The New York Times

August 14, 2005

Death Tax? Double Tax? For Most, It's No Tax

By EDMUND L. ANDREWS
WASHINGTON

WHEN Congress comes back from its summer recess, one of the first things Senate Republicans will try to do, again, is kill the estate tax.

Perhaps no other tax has so many passionate, persevering and politically organized opponents as the estate tax, or "death tax," as they have branded it.

As Michael J. Graetz and Ian Shapiro of Yale recount in "Death by a Thousand Cuts" (Princeton University Press), their entertaining account of the repeal movement, opponents of the estate tax have already achieved a remarkable political feat by building broad public support for abolishing a tax that currently affects only 2 percent of all estates.

But repeal would be costly - more than $70 billion a year, once it was complete - and many of the populist arguments in favor of repeal are misleading. If estate or inheritance taxes were frozen at today's levels, they would have almost no impact on family farmers and most small-business owners.

And while opponents contend that the estate tax is a "double tax," many of the earnings that are subject to it were never taxed in the first place.

The tax opponents, many of whom began as political neophytes more than 20 years ago, lead a powerful coalition of small-business owners, farmers, trade associations and corporate lobbying groups like the American Council on Capital Formation.

Killing the estate tax is one of President Bush's top priorities, and the House of Representatives has already passed a repeal measure four different times. But Senate Republicans, despite attempts to cut a deal with conservative Democrats before the summer recess, have been stalled on the issue.

Unable to muster the 60 votes they need to overcome a Democratic filibuster, Senate leaders are now vowing to push for full repeal as soon as they come back in September.

Hoping to pressure Democrats from conservative farming states just before Congress adjourned, two business-backed advocacy groups spent about $500,000 on television ads last month in states including Montana, North Dakota, Arkansas and Louisiana.

The ads, produced by the American Family Business Institute and the Free Enterprise Fund - the first an advocacy group dedicated to abolishing the estate tax, the second an advocacy group aimed at a wider range of tax cuts - focused on images of soldiers fighting on D-Day in World War II.

"The I.R.S. hits this greatest generation with an unjust double tax, the death tax," the narrator intoned in an ad aimed at North Dakota. Viewers are urged to "tell Kent Conrad," the state's Democratic senator, to "change his vote."

But despite the populist rhetoric and oft-repeated horror stories about families being forced to sell their farms in order to pay estate taxes, the battle is over a very large amount of money held by a very small number of families. A report last month by the Congressional Budget Office found that in 2000 only 2 percent of all estates - about 52,000 - were subject to any estate tax. At that point, taxes were imposed only on estates worth $675,000 or more. The limit rose to $1.5 million in 2004, and if that limit had been in effect in 2000, only 13,771 estates - fewer than 1 percent - would have been subject to the tax. All but 740 of them would have had enough in liquid assets to cover estate tax liabilities, the office estimated.

At the moment, taxes are imposed only on estates worth more than $1.5 million. Under Mr. Bush's tax cut of 2001, the estate tax is set to shrink steadily over this decade and disappear in 2010. But the 2001 bill called for the estate tax to reappear in full force in 2011.

The nonpartisan Joint Committee on Taxation estimates that full repeal would cost $290 billion over the next 10 years, but that calculation understates the true cost because full repeal would not occur until 2011.

Once the estate tax was fully repealed, the Treasury would lose more than $70 billion a year in today's dollars. Over the first 10 years of full repeal, the cost would total more than $700 billion, plus interest. Assuming that the government is still running an annual deficit in 2011, which is more likely than not, the total 10-year cost would be close to $1 trillion.

A compromise being floated by Senator Jon Kyl, Republican of Arizona, could be almost as expensive. Indeed, because of a strange wrinkle, the compromise could end up being far more generous to many heirs than outright repeal.

Mr. Kyl's proposal called for excluding estate taxes on all property up to $3.5 million and taxing anything above that amount at 15 percent – the same rate now charged on capital gains. Under current law, estate tax rates range up to about 45 percent.

As a practical matter, Mr. Kyl's approach would eliminate the estate tax for more than 99 percent of all families and greatly reduce taxes for the few who owed anything at all. If the $3.5 million exclusion were in effect in 2000, the Congressional Budget Office estimated, only 3,676 estates - about 0.15 percent of all estates - would have had to pay any tax. But the proposed compromise also comes with an important twist that could make it more expensive than the $53 billion a year estimated by Congressional tax scorers.

The twist is that the proposal would retain a big tax break that is supposed to disappear along with the estate tax. That break is known as the "stepped-up basis," and it means that an heir does not owe any capital gains taxes on any increase in value of property during the life of the person who died. A mansion that appreciated to $10 million from $1 million, for example, would not be subject to any capital gains taxes on that profit if an heir sold it. For many families with estates worth less than $3.5 million, that could amount to a double tax break. A person could build up wealth for years, yet avoid paying taxes because the gains were all "unrealized." His children could then inherit the property, sell it and avoid both the capital gains and estate taxes.

The added cost of retaining a stepped-up basis may be only partially reflected in the official cost estimates of Mr. Kyl's proposal, because it is difficult to estimate when people will sell inherited property. But the American Family Business Institute has said that a very high percentage of heirs sell or restructure their holdings within five years.

That's why it is misleading for opponents of the estate tax to claim that it is a double tax on earnings that have already been taxed once.

In many cases, that's not true. "A lot of assets that passed through very large estates have never been taxed and never will be," said Mr. Graetz of Yale. "It's a very big issue."

For thousands of single-digit millionaires, that could be a very good deal indeed.