“Estate Taxes: An Historical Perspective”

Testimony of
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Mr. Chairman and members of the Committee, I am Gary Robbins, President of Fiscal Associates and Senior Research Fellow at the Institute for Policy Innovation (IPI). I thank you for the invitation to appear at this hearing on “Preserving and Protecting Family Business Legacies.” My remarks summarize work on estate taxes that Aldona Robbins and I have been doing for IPI.[1]

Until recently estate taxes were the almost exclusive headache of the super rich, their tax attorneys and their estate planners. But, a strong economy, an ever-widening distribution of wealth – both good things – coupled with tax policy that has failed to keep up with economic growth have extended the reach of estate taxes well into middle class America.

I would like to begin with a brief history of estate taxes, discuss the economic implications of estate taxes, look at some examples of how the estate tax affects family businesses, and conclude with some suggestions as to how the tax should be changed.

A Brief History of the Estate Tax

Estate taxes date back almost three thousand years. As early as 700 B.C., there appears to have been a 10 percent tax on the transfer of property at death in Egypt.[2] In the first century A.D., Augustus Caesar imposed a tax on successions and legacies to all but close relatives.

Transfer taxes during the Middle Ages grew out of the fact that the sovereign or the state owned all assets. Although the king owned all real property in feudal England, he did grant its use to certain individuals during their lifetimes. When they died, the king would let the estate retain the property upon payment of an estate tax.

In the United States, the tradition of taxing assets at death began with the Stamp Act of 1797. While the first Stamp Act on tea helped precipitate the Revolutionary War, the second was far less dramatic. Revenues from requiring a federal stamp on wills in probate were used to pay off debts incurred during the 1794, undeclared naval war with France. Congress repealed the Stamp Act in 1802.

That set a pattern for the next hundred years or so in which estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.

To help finance the Civil War, the Tax Act of 1862 imposed a federal inheritance tax. As costs mounted, the Congress increased the inheritance tax rates and added a succession tax in 1864. When the need for added revenue subsided after the war, the inheritance tax was repealed in 1870.

In 1874, a taxpayer challenged the legality of the Civil War estate taxes, arguing they were direct taxes which, under the Constitution, must be apportioned among the states according to the census. The Supreme Court disagreed saying that direct taxes pertained to capitation taxes and taxes on land, houses and other permanent real estate.[3]

Another legal decision bearing on, but not directly related to, estate taxes concerned The Income Tax Act of 1894, which included gift and inheritances as income subject to tax. The Supreme Court struck down the whole bill because the tax was imposed on, among other things, real estate gains and, therefore, considered a direct tax.[4] This decision is particularly notable because it set the stage for the Sixteenth Amendment which allows the federal government great latitude in the types of taxes it can collect.

The Modern Estate Tax Evolves: 1916 to 1975

In the early 20th century, worldwide conflict cut into trade tariffs – a mainstay of federal revenues – and Congress turned to another revenue source. The Revenue Act of 1916, which introduced the modern day income tax, also contained an estate tax with many features of today's system. After an exemption of $50,000 (almost $11 million in terms of today's wealth), tax rates started at 1% and climbed to 10% on estates over $5 million (over $1 billion in terms of today's wealth). Estate taxes were increased in 1917 as the U.S. entered World War I.

However, unlike before, the estate tax did not go away after the war ended. Despite sizable budget surpluses, Congress increased rates and introduced a gift tax in 1924. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. During the 1920s through the 1940s, estate taxes were used as another way to attempt to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of a few.

While the Internal Revenue Code of 1954 overhauled the federal income tax, it made a seemingly minor structural change to estate taxation. Specifically, it expanded the tax base to include most life insurance proceeds, which could substantially raise an estate's tax bill.

Reshaping Federal Transfer Taxes: 1976 to the Present

During the late 1960s and early 1970s loophole closing preoccupied tax reformers. These efforts culminated in a 1976 tax bill which overhauled estate taxation, giving us the system we still have today.   Perhaps the biggest change was combining the previously-separate exemptions for estate and gift taxes and transforming them into a single, unified estate and gift tax credit.

The 1981 tax bill brought some relief. Rates were cut – the top rate went from 70 to 50 percent, and an increase in the unified credit took a lot of smaller estates – those under $600,000 – off the tax rolls. But, after that, the search for revenue to close budget deficits led to more than a decade of bills that largely increased estate taxes.

In 1997, Congress provided some relief with the first increase in the unified credit since 1987. Gradual increases, which began in 1999, are slated to raise the unified credit to $1 million by 2006.

Summary of U.S. Estate Taxation

Several main points emerge from the history of estate taxation in the United States:

- Until the 1920s, estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.

- From the 1920s through the 1940s, estate taxes became another weapon in the arsenal to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of a few. Graph 1 shows the starting and top estate tax rates since 1916.

- Loophole closing preoccupied tax reformers during the late 1960s and early 1970s. Their efforts culminated in a 1976 tax bill that overhauled estate taxation and combined the estate and gift tax exemptions into a unified credit.

- Lower income tax rates enacted in 1981 were extended to estate taxes and the exemption was increased to remove smaller estates from the tax rolls.

- Since then, estate taxes have been on the rise, this time a weapon in the arsenal to reduce federal deficits. Time has seriously eroded the value of the estate tax exemption.

Estate Taxes and the Economy

The estate tax has a large dead-weight loss. Because the estate tax falls on assets, it reduces incentives to save and invest and, therefore, hampers growth. Along with income taxes, estate taxes help raise the tax rate on income from assets relative to income from working. This unequal treatment of income leads to an inefficient mix of capital and labor.

The size of the dead-weight loss depends on how much of a nation’s assets are subject to the tax and the amount of distortion. The estate tax exemption determines the proportion of wealth covered and the rate structure determines the degree of the distortion.

A rough measure of the distortion is the ratio of marginal to average rates for those paying the tax. The average rate is a proxy for the amount of revenue raised while the marginal rate is a proxy for the overall price distortion. Under a uniform tax, the ratio would be one and the amount of distortion would be minimized. The greater the difference between the marginal and average tax rates, however, the greater the distortion and, therefore, the larger the dead-weight loss.

Currently, the marginal estate tax rate is nearly 3 times higher than the average. Even though the estate tax rate structure is progressive, the high ratio is due mostly to the unified credit. In 1916, the statutory exemption was $50,000. Adjusting the exemption for the growth in wealth between 1916 and 2001 indicates that estates under $11 million (in today's wealth) would not have been taxed. In 1931, the exemption was worth even more – $13.6 million (in today's wealth). As Graph 2 shows, however, since then the real value of the exemption has fallen dramatically. The low of about $343,000 was reached in 1976.

Tax bills in 1981 and 1997 provided modest increases in the exemption. However, the exemption of $675,000 in 2001 is still a far cry from its $11 million counterpart in 1916. This failure of the estate tax exemption to keep up with rising wealth is the main reason increasing numbers of average Americans face the prospect of having their heirs presented with an estate tax bill. A middle class family who owns a home and has IRAs, 401(k)s or other retirement accounts could easily have assets exceeding $675,000 today or even $1 million five years from now.

While the eroding exemption has greatly expanded the estate tax base, both the lowest and highest tax rates also have gone up significantly since 1916. As a result, more of a taxable estate is taxed at the highest marginal rate. As Graph 3 shows, in 1916, only estates over $1 billion (in today's wealth) would have been taxed at the top rate of 10%. Contrast that with the top rate of 55% on estates of $3 million in place this year.

The applicable rates are more compressed than Graph 1 suggests because of the unified credit. Under an exemption system, the estate would begin paying tax at the lowest statutory rate. Under the credit, however, the effective bottom rate is not the statutory18% shown in the graph, but 39%. While current effective tax rates range from 39% to 55%, as the credit continues to erode in value, the lowest effective rate will rise to 41% by 2006.

Effect on Family Business

The estate tax is particularly harmful to families who own businesses or farms. Even though the amount of the tax is based on asset value, the simple fact is that the tax must be paid out of income.

Let us look at two small business examples. Take a family-run store yielding a 10 percent return each year. Taxes reduce the return to 5 percent.[5] If the owner dies and is subject to the 55 percent estate tax rate, how do the heirs pay the bill? They could send 55 percent of the store's inventory or other physical assets to Washington except Treasury does not accept payment-in-kind, only cash. Devoting the entire 5% annual return, the heirs could be pay off the estate tax in only 11 years except Treasury wants the money now. The heirs could borrow from the bank at 9% (4.5% after tax) and pay off the loan in 50 years, but rather than run the store for 50 years for free, they probably would sell.

This example is not as outlandish as one might think. Consider the small farmer who owns land near an urban area. His farm would yield a 10% return only when it is valued as farm land. But, tax law requires that the asset be valued at its "best use," lowering the pretax return to 5% (2.5% aftertax). In this case, even the 50-year bank loan will not save the farm.

The lesson to be learned here is that all taxes are paid out of income. Even if the estate tax is a "rare" event, only one chance in a lifetime, its average impact is very large – large enough that for some the combined effects of income and estate taxes approach 100 percent.[6] The prospect is that as much as 55% of the principal of any investment will be taken in estate taxes on top of income taxes. In cases like these, the clear message is "don't invest, consume."

The Congress has tried to address the hardship circumstances for farmers and small business in general. But, the remedy effectively has the government standing in for the bank. The final result is the same – heirs are left with a choice of owning a nonperforming asset for a number of years or simply selling. What is more, the IRS has taken these half measures as an excuse to raise appraised estate values, thereby reducing the tax relief.

The investment decision becomes even more complicated if there are ways to organize holdings to pass the income stream to heirs. Tax planning can significantly mitigate the effect of the estate tax. Because amounts involved tend to be large, estate planning richly rewards taxpayers who can anticipate that they might be subject to the tax. Those that do not plan or cannot anticipate are caught and pay the tax. This is simply unfair.

That is one reason why the largest estates do not pay the highest tax rates. Who does? Typically they are owners of small businesses, family farms and savers who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax.

Conclusion

In summary, the estate tax is one of the most inefficient features of the current tax system. Its sheer complexity results in high compliance costs – as much as estate taxes raise by some estimates. High compliance costs along with distortions to economic activity warrant serious reduction or outright elimination of estate taxes.

Failing repeal, the exemption should be raised significantly. Increasing the exemption to the range of $5 to $10 million would restore eroded value and reduce the proportion of wealth subject to tax to be more in line with the 1920s and 1930s.

This would only partially address the impact of the tax, however. Under the unified credit structure, raising the exempt amount above $3 million would make the lowest marginal rate 55%, meaning the tax would be even less efficient than current law. While the amount of wealth subject to tax would be reduced, the rate structure would be harsher, increasing the ratio of marginal to average rates. The way to avoid this result is to convert the exemption from a credit to a deduction.

Another desirable change would be to expand the rate brackets. As we have seen the current rate brackets have become compressed when compared to prior law. Expanding the brackets would reduce marginal rate relative to the average and produce a more efficient system. Similarly, reducing estate tax rates would also help to improve the system. The best solution, however, would be to eliminate the estate and gift tax altogether.

Endnotes

1. Gary and Aldona Robbins, *The Case for Burying the Estate Tax,* Lewisville, TX: Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 150, March 1999. This report is available at the website *www.ipi.org*.

2. More on the history of estate taxes is available in John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995 and Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97.

3. *Scholey v. Rew*, 23 Wall. (90 U.S.) 331 (1874).

4. *Pollock v. Farmers' Loan and Trust Company,* 158 U.S. 429 (1895).

5. A tax rate of 50 percent might seem high, but we calculate the economy-wide, marginal tax rate on private business capital at roughly 67 percent.

6. The impact of a tax imposed on assets must be multiplied by one divided by the aftertax rate of return. Thus, the impact of the estate tax is magnified by 10 for an asset with an aftertax return of 10% and by 20 for an asset with a 5% return.