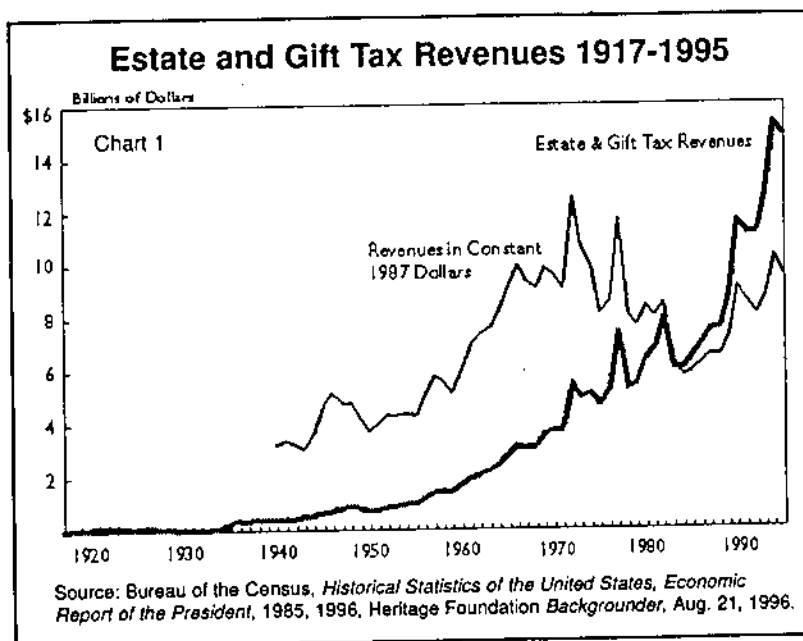


# ISSUES TODAY

## The case for eliminating the death tax

Estate tax boosts estate planning industry while destroying small business

July 1997



The unified estate and gift tax has a two-fold purpose, to raise revenue for the U.S. Treasury and to limit the concentration of wealth in America. In reality, the tax does neither well. In addition, the estate tax crimps economic growth, destroys small businesses, and promotes the break-up of America's farms. The estate tax actually encourages conspicuous consumption while discouraging savings and capital investment.

The estate tax has single-handedly created the estate planning industry which diverts enormous resources from more productive endeavors including business expansion and direct job creation.

Failing to meet either of its objectives while adversely affecting the American economy as well, the estate tax must be repealed.

**"In this world nothing is certain but death and taxes."**

- Benjamin Franklin

### Overview and history of the estate tax

The unified estate and gift tax is a tax on the assets of a deceased taxpayer. The tax applies to estates with assets greater than \$600,000. The first dollar above the \$600,000 threshold is taxed at a rate of 37%, with rates progressing to a maximum of 55%.<sup>1</sup> To prevent taxpayers from avoiding the estate tax by giving their assets away, a gift tax is also imposed. Estate taxes, then, include a tax on the value of the estate, plus the value of all gifts made during the lifetime of the taxpayer, less appropriate exemptions.<sup>2</sup>

The first tax on American estates was as an emergency fund raising measure designed to help finance the War with France in the late 1700s. The tax was repealed in 1802, but the need for revenue during the Civil War led to the passing of another estate tax in 1862. This tax was also repealed, this time in 1870.<sup>3</sup>

Eventually, however, the post-Civil War fascination with policy-making at the federal level led to establishment of the income tax in 1913. Establishment of the estate and gift tax followed in 1916. Although the tax may have been imposed as a revenue-raiser, the progressive rates inherent in its structure indicate that redistribution of wealth was also a goal.

From 1920 to 1976 the estate tax was broadened to include increasing numbers of taxpayers at increasingly higher rates. The top marginal estate tax rate was raised from 10% to 40% in 1924, to 45% in 1932 and on up to 77% in 1941.<sup>4</sup>

This trend was reversed in 1976 when Congress expanded the marital deduction for small estates and lowered the top rate to 70%. The Economic Recovery Tax Act of 1981 dropped the top rate to 50% and created the \$600,000 exemption in effect today.

### The estate tax as revenue raiser

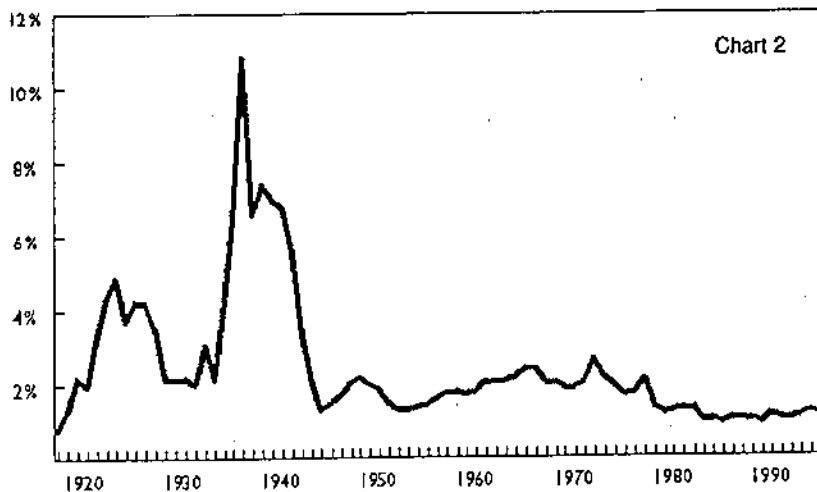
Despite the fact that the federal government can take more than half of an estate's assets (in excess of the exemption),

the estate tax is the government's least important source of revenue. In fiscal year 1997 the estate and gift tax will raise about \$17 billion according the Office of Management and Budget. This will account for just over 1% of federal revenues.<sup>5</sup> When adjusted for inflation, revenue from the estate tax is well below the peak reached in the early 1970s, in spite of the fact that revenues have increased since liberalization of the estate tax laws in 1981.

Estate and gift tax revenues as a share of federal revenues have also fallen over the last three decades even as total wealth has risen. (See chart 2.)

Furthermore, the benefits the federal government is receiving from the estate tax could well be overstated. That's because certain facets of estate planning impact the income taxes owed during the taxpayer's lifetime. For example, a "charitable remainder" trust can be established which allows the taxpayer to transfer assets to a charity while retaining the income. Because the donation removes the assets from the donor's estate, the charitable deduction reduces income taxes as well. In aggregate, lost income tax revenue from such transactions may offset the entire proceeds from the estate tax each year.<sup>6</sup>

**Estate and Gift Taxes as Share of Federal Revenues  
1917 - 1995**



Source: Bureau of the Census, *Historical Statistics of the United States, Economic Report of the President, 1985, 1996, Heritage Foundation Backgrounder, Aug. 21, 1996.*

**Estate and Gift Tax Rates**

Taxable estate	Marginal rate
\$10,000	18%
\$20,000	20
\$40,000	22
\$60,000	24
\$80,000	26
\$100,000	28
\$150,000	30
\$250,000	32
\$500,000	34
\$750,000	37
\$1.0 mill.	39
\$1.25 mill.	41
\$1.5 mill.	43
\$2.0 mill.	45
\$2.5 mill.	49
\$3.0 mill.	53
\$3 mill.+	55

Table 1

There are also indirect costs related to the estate tax. The amount of money the federal government spends on enforcement coupled with what taxpayers spend on compliance amounts to 65 cents of each dollar collected from the estate tax. And this excludes the massive costs related to estate planning. The price tag of preparing for the burden of estate taxes is estimated to equal or exceed total estate tax revenues.<sup>7</sup>

**The estate tax as destroyer of farms and small business**

It is unusual in America for a small business to be passed onto the next generation. In fact, only 30% of all family-owned businesses reach a second generation. A mere 13% reach a third. It is the rare company indeed that survives four generations. Only 1% of all family-owned businesses boast such a life span.<sup>8</sup>

While several factors account for these statistics, the estate tax plays a major role in the attrition of these job-creating enterprises. According to the National Federation of Independent Business, one-third of today's small-business owners will have to liquidate or sell at least a part of their companies to pay estate taxes. And half of those who liquidate will eliminate 30 or more jobs apiece. Surveys also reveal that 61% of business owners say the prospect of estate taxes is limiting their growth, and 13% say estate taxes have made growth impossible.<sup>9</sup>

The family farm is also at risk. Rather than encouraging farmers to keep the farm in the family, the estate tax makes such a proposition costly, complex and uncertain. And because the estate tax is a tax on the value of assets, heirs to the family farm can be faced with paying taxes which have no relationship to the income produced by farming or ranching operations. Farmland near commercial developments, for example, can carry an inflated value bearing no relationship to the income-producing characteristics of the land.

Furthermore, the estate tax is not just a worry of nation's farming elite. In 1995, the average farm in Nebraska stood on 840 acres. But because Nebraska

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farmland is worth about \$500 an acre, the average-sized farm in that state is valued \$420,000.<sup>10</sup> It is easy to see how farm equipment and a homestead could make the "average" farmer subject to estate and gift taxes.

It is because of these anti-farm attributes of the estate tax that the California Farm Bureau supports its absolute repeal.

### The estate tax as redistributor of wealth

If the purpose of the estate tax is to reduce the concentration of wealth in America, the estate tax has failed in its mission. In fact, those who favor income redistribution have been the quickest to tout

Tax Rates vs. Size of Estate		
Estate Size (\$mill)	Total Taxes (\$mill)	Percent of Estate (Tax Rate)
\$0.6-\$1.0	651	23.0%
\$1-2.5	3,000	8.3
\$2.5-5	2,748	15.2
\$5-10	2,053	17.6
\$10-20	1,384	17.6
\$20+	2,003	12.9

Source: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1991-1995," Statistics of Income Bulletin, vol. 16, no. 3, pp. 42,46, and National Center for Policy Analysis.

studies which argue that wealth has never been more unequal. (We would argue this historic disparity is in part due to America's tax policies - including the estate tax, the capital gains tax and inadequate depreciation allowances - which discourage investment in productive endeavors while encouraging consumption and investment in tax free bonds and tax avoidance schemes.)

Furthermore, for families with significant wealth, the estate tax encourages behavior which exacerbates differences between them and less wealthy Americans. Taxing "what is left over" at death promotes consumption, rather than saving or investment. This lost savings is money which might otherwise be pooled with other bank assets and loaned to an upstart or expanding business. Instead, the funds are used to purchase goods which are not taxed (or taxed hardly at all). Surely, encouraging the wealthy to spend more money with upscale retailers, car dealers and jewelers is not a goal of those concerned with narrowing the gap between the rich and poor.

The estate tax also encourages gifts to children well in advance of the taxpayer's death. Such gifts widen the disparities between wealthy children and others. These gifts can also encourage consumption while discouraging self-reliance and pursuit of productive endeavors.

### The estate tax and inter-generational wealth

Those most intent on redistributing income particularly resent the idea that a family's wealth today is largely due to the accumulation of wealth by a distant ancestor. The fact is, the vast majority of wealthy people in America today are "self-made." Fewer than one in five American millionaires inherited even 10 percent of their wealth.<sup>11</sup> Since most of these millionaires are business owners, the estate tax, rather than breaking up family dynasties is breaking up family businesses, forcing their sale or liquidation.

When a business is sold to pay estate taxes it is often the large corporation who steps in to purchase the operations. Few would argue that

## ESTATE TAXES & REAL PEOPLE:

### A Texas rancher explains how the estate tax threatens the family business

*My family thought that passing our business down to our children, as our father did for us, was the quintessential slice of the American dream.*

*Our business, Dudley Brothers Ltd. Ranches, is a registered and commercial Hereford operation in Central Texas that was formed in 1938 by my father, two uncles and their wives. As their families expanded, so did the ranch. In 1974, they set up a limited partnership for my brothers, cousins and me so that we could continue to own and work in the business.*

*My family used to think there would be nothing better than having our children carry on the business that we have worked so hard to build. But we are beginning to worry that, for our children, doing so may be more of a burden than a blessing.*

*Like all ranching families, we have struggled with market forces and climactic conditions. We expect it and are happy to do it for the sake of our business. But the impact of such conditions are nowhere near the impact that death-related taxes can have on one's family business, such as those that were imposed on our ranch when my father died in 1976 and my uncle died in 1982.*

*As the law stands, estate or "death taxes" can eat away 37 percent to 55 percent of a family business. I know firsthand that this is accurate, since each death tax debt that we had to pay for my father and my uncle was several hundred thousand dollars. It took my family 10 years to pay my father's debt and 15 years to pay my uncle's, and for four of those years our payments overlapped. That put our operation in a tremendous financial bind.*

*Not only did the payments greatly complicate sound business practices like investing in equipment and making other improvements, they also sapped the cash that would have been spent on conservation efforts, such as brush control, water development, fence repair and wildlife management.*

*In fact, a survey by the Texas and Southwestern Cattle Raisers Association showed that our business wasn't alone in altering its practices because of death taxes: More than 78 percent of the respondents said the current death tax law has affected their ranching and farming operations.*

*My family was fortunate because we were able to pay my father's and my uncle's death tax debts by leasing our land to hunters. Other ranching and farming operations aren't so lucky. Many times, families must sell off critical assets or lose their business altogether in order to pay their tax burden.*

*In addition, the serene beauty and abundance of*

**Continued on back page**

such a transaction shifts money and power from the strong to the less powerful.

## The estate tax and the economy

America devotes a tremendous amount of resources to deciphering the 371 pages of the IRS code and accompanying regulations devoted to the estate and gift tax.<sup>12</sup> The tax has created an entire industry of accountants, attorneys and trust officers dedicated to estate tax planning and avoidance. There are 16,000 members of the American Bar Association alone who practice primarily trust, probate or estate law.<sup>13</sup> The resources devoted to estate planning, including investments made in non-productive tax avoidance schemes, are resources which could otherwise be used to expand existing businesses and create jobs. Instead, estate planning and compliance consumes an estimated 8% of the country's savings each year.<sup>14</sup>

Eliminating the estate tax would cost the government just over 1% of its revenues, some of which would be recouped directly through higher income taxes (due to the elimination of certain deductions.) The economy would indirectly benefit from additional investment, and the extended life of farms and small businesses which would otherwise be liquidated to satisfy estate tax liabilities.

## Conclusion: Repeal the estate tax

The estate tax neither effectively raises revenues nor limits the concentration of wealth. The tax not only is a drag on the economy, it encourages consumption, discourages investment and diverts savings. The \$600,000 exemption which has been in effect since 1981, is worth only \$377,000 when adjusted for inflation. That is, this punitive tax has become significantly more punitive over the past 16 years.

Despite the fact that the unified estate and gift tax is designed to tax the largest estates with the highest rates, the wealthiest families have a clear advantage in estate planning due to high cost and complexity. In fact, successful estate planning enables the very largest estates to pay taxes at lower rates than moderate-sized estates.<sup>15</sup> (See Table 2.)

Because the estate tax fails to accomplish the objectives of redistributing income or raising significant revenue for the U.S. Treasury, the tax should be abolished.

### Notes:

<sup>1</sup> There are also estate tax rates ranging from 18% to 34%, but these rates apply to estates below the \$600,000 threshold. That is, they do not apply in reality. The first dollar of an estate above \$600,000 is taxed at 37%. Source: Bruce R. Bartlett, Senior Fellow National Center for Policy Analysis, Congressional testimony presented to the Subcommittee on Tax, Finance, and Exports Committee on Small Business, June 12, 1997 - footnotes.

<sup>2</sup> A taxpayer may give \$10,000 (worth of assets) annually tax free to any number of individuals. This is known as the unified transfer tax credit.

<sup>3</sup> William W. Beach, The Case for Repealing the Estate Tax, The Heritage Foundation, Aug. 21, 1996, p4.

<sup>4</sup> Ibid., p. 5.

<sup>5</sup> Bruce R. Bartlett.

<sup>6</sup> According to Professor B. Douglas Bernheim of Stanford University. Source: Bruce R.

Bartlett.

<sup>7</sup> "Estate Tax Reform," Issue Summary, Association of Equipment Distributors, May 12, 1997.

<sup>8</sup> Ibid.

<sup>9</sup> "Death tax reform - helping the family business stay alive," Issue Briefing, National Federation of Independent Business, 1997.

<sup>10</sup> "Nebraska's Economic Performance, 1995," Nebraska Department of Economic Development, July 1996.

<sup>11</sup> Dr. Thomas J. Stanley and Dr. William D. Danko, "The Millionaire Next Door," Longstreet Press, Inc., 1996.

<sup>12</sup> "Inheritance Tax Imperils Family Businesses, Farms," Daily Policy Digest, National Center for Policy Analysis, 1996.

<sup>13</sup> Bruce R. Bartlett.

<sup>14</sup> "Inheritance Tax Imperils Family Businesses, Farms."

<sup>15</sup> Bruce R. Bartlett.

## Estate tax siphons resources from productive endeavors

A September 1995 Gallop poll found that business could create more jobs if they did not have to devote resources to estate taxes and estate planning activities.

According to the poll, if estate taxes were eliminated, companies with market values below \$5 million would create seven new jobs. Firms with market values between \$5 and \$10 million would hire more than 30 employees.

As a result, the estate tax not only imperils job security, it stifles job creation by America's small businesses.

Source: Associated Equipment Distributors.

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wildlife that flourishes on ranches and farms frequently are destroyed when high death taxes are combined with rising property values. The result is that properties are sold to the the highest bidders, who often use the land to build tract housing and shopping malls

Not only is that a hideous deal for families who had hoped to keep their land and business around for future generations, but it takes the business contributions of employment, economic activity and tax revenues away from the local and national economy.

For those reasons, death taxes should be repealed or the law significantly modified. Studies show that death related taxes have a more depressing effect on the economy than allowing the assets of a business to remain with the family.

Only three surviving partners are left from my dad's and uncle's original business: my mother, an uncle and his wife. They all are over 80, and our family won't be able to service their estate tax debts without selling a portion of our property.

Even though Congress stated in an overview on federal taxes that death taxes are "an appropriate means of recompensing the government for the protection of property rights," my family and I wonder, after paying 25 years of death taxes and looking down the road to selling assets to pay additional death taxes, how much are those property rights really worth to us and our children after all?

John Dudley is a cattle rancher in Comanche, Texas.