ESTATE TAX

By Ann Alvarez & Natalie Done

History of the Estate Tax

- One of the oldest federal taxes
- First imposed in 1797
- Principal purpose was revenue, not redistribution
- 1802 Repealed when need for revenue fell
- 1862 Revived solely for revenue purposes
- 1870 Repealed when need for revenue fell again
- 1898 Another Estate Tax imposed to pay for the Spanish-American War
- 1902 abolished

Permanence

- Permanently established in 1916
- Imposed to offset a decline in tariff revenue caused by WWI
- Has been altered many times
- Highest rate was 77%
- Amount exempt has increased and decreased over the years
- Has not been adjusted for inflation

Are Estate Taxes Fair?

- Government contributes to the accumulation of wealth by defining and protecting property rights
- Taxes on the transfer of this property at death or during life seem appropriate

Fair?

- Based on ability to pay
- Reduce the amount of wealth permanently held by a few individuals in society
- Foster economic growth by circulating property and wealth among individuals

Estate Tax - Funds

- Healthcare
- Defense
- Education

Estate Tax – The Basics

- Tax on your right to transfer property at death
- Consists of accounting of all you own or have certain interests in, at date of death
- Fair market value of items used, not necessarily what paid for them or what their values were when acquired
Basics cont.

- May apply to your taxable estate at death
- Your taxable estate is your gross estate less allowable deductions
- Most estates not subject to the Estate Tax

Gross Estate – Includes at death:

- Value of all property
- Life insurance payable to your estate or, if you owned the policy, to your heirs
- Value of certain annuities payable to your estate or your heirs
- Value of certain property transferred within 3 years before your death
- Trusts or other interests established by you or others in which you have certain powers

Taxable Estate – allowable deductions

- Marital deduction – generally, value of property passing from your estate to surviving spouse
- Charitable deduction to a qualifying charity
- Mortgages and debt
- Administration expenses of estate
- Losses during estate administration
- Funeral expenses paid out of your estate

3 Big Ways to Reduce Taxes Owed

- Gifts
- Charitable Contributions
- Setting up a Trust

The Gift Tax

- "If you give people a lot of money or property, you might have to pay a federal gift tax.
- Most gifts are not subject to the gift tax.
- For instance, you can give up to the annual exclusion amount ($11,000 in 2005) to a person, every year, without facing any gift taxes, and without the recipient owing an income tax on the gifts.
- You can give up to $1,000,000 in gifts, total, in your lifetime, before you start owing the gift tax."

Gift Tax cont.

Example

- Person makes an annual gift to a single donee of $50,000
- Additional $39,000 does not qualify for the annual gift tax exclusion
- Reduce the unified credit from $1,000,000 to $961,000
Charitable Contributions

- "The estate tax is an important motivation for charitable giving.
- People do not give to charity simply because of the tax code.
- Estate tax does encourage an already charitably oriented person to give more
- Charitable contributions are fully deductible.
- Charitable bequests are the second largest type of deduction taken for estate tax purposes
- Second only to the full deduction for assets left to a surviving spouse."

http://www.faireconomy.org/estatetax/ETCharity.html

Capital Gains to Descendants Are “Stepped-Up”

EXAMPLE
- Decedent dies owning stock purchased for $5
- Current value = $100
- Full $100 value is used to determine the Estate Tax
- Stock then receives a stepped-up basis of $100 in the hands of the descendent/recipient
- No income tax paid by descendent/recipient on subsequent sale of stock for $100 or less
- Income tax only paid on sale of stock in excess of $100

http://www.taxprophet.com/pubs/estat_nl.html

Even for smaller Estates – Planning Ahead Pays Off

Party Lines

- Democrats typically favor the Estate Tax because it is a redistribution of wealth
- Republicans are typically against Estate Tax – or the "DEATH Tax" as they like to call it

Does calling it the death tax affect the way you view the tax?

http://www.freedomworks.org/images/grim.jpg

Is the Estate Tax Double Taxation?

- Majority of large estates $10 million+ have capital gains that have never been taxed
- CAPITAL GAINS: "stocks, and bonds that have appreciated in value since...purchased by the decedent but have never been subject to tax"

A Parody

http://www.agitprops.org/estatetax.html

Help President Bush and the Republicans

SAVE Paris Hilton’s Inheritance!
Billionaires Applaud Buy-Partisan Plan to End Estate Tax

- "the Billionaires for Unlimited Inheritance, a coalition of the mega-rich, are letting the champagne corks fly. They are particularly pleased that the [new] legislation will abolish the estate tax..."
- We've paid far too much in campaign contributions to pay these taxes as well!
- "the cooperation of both parties proved vital in the success of the tax package... It shows the wisdom of our buy-partisan strategy of buying both Democrats and Republicans. This way, we always win!"
- We're thrilled to have shifted more of the tax burden onto the poor... but there is far more to do. The minimum wage is still too high, workers still have unions, and our businesses are still subject to regulations. Inequality is still not growing fast enough.

Bush is against the Estate Tax

Do you agree?

"It has been said the greatness of a nation is determined by how it treats the poorest of its citizens. By cutting taxes for the rich and decreasing help for the poor, we are robbing our country of this greatness."

Bush is against the Estate Tax

EGTRRA – Economic Growth and Tax Relief Reconciliation Act of 2001

- Estate Tax is just one component of this huge tax legislation act
- Estate Taxes will decline each year
- Amount of net assets exempt from taxation will increase through 2009
- In 2009 the tax will equal 45% of net assets over $3.5 million

How Many Estates Pay Estate Tax?

Prior to EGGTRA

- Only Two Percent of Decedents Pay Estate Tax

Affect of EGGTRA as of 2009

- 2 out of 100 Estates pay tax
- Less than 1 out of 100 Estates pay tax

Current Law –as of 2005

- If someone dies and leaves estate worth more than $1.5 million
- Estate must file return
- LIABLE for taxes of 43% to 47% on assets (minus deductions) above $1.5 million

Scheduled Changes in Tax Rates & Exemption Amounts under EGGTRA

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<th>Year</th>
<th>Lowest Tax Rate</th>
<th>Highest Tax Rate</th>
<th>Exemption Amount</th>
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<tr>
<td>2002</td>
<td>41%</td>
<td>49%</td>
<td>$1 million</td>
</tr>
<tr>
<td>2003</td>
<td>41%</td>
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<td>2007-2008</td>
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<tr>
<td>2009</td>
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<tr>
<td>2010</td>
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<td>55%</td>
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Source: Congressional Budget Office


http://www.cbpp.org/5-25-00tax.pdf - page 3

http://www.cbpp.org/6-17-03tax.pdf - page 2
One Proposal once EGTRRA Expires

Reform the Estate Tax instead of Repeal

Effective Tax Rate

- Effective tax rate for estates paying tax, in 2003 was about 19%
- This is more than half the top estate tax rate for that year (49%)
- Why is the effective tax rate so much lower than the top tax rate?
- Estate taxes are due only on the portion of an estate’s value that exceeds the exemption level, not on the entire estate

EGTRRA cont.

- Estate Tax scheduled to sunset in 2010
- SUNSET means unless new laws are passed to extend the provisions, things revert to the way they were before EGTRRA

Those who benefit by dying in 2010…

- One year absence in 2010 “Because the estate tax might reappear in 2011 after a one year absence, commentators have humorously speculated that persons with large estates should consider passing away in 2010 to avoid taxes”

Not all wealthy are against Estate Tax

- In 2001, estate tax repeal proponents were anticipating an easy victory until a Boston organization called Responsible Wealth organized a group of affluent Americans, including Bill Gates Sr. and Warren Buffett, to announce their opposition to total repeal.

Responsible Wealth

- Responsible Wealth is a national network of businesspeople, investors and affluent Americans who are concerned about deepening economic inequality and are working for widespread prosperity. Our three primary areas of work are tax fairness, corporate responsibility and living wages.
Why do people favor repeal of the tax if only a small % of Estates are affected?

President Bartlett from the NBC series West Wing addressing why Americans want the Estate Tax repealed:

"It doesn't matter if most voters don't benefit. They all believe that someday they will. That's the problem with the American dream. It makes everyone concerned for the day they're gonna be rich..."

Or do you agree with?

"It has been said the greatness of a nation is determined by how it treats the poorest of its citizens. By cutting taxes for the rich and decreasing help for the poor, we are robbing our country of this greatness."

Or do you agree with?

Or do you agree with?

Revenue Act of 1935

- The estate tax did not become explicitly redistributive until the Revenue Act of 1935, passed by the Roosevelt Administration for the sole purpose of redistribution.
- Roosevelt rationalized this policy as necessary to stave off even more redistributive proposals being propounded by Huey Long and others. To combat these "crackpot ideas," Roosevelt said, "it may be necessary to throw to the wolves the forty-six men who are reported to have incomes in excess of one million dollars a year."

Purpose of the tax...

- Though the estate tax was historically a revenue source, today it serves mainly redistributive purposes, since the revenue yield is minuscule.
- The estate and gift tax is the federal government's least significant revenue source. In fiscal year 2000, it raised just $30 billion, according to the Office of Management and Budget. With total federal revenues estimated at $2 trillion, the estate and gift tax contributes just 1.5 percent.

Roosevelt’s Impact and Criticism

- The top estate tax rate, which was 45 percent when Roosevelt took office, was ratcheted up to 60 percent in 1934 and 70 percent in 1935.
- This and other provisions of the legislation designed to "soak the rich" were heavily criticized by economists as undermining business confidence and shifting the tax system away from its primary purpose of raising revenue.
A fundamental justification for the estate tax is that only those who can most easily afford pay--i.e., the rich are impacted. This year, just 2.03 percent of adult deaths in the United States are expected to result in taxable estate. However, the burden of the tax falls primarily on the recipient, not the giver. For this reason, one cannot state with certainty what the distributional effect of the estate actually is, since heirs may be either wealthy or poor. This alone may be sufficient reason to abolish the estate tax.

Moreover, that the burden of the estate tax falls on heirs rather than decedents also raises important distributive questions. Generally speaking, heirs have less wealth and income than decedents. Hence, attributing the estate tax to the former rather than the latter would show the burden of the estate tax on those with middle incomes to be much higher than standard distributional tables indicate. Indeed, Congress's Joint Committee on Taxation has resisted inclusion of the estate tax in its distribution tables, owing to uncertainty about who actually bears the burden of the tax.

The reason for this disparity is that careful estate planning can virtually eliminate the tax. At the simplest level, individuals can give away up to $10,000 per year, per person, free of gift tax. This means that a husband and wife with two married children, each with two children of their own, could give up to $160,000 per year to their offspring free of tax. Also, there is a large deduction for gifts made to spouses, whose estates may be taxed separately. Thus for most married couples, the estate tax only applies to estates larger than $1.35 million.

Beyond that, there are a number of increasingly complex methods for reducing the burden of the estate tax. They include life-insurance trusts, qualified personal-residence trusts, charitable-remainder trusts, charitable-lead trusts, and generation-skipping trusts. So effective are these methods of avoiding estate taxes that it has been argued that the estate tax is essentially voluntary. However, the ability to exploit existing tax-avoidance techniques is not uniform across estates. Those with the largest estates generally have the greatest ability to engage in estate planning.

Because of legal estate planning techniques, much less of the tax actually falls on the wealthy than is commonly believed. In 1997, more than 50 percent of all estate tax revenue came from estates under $5 million. The effective estate tax rate actually falls for estates above $20 million. In fact, a recent study estimates that two-thirds of the wealth of the nation's richest families goes untaxed.

The reason for this is because many estate-planning techniques are costly and require long lead-times to implement. Families with long histories of wealth are more likely to be familiar with them. Thus a disproportionate burden of the estate tax often falls on those with recently acquired, modest wealth: farmers, small businessmen, and the like. In many cases, their incomes may not have been very high, and they died not even realizing they were "rich."
Another reason why those with larger estates are more likely to engage in complex estate planning is, of course, because they pay higher tax rates on their assets. Consequently, research shows that during periods when estate tax rates were rising, revenue from the estate tax fell as the incentive to engage in estate planning increased. Conversely, lower estate tax rates increased estate tax revenue, because it was no longer as profitable to engage in such planning.

A survey of family businesses in New York found that they had spent $125,000 each in estate planning. These include attorney’s fees, insurance premiums, and other expenses designed to mitigate the effects of the estate tax. In a review of the data from this survey, economist Douglas Holtz-Eakin concluded that the estate tax has a much greater distortionary effect on entrepreneurs than previously thought. It causes them to cut back on labor, investment, and risk-taking.

Academic research has also looked at the impact of the estate tax on small businesses. According to one study, its main effect is on business liquidity. Since most small businesses are undercapitalized to begin with, the estate tax can literally suck the lifeblood out of a business. Furthermore, increasing the ability of entrepreneurs to leave an inheritance can greatly increase the chances of a small firm’s survival. Other research found that the estate tax encourages small business owners to sell out or merge with large firms.

According to a recent survey, 51 percent of family businesses would have significant difficulty surviving in the event of a principal owner’s death because of the estate tax. 14 percent of businesses said it would be impossible for them to survive. Only 10 percent said the estate tax would have no effect.

This same survey found that 41 percent of businesses would have to borrow against equity to pay the estate tax. 30 percent said they would have to sell all or part of the business. Eighty-one percent of family businesses reported having taken steps to minimize the estate tax bite. These included purchasing life insurance, making lifetime gifts of stock, putting the business into trust, or other arrangements.

The impact of estate planning goes beyond the estate tax to the income tax as well. For example, under a charitable remainder trust, one donates assets to a tax-exempt institution but retains income from the assets until death. Not only are the assets fully shielded from the estate tax but the charitable donation reduces one’s income taxes as well.
Impact…

- Because of such interactions between the estate tax and the income tax, economist B. Douglas Bernheim estimated that lost income tax revenue may offset all of the revenue from the estate tax. It should also be noted that lawyers and accountants fees for estate planning can, in many cases, be deducted from one's income taxes, which is another way the estate tax reduces income tax revenues.

Possible Changes to Estate Tax

- #1: Abolish the estate tax, but broaden the taxation of gifts by treating them as income and therefore paying income tax.
- A variation of this idea would be to switch from an estate tax, where assets are taxed as a whole, to an inheritance tax, where heirs are taxed individually, as most other countries do. This reform is supported by some liberals as encouraging the breakup of large estates.

Possible Changes to Estate Tax...

- #2: Another group sees taxation of capital gains at death as a better way of taxing estates than the current estate tax. Under such a scheme, death would be treated as a realization of capital gains for tax purposes.

Change #2 Continued…

- Canada has such a system in lieu of an estate tax. Not only would it raise about the same revenue as the estate tax but it would redress an unfairness resulting from the "step-up" of basis at death. (Under the current law, the value of assets is "stepped-up" at death—meaning that an heir who acquires an asset through inheritance will pay capital gains tax only on any increase in value from the time he received it. Any increase in value during the life of the person who originally purchased the asset thus escapes taxation.) Even conservative Republicans, now favor taxing capital gains at death as a substitute for the estate tax.

Other Suggestions..

- However, while the problems of the estate tax would seem to make it ripe for repeal or major reform, the vast growth in wealth in America is, at the same time, fueling support for new taxes on wealth.
- For example, New York University economist Edward Wolff has proposed an annual wealth tax for the United States of 0.3 percent on assets over $1 million, which he estimates would raise more than $40 billion per year.
- Two Yale Law School professors have proposed a 2 percent annual wealth tax that would raise $255 billion per year in order to finance an $80,000 grant to all Americans on their twenty-first birthdays.
- And during his abortive run for the Reform party presidential nomination, Donald Trump proposed a one-time tax of 14.25 percent on all wealth above $10 million to pay off the national debt.

Does it even matter…

- Virtually all research shows that inheritances are insignificant as a source of major wealth in America.
- A 1961 Brookings Institution survey found that among the affluent, only 6 percent acquired most of their assets from gifts or inheritances.
- Sixty-two percent of the affluent reported no inheritances whatsoever. The vast bulk of wealth arose from saving and an increase in the value of assets.
Continued…

- Another study, by economist James P. Smith, found that among the top 5 percent of households ranked by wealth, *inheritances* accounted for less than 8 percent of assets.
- The study concluded that "wealth inequality is largely the same when the direct effects of financial *inheritances* are removed."

Finally…

- And a recent study of U.S. millionaires found that 80 percent acquired their wealth in a single generation, without the benefit of *inheritances*.
- Likewise, a U.S. Trust Corporation survey of the wealthiest 1 percent of Americans found that *inheritances* were a significant source of wealth for only 10 percent of respondents. Earnings from privately owned businesses were the dominant source of wealth (46 percent), followed by earnings from corporate employment (33 percent), and earnings from a professional practice (29 percent).

The American Dream...

- The reality is that the pursuit of wealth—including the desire to pass it on after death—is a major motivation for work, saving, investment, risk-taking, invention, innovation, and entrepreneurship.
- In the process of acquiring personal wealth, however great it might be, individuals create far more wealth for society.

How Do We Evaluate…

- Questions to ask ourselves?
  - #1 Does it achieve its purpose of redistributing wealth?
  - #2 Is the revenue that it generates sufficient or is it not worth the administration costs?
  - #3 Is it fair to tax money that people have already paid taxes on?
  - #4 What should we do with small businesses and farmers?
  - #5 Should it ultimately be removed?
  - #6 WHAT DO YOU THINK?

Thank you for your attention!

Do you have any questions?