discussion would cost more than 90 percent as much. These costs would add to current annual deficits of over \$400 billion<sup>2</sup> and the \$7.7 trillion national debt.<sup>3</sup> The nation would bear the weight of these enormous costs as a whole, but the benefits would go to a small number of America’s wealthiest heirs.

A group of Senators led by Senators Baucus, Schumer and Kyl have already begun negotiations over the future of the estate tax. This memo outlines the severe problems with full or substantial repeal, and provides guidelines for more positive reform options.

## Overview

Repealing or virtually repealing the estate tax is an affront to core American values including meritocracy and fairness.

Repealing the estate tax:

- **Violates core American values** including fairness and a belief in a meritocracy;
- **Denies core American priorities** by limiting our ability to address Social Security’s solvency gap and further shifting the burden of the tax code to work;
- **Weakens our nation’s fiscal health** by adding hundreds of billions to the national debt as Congress cuts Medicaid and other programs for those most in need;
- **Undermines incentives for charitable giving;** and
- **Constitutes the most regressive tax cut ever** — shifting a greater share of taxes onto the middle class, while benefiting only the heirs of a handful of multi-millionaires.

## Violating Core American Values

### *Meritocracy*

At the core of this debate is a simple American principle: we do not believe that because of accidents of birth one group should have unrivaled economic power. *Efforts to completely or virtually eliminate estate taxes on even the nation's most wealthy estates offend basic American values that have long held that economic success should depend on hard work, entrepreneurial spirit and merit rather than one's original station in life.* In the words of President Franklin D. Roosevelt, "Such inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government."

As Americans we also value workers' aspirations to save so they can pass on the fruits of their labor to their children. In holding with this value, most progressive estate tax reform proposals allow parents to pass millions of dollars to their heirs tax free. However, estate tax repeal proponents seek to pervert this value to justify removing *any* limit on inherited wealth. Maintaining an exemption of several million dollars would protect the ability of over 99 percent of American families to pass on wealth tax free to their heirs. A reasonable exemption simply limits the windfall to heirs who would still receive massive unearned wealth simply because they were fortunate enough to be born into one of America's wealthiest families.

Yale University professors Michael Graetz and Ian Shapiro have written that the estate tax repeal should be called the "Paris Hilton Benefit Act" because it signifies the type of already extremely well-off heirs that would see their already massive fortunes grow through no work of their own should the tax be eliminated.

### *Fairness: Repeal as the Most Regressive Tax Cut Ever*

Under Bush administration's tax policy, those with high incomes have reaped the lion's share of benefits. Eliminating the estate tax would continue this trend of rewarding those who have already amassed great wealth, while shifting a larger share of the nation's taxes onto the middle class. Repeal would also further perpetuate the concentration of wealth by creating a continuous cycle where a fortunate few could accumulate great fortunes virtually tax free and then pass on those fortunes tax free from generation to generation.

Currently, less than 1 percent of estates pay any tax—with the vast majority of the population owing nothing. In 2004, this translated into an estimated 18,800 estates.<sup>4</sup> Under current law, this number will decline even further as the estate tax exemption rises. By 2009 (when the law will allow a couple to pass \$7 million and an individual to pass \$3.5 million of any estate to their heirs tax free), less than 0.3 percent of estates will owe any tax.

If we choose to continue down the path to repeal, the benefits to these few estates will be substantial. For instance, repealing the estate tax in 2009 would bestow an average \$3

million tax cut on the just over 7,000 estates that would otherwise pay the tax that year. For the around 600 estates worth more than \$20 million, the average cut would be about \$18 million.<sup>5</sup>

The obligation to pay one's fair share is never clearer than in a time of war. It is simply unconscionable that while young Americans put their lives on the line to serve their country, the president and Congress would pass massive tax cuts so the heirs of multi-millionaires can avoid even modest sacrifice to help provide support.

### **Strengthening Social Security by Preserving the Estate Tax**

Retaining the estate tax would be a more effective way to improve Social Security solvency than the president's plan to cut middle-class benefits and move towards privatization. According to the Center on Budget and Policy Priorities, the White House proposal would close only 30 percent of the 75-year shortfall.<sup>6</sup> In contrast, the revenue saved from retaining the estate tax with a \$5 million per couple exemption and a 45 percent tax rate could address as much as 40 percent of this long-term deficit.

Even raising the normal retirement age to 70 would hardly have a more significant effect than dedicating revenue from this estate tax reform: according to the Social Security Actuaries such a reform would similarly close, just under 40 percent of the 75-year shortfall.<sup>7</sup>

It is shocking that while president has called on middle-class families to give up large portions of their hard earned Social Security dollars, he is unwilling to ask the heirs to enormous fortunes to contribute even a modest portion of their inheritance.

At the very least, common sense demands that Congress wait to consider spending tens of billions of dollars a year to repeal the estate tax until after it has found the resources needed to assure Social Security's health for future generations.

### **The Creeping Wage Tax: Estate Tax Repeal Shifts Tax Share onto Work**

Repeal or near repeal of the estate tax would also distort our values for honoring work. Eliminating taxes on inheritance is just one piece of what has been acknowledged as an incremental strategy to dramatically shift the burden of our tax code onto the wages of workers, while seeking near zero taxation for those few Americans who can generate the preponderance of their income through investing their wealth. By increasing the share of taxes collected from workers' wages, this strategy seeks to distort our progressive tax system and push us closer to the day when federal finances depend on wage taxes alone.

President Bush is not pursuing this agenda through a single major reform; rather, he is pursuing it slowly and piecemeal. The agenda was spelled out by tax lobbyist Ernest Christian in a 2003 article entitled "Five Easy Pieces." The "pieces" were cutting marginal rates, eliminating taxes on dividends and capital gains, increasing depreciation of business investment, eliminating the estate tax, and providing new tax-free savings

vehicles. The Bush administration has now accomplished four of these objectives in whole or in part. Estate tax repeal is central to the plan. And we are witnessing the results. On Sunday, June 5th, *The New York Times* reported that under the Bush tax cuts those taxpayers earning the top 400 incomes (making at least \$87 million in 2000) now pay about the same percentage of their incomes in income, Medicare and Social Security taxes as Americans earning between \$50,000 and \$75,000.<sup>8</sup>

If President Bush really wants create an “ownership society” he should be crafting policies to help average Americans create new wealth of their own—say through tax incentives to help low- and middle-income earners struggling to save for retirement or to collect a down payment on their first house. Instead, the effort to end the estate tax seeks to push a greater share of the tax burden onto the backs of working people and will simply consolidate ownership in the hands of the few by protecting the inherited wealth of our nation’s most fortunate.

### **A Stunning Failure of Priorities**

Under the nation’s current fiscal constraints, it is critical to examine the trade-offs involved in devoting nearly \$1 trillion—\$745 billion in lost revenue and \$225 billion in additional interest payments in the first ten years of repeal alone—to such a generous tax cut for the heirs of America’s wealthiest families.

To put the cost of repeal in perspective, consider the pressing national concerns we could address with even a small portion of this \$75 billion average annual cost:

- We could prevent all of the proposed **\$10 billion** in cuts to Medicaid included in the 2005 budget—about than 13 percent of the cost.
- We could replace the Army’s 10,000 Humvees that rely on incomplete, improvised shielding with fully up-armored vehicles for about **\$1.4 billion**—less than 2 percent of the cost.<sup>9</sup>
- We could offer Trade Adjustment Assistance (TAA) benefits, including job search and retraining assistance, to all workers, regardless of why they lost their jobs, for about **\$12 billion a year**—about 16 percent of the cost.<sup>10</sup>
- We could enhance retirement security in addition to Social Security for 50 million families seeking to someday have their own estate by offering progressive saving incentives of \$500 per year for an annual cost of **\$25 billion**—less than a third of the cost of repeal.

In fact, we could do all of the above for significantly less than estate tax repeal.

These numbers are even more striking when you stack up the costs against current spending priorities. The revenue loss of full repeal would dwarf than the total amount we currently spend annually on homeland security (\$38 billion), K-12 education (\$36 billion), health care for veterans (\$29 billion), or student financial assistance (\$14 billion).<sup>11</sup> It is many times the size of all cuts to entitlement programs combined in the 2006 federal budget (\$35 billion over 5 years).<sup>12</sup>

## Concerns about False Compromises

While reforming the estate tax is appealing, it is important to note that a bad compromise—one that abandons American values and that loses significant revenue—is just as bad as full repeal.

### *Revenue loss*

Some on the right have proposed “compromises” that involve lowering the top estate tax rate—usually to 15 percent. According to *The Wall Street Journal*, Sen. Jon Kyl, who is leading Republicans in negotiations, has been pushing to not only lower the rate to 15 percent, but also increase the per couple exemption to \$20 million.<sup>13</sup> This proposal would cost 94 percent as much as repeal.<sup>14</sup> Even combining a 15 percent top rate with a lower \$5 million per couple exemption would still cost 82 percent as much as repeal. These reforms are so costly because with the top marginal rate at 15 percent, the *effective* tax rate—the share of an estate actually paid in taxes—would slump to an average of 5 to 6 percent.<sup>15</sup> In contrast, a sensible reform measure—which sets the rate to 45 percent and raised the exemption to \$5 million per couple—would preserve approximately 60 percent of estate tax revenues.

### *Family-owned farms and businesses*

Much of the rhetoric behind the estate tax repeal movement centers on family farms and businesses. While farmers and small businesses owners might, in theory, struggle to pay estate taxes, this concern has been grossly exaggerated.

To see why, consider how few small business owners and farms pay the tax: in 2004, only about 340 small farm or business estates—where farm or business assets worth less than \$5 million made up more than half of the total estate—paid any estate taxes; only 440 estates comprised primarily of a farm or business of *any size* paid the tax. *Had the per couple exemption been \$7 million in 2004, a mere 30 small farm or business estates and 110 estates with more than half their assets tied up in farms or businesses of any size would have paid the tax.* To quote Henry Aaron of the Brookings Institution: “To use the easily handled problems of family farmers and small-business owners as justification for repealing the entire tax, thereby giving an enormous tax cut to a few extremely wealthy households, is simply dishonest demagoguery.”<sup>16</sup>

While few business owners or farmers pay the tax now, thousands of small businesses could end up facing higher taxes under repeal. This is because the president’s proposal would eliminate the “stepped-up basis” rule, under which someone who inherits a small business does not owe capital gains taxes on the increase in the business’ value while the decedent owned it. Regardless of the merits of a switching to a stepped-up basis, it is clear that this change will raise taxes on the very estates repeal proponents claim they want to protect. According to Paula Calimafde, chair of the Small Business Council of America, about 40,000 estates take advantage of this “stepped-up basis” rule each year. By her account, while “proponents of repeal tout the benefits of estate tax repeal to the

small business owner...in fact, repeal will actually harm most small business owners.”<sup>17</sup> John Buckley, chief Democratic tax counsel for the House Ways and Means Committee, argues, “There is no question that there will be vastly more losers than winners from estate tax repeal,” and predicts that almost five times as many estates could be affected under the new rules. He sees “little question that the number of farm estates facing tax increases from carryover basis would exceed the number of farm estates receiving a benefit.”<sup>18</sup>

Under current law, there are already provisions that benefit small family farms and businesses such as the ability to pay estate tax liability over a number of years, and special discounted valuation methods for farms and businesses. These provisions can be reformed and enhanced to minimize the impact on those whose assets are wrapped up in a farm or business without abandoning the estate tax altogether.

When considering expanding the special provisions for family farms and businesses policymakers must be mindful of the extent to which family farm and business provisions can create enormous loopholes. If all family farms and businesses are exempt from taxation, it would provide enormous incentives for very wealthy individuals to purchase tax-preferred businesses or property prior to death simply to avoid taxation. Think of Donald Trump buying a large portion of Iowa and calling it a farm so he could pass on his wealth tax free.

#### *Diminishing incentives for charitable giving*

The estate tax creates a strong incentive for wealthy Americans to support charitable causes. Some people with estates valued close to the exemption level are compelled to give to charity so their heirs can avoid paying the tax altogether. Others would rather see large portions of their estate go to charity than to the government. Either way, the effects are substantial. According to a 2004 Congressional Budget Office (CBO) report, charities received between \$13 billion and \$25 billion in additional donations in 2000 because of the estate tax.<sup>19</sup> That estimate puts the total effect somewhere in between the total amount that U.S. corporations gave to charities (\$11 billion) and the total amount all foundations gave to charities (\$25 billion) that year. Further, CBO found that moderate increases in the estate tax exemption would have a comparatively modest effect. According to their estimates, had the per couple exemption been \$4 million or \$7 million in 2000, charitable giving would have been only \$1 billion or \$6 billion lower—a much smaller amount than the huge losses charities would see if Congress repeals the estate tax altogether.<sup>20</sup>

#### **Parameters of Sensible Reform**

Congress can easily pass sensible reform that ensures an even tinier fraction of estates are subject to any tax, while still preserving significant revenues from the estate tax. While it would be best if any reform followed the “pay-as-you-go” principles that were so critical to fiscal discipline in the 1990s, as a bare minimum any reform should at least maintain well over half of current revenues from the estate tax.

One possible reform package would be the following:

- **Allow a rock-solid \$5 million estate tax exemption per couple:** *Only about one half of one percent of estates* would have to pay any estate taxes if the individual estate tax exemption were set at \$2.5 million a person, so that married couples could leave heirs \$5 million tax free.
- **Allow family farms and businesses worth less than \$8 million to be passed down by couples completely tax free.**
- **Reform the tax to allow spouses to automatically transfer their deduction to the other spouse:** Current law technically only allows for an individual estate tax exemption—though couples can essentially double that exemption with tax planning. Allowing any married person to automatically transfer their exemption to their spouse would create a new couple exemption—in this case at \$5 million.
- **Maintain a rate above the exemption level of 45 percent.**
- **Close costly loopholes:** A comprehensive reform of the estate tax also provides an opportunity to close often exploited loopholes and to simplify the tax code. Cracking down on common estate planning schemes could generate additional revenue, reduce compliance costs, and increase the overall fairness of the tax.

## Conclusion

One of our greatest Republican presidents, Theodore Roosevelt, made the argument for taxing inheritance almost a century ago, claiming that the “really big fortune, the swollen fortune, by the mere fact of its size acquires qualities which differentiate it in kind as well as in degree from what is possessed by men of relatively small means. Therefore I believe in a ... tax which is far more easily collected and far more effective—a graduated inheritance tax on big fortunes, properly safeguarded against evasion and increasing rapidly in amount with the size of the estate.”

Theodore Roosevelt also stated, “We are bound in honor to refuse to listen to those men would make us desist from the effort to do away with the inequality, which means injustice; the inequality of right, opportunity, of privilege.”

In a time of massive inequality, President Roosevelt understood that the estate tax was essential in maintaining the American notions of merit and individual success. We should not abandon this basic principle either by eliminating the estate tax or agreeing to any misguided compromise.

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<sup>1</sup> Joel Friedman and Ruth Carlitz, "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options with Low Tax Rates Raise Very Little Revenue," Center on Budget and Policy Priorities, March 16, 2005. According to CBPP estimates estate tax repeal starting in 2011 would squander about \$745 billion in tax revenue and add an addition \$225 billion debt service payments in the first 10 years.

<sup>2</sup> [Congressional Budget Office](#), "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," January 2005.

<sup>3</sup> "The Debt to the Penny," Bureau of the Public Debt: <http://www.publicdebt.treas.gov/opd/opdpenny.htm>

<sup>4</sup> Tax Policy Center estimates of number of taxable estates in 2004. The Nationals' attendance is about 32,000 per game. See <http://www.washingtonpost.com/wp-dyn/content/article/2005/06/01/AR2005060101150.html>.

<sup>5</sup> Based on the authors' recalculation of Tax Policy Center revenue estimates to include both the direct and indirect effects on taxes collected.

<sup>6</sup> Jason Furman, "The Impact of the President's Proposal on Social Security Solvency and the Budget," May 10, 2005.

<sup>7</sup> Based on estimates from a Social Security Administration memo by Chris Chaplain and Alice Wade, "Estimated Long-Range Financial Effects of Several Provisions Requested by the Social Security Advisory Board," February 7, 2005.

<sup>8</sup> David Cay Johnston, "Richest Are Leaving Even the Rich Far Behind," *New York Times*, June 5, 2005.

<sup>9</sup> Michael Moss, "Safer Vehicles for Soldiers: A Tale of Delays and Glitches," *New York Times*, June 26, 2005.

<sup>10</sup> Kletzer and Rosen, "Easing the Adjustment Burden on U.S. Workers," in *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, 2005.

<sup>11</sup> Budget of the United States Government, Fiscal Year 2006, Historical Tables.

<sup>12</sup> Robert Greenstein, "The Tough Fiscal Challenges that Lie Ahead," Center on Budget and Policy Priorities, [http://www.nyrag.org/usr\\_doc/Robert\\_Greenstein's\\_presentation\\_3\\_31\\_05.ppt#280,36,Slide 36](http://www.nyrag.org/usr_doc/Robert_Greenstein's_presentation_3_31_05.ppt#280,36,Slide 36)

<sup>13</sup> Brody Mullins, "Senators Near Deal to Eliminate Estate Tax for All but the Richest," *Wall Street Journal*, June 22, 2005.

<sup>14</sup> Friedman and Carlitz, "Estate Tax Reform," March 16, 2005.

<sup>15</sup> Joel Friedman, "Estate Tax 'Compromise' May Differ Little from Permanent Repeal," Center on Budget and Policy Priorities, April 20, 2005.

<sup>16</sup> Henry Aaron, "Death and Taxes: Now's Hardly the Time to Favor the Richest Among Us," *The Washington Post*, May 4, 1997.

<sup>17</sup> Sara Hansard, "Death-tax Repeal Could be Deadly, Some Fear; Advisers Fret About Losing Capital Gains Basis Step-Up," *Investment News*, April 25, 2005; "Small Business Council of America Warns that Estate Tax Repeal Will Harm Many Small Business Owners," *Business Wire*, April 14, 2005.

<sup>18</sup> John Buckley, "Estate Tax Repeal: More Losers than Winners," *Tax Notes*, February 14, 2005.

<sup>19</sup> Congressional Budget Office, *The Estate Tax and Charitable Giving*, July 2004.

<sup>20</sup> See also, David Kamin, "New CBO Study Finds that Estate Tax Repeal Would Substantially Reduce Charitable Giving," August 3, 2004.