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Commentary Understates Cost of Estate Tax Repeal

By John S. Irons

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I. Summary

A recent commentary by Wilbur Steger and Frederick Rueter of CONSAD Research Corp., as published in *Tax Notes*, presents a misleading analysis of the impact of estate tax repeal and the introduction of a carryover basis regime.[1] The authors' commentary and analysis is based on a prior report prepared in 2003 for the American Family Business Institute by CONSAD.[2] The authors' update to the CONSAD report claims that replacing the estate tax with a limited carryover regime would raise federal revenue by $1.74 billion over the 2004-2015 period.

That analysis, however, is fundamentally flawed. In particular, the study overestimates the amount that would be raised by taxing unrealized capital gains and grossly underestimates the loss in estate tax revenue from repeal. Because of that second factor alone, the commentators' update to the original CONSAD report understates by $109 billion over the next 10 years the amount of estate tax revenue that would be lost due to repeal.

The findings of their report depend on the assumption that taxing estates on a partial carryover basis — as current law is set to do in 2010 — could actually be implemented. But a system based on a carryover regime would impose massive additional accounting costs for the families of decedents. Such a system was tried once before, in the 1970s, and was ultimately rejected by the Treasury Department as unworkable — there is little reason to believe that such a system would be any more workable today.

The report estimates that repeal of the estate tax would result in a surge of income tax revenues, largely from taxing unrealized capital gains. That conclusion, however, stands in stark contrast to the estimates of both the Joint Committee on Taxation and the Bush administration's Treasury Department. Both of those official estimators find that repealing the estate tax would lead to a *reduction* in income tax revenues, not an increase as suggested by the CONSAD report.

The CONSAD report reaches such different conclusions because its estimates are based on faulty assumptions. For instance, its two key assumptions that determine the magnitude of revenue changes from the repeal and step-up modification are grossly different than the best available estimates. In particular, the study assumes that unrealized capital gains are 25 percent higher than best estimates in large estates. Also, the study assumes that estates' entire portfolios are rebalanced — and hence heirs realize all capital gains — within three to five years of death. Both of those unsupported assumptions lead to an overestimate of the amount of capital gains revenue.

The original CONSAD report and the subsequent update significantly understate the cost of repeal and significantly overstate the revenue from modifying the step-up in basis rules.

Finally, the cost of estate tax repeal has also been underestimated. The study estimates total revenue from the estate tax to be $201 billion over 10 years. The CONSAD estimates of estate tax revenue are largely consistent with Congressional Budget Office estimates for 2004 through 2009. After 2010, however, CBO estimates significantly higher estate tax revenue than reported in the CONSAD analysis. Over the 2005-2014 period, the updated CONSAD analysis shows estate tax revenue to be $109 billion lower than CBO's estimate. By that sleight of hand, CONSAD understates the estate tax revenue that would be lost under repeal.

In total, the original CONSAD report and the subsequent update significantly understate the cost of repeal and significantly overstate the revenue from modifying the step-up in basis rules. The net result of the repeal/carryover regime is very unlikely to be a net gain in revenue.

II. Summary of CONSAD Repeal Option

The CONSAD report simulates the 10-year revenue implications of immediate estate tax repeal, combined with a ''limited step-up'' in basis for the estate tax. In particular, the policy option considered is the same as the one set to take effect in 2010 under current law: It would immediately repeal the estate tax and allow a $3 million step-up in basis for a surviving spouse and an additional

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[1] Wilbur A. Steger and Frederick H. Rueter, ''The Revenue Effects of Estate Tax Repeal and Basis Step-Up Limits,'' *Tax Notes*, June 6, 2005, p. 1314.

[2] CONSAD Research Corp. (2003).

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Basis: Definitions and Concepts

Basis: An asset's basis is the initial value of the asset used to compute capital gains. When an asset is sold, tax is due on the difference between the sale price and the asset's basis.

Step-up in basis: Step-up allows the revaluation of an assets' basis for capital gains taxation purposes. That is, the "initial value" of the asset is recalculated at the time of the step-up, usually at the time of death of the decedent. Step-up in basis reduces the capital gains tax when the asset is sold.

Carryover basis: Carryover basis maintains the assets' original purchase price as its basis. That leads to greater capital gains tax burden relative to step-up in basis. It might be very hard to determine for assets that have been passed down across many generations.

$1.3 million for the spouse or other heirs, with the rest of the estate taxable as capital gains using a carryover basis.

III. Overstating Revenue Gain

A. Overstating Unrealized Capital Gains

The amount of the value of estates that consist of unrealized capital gains is one important parameter in determining the additional revenue raised by removing the step-up in basis and replacing it with capital gains on inheritances. For example, if 50 percent of an estate is unrealized capital gains, half of the estate will, at some point, be subject to a capital gains tax when the assets are sold. A greater percentage will lead to more capital gains revenue.

Best estimates for large estates (over $10 million) indicate that about 56 percent of estates consist of unrealized capital gains. See Poterba and Weisbenner (2001). That study uses data from the Survey of Consumer Finances, the most comprehensive survey of individuals' assets and overall finances. While citing that figure, the CONSAD report instead assumes that on average 70 percent of assets are unrealized capital gains. That larger figure is justified by saying that "several estate planners interviewed by the coauthors have indicated that . . . unrealized capital gains comprise a much larger proportion." Unfortunately that "evidence" from estate tax planners is undocumented and unsupported.

That faulty assumption is likely to grossly overstate the amount that would be raised by the modified step-up. Because a large percentage of revenue is raised from large estates, that will have a significant effect on the report's bottom-line findings. As the report notes, reducing the percentage from 70 percent to 60 percent would bring down its final revenue estimate to a revenue loss of about $26 billion.

B. Overstating Degree of Rebalancing

A second key assumption is the time frame in which portfolios are rebalanced — that is, sold to purchase other assets. When an asset is sold, under the modified step-up scheme, capital gains tax would be due to the government. The longer the assets are held, the less the turnover, and hence the less government revenue in the immediate future. Also, holding onto the assets for a longer period will also decrease the present discounted value of total tax receipts from the new step-up basis.

The CONSAD analysis assumes that *all* unrealized capital gains will be realized between three and five years after the death of the decedent. In other words, all assets will be sold, and taxes on all inherited unrealized capital gains will be paid, within five years of the death of the decedent. Promoters of estate tax repeal often cite sale of assets as an undesirable effect of the tax — arguing that repeal would allow families to hold on to long-held assets — yet the CONSAD analysis assumes that under the new regime assets will be sold quickly by heirs after death.

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That assumption is justified by claiming that "estate planners report" that kind of general behavior. As above, there is no documentation of that evidence and it is not supported by any other studies.

While average holding periods for some types of assets are within the three-to-five-year window — corporate stock is held, on average, just under 3 years — many other assets are typically held much longer. For the general population, businesses are held for over 6 years on average, and personal residences, land, and farmland are each held for more than 10 years on average (Burman, 1999). Assuming the rebalancing will be completed after 5 years seems very unrealistic.

The report notes that if the rebalancing window were between 4 and 5 years, its final revenue estimates would decline to a revenue loss of $35 billion. The report does not estimate the effect of assuming a rebalancing beyond 5 years, but it would likely have a significant effect.

Importantly, even if heirs currently engage in complete rebalancing in 3 to 5 years, as claimed, they would be unlikely to continue to do so under the limited step-up regime. With the current step-up in basis, relatively little will be paid in the form of capital gains tax if the portfolio is rebalanced immediately. Under a limited step-up basis, heirs would have a greater incentive to hold onto appreciated assets for a longer period of time. That behavioral effect is not considered in the report.

IV. Understating Cost of Repeal

Over the 2005-2014 period, the analysis estimates that the estate tax will raise $201 billion in federal revenue. While the analysis is consistent with other estimates until 2010, it is not consistent with estimates after 2010.

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**Table 1. Estimated Revenue Loss From Estate Tax Repeal Legislation
Adjustment to CONSAD: Cost of Repeal
(Billions of Dollars)**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-2014
Congressional Budget Office[a] (Extend repeal after 2010)	0	1	2	2	2	3	28	55	59	67	219
Estate tax revenue projections:											
Congressional Budget Office[b]	24	27	25	26	27	21	19	43	46	52	310
CONSAD	24	27	25	26	27	10	7	17	18	20	201
CONSAD Underestimate	0	0	0	0	0	11	12	26	28	32	109

[a]Congressional Budget Office (2005c).
[b]Congressional Budget Office (2005a).

The deviation comes from 2011 through 2014. For those years, the authors assume that, contrary to current law, the estate tax exemption would be $2.5 million with a tax rate of 35 percent. That is a significant departure from CBO practice of scoring legislation relative to current law (which sets the exemption level at $1 million and the top rate at 55 percent starting in 2011) and significantly understates the cost of repeal.

To get a sense of the magnitude of revenue implications of that assumption, CONSAD is projecting that estate tax revenue would be just between $17 and $20 billion from 2012 through 2014 (see Table 1). CBO estimates put baseline estate tax revenue from between $43 and $52 billion for those years. A combination of the pre-2010 CONSAD estimates with the post-2010 CBO estimates shows that the total 10-year underestimate of the estate tax revenues that would be lost under repeal is about $109 billion.

Also, when looking at the income tax effect of estate tax repeal, Treasury and CBO find that additional revenue would be lost from repealing the estate tax. For instance, Table 1 shows CBO's estimate of the cost of extending estate repeal beyond 2010. When repeal is in effect from 2011 through 2014, CBO shows that the cost of repeal exceeds the total amount of estate tax revenues that CBO projects for that period by $49 billion. Thus CBO predicts a *reduction* in income tax revenues when the estate tax is repealed.[3] That stands in stark contrast to the CONSAD analysis, which, by relying on the faulty assumptions discussed above, shows an *increase* in income tax revenues of $114 billion for that period.[4]

[3]For a discussion of the Treasury estimates, see Noto (2005).

[4]Some might argue that the CBO estimates, because they reflect only the cost of extending repeal after 2010, do not include income tax revenue gains from additional capital gains realizations that would take several years to fully materialize. But other CBO estimates that reflect the cost of immediate repeal show that over 10 years repeal would still result in substantial income tax losses in addition to the loss of estate tax revenues. *See* estimates in CBO (2005b).

IV. Conclusion

While moving to a limited step-up in basis would certainly raise more revenue when compared to a full step-up in basis, the additional revenue would not be nearly enough to compensate for the loss of the estate tax. The CONSAD analysis significantly understates the cost of repeal and significantly overstates the revenue raised from modifying the step-up in basis rules.

In their far more thorough study, Poterba and Weisbenner (2001) find that "total revenue associated with the current estate tax is far greater than that associated with the taxation of capital gains at death." In their analysis of 1998 data, eliminating the estate tax and taxing capital gains at death (with a $250,000 deduction for a residence) would reduce taxes for 95 percent of those worth more than $1 million and would have an average tax savings of $672,700 per person.

Also, taxing on a partial carryover basis contains massive additional accounting costs for the families of decedents. Taxing assets on a carryover basis imposes significant additional reporting and recordkeeping burdens on those that must pay the tax and adds significant complexity to the code. For many assets passed down through many generations, determining the correct basis is simply unworkable and will likely impose a significant burden on far more families than the estate tax (see Buckley, 2005).

A carryover basis regime was in fact passed nearly 30 years ago, in 1976, but was scrapped before it took effect. The carryover regime set to take effect in 2010 will likely suffer the same fate. We should instead be looking to reform and improve the current estate tax, rather than repealing the estate tax and trying to replace it with an unworkable and overly complex regime.

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