The Estate Tax is Dead – Long Live the Estate Tax

By Eric J. Gouvin

It’s a presidential election year. As required by long tradition, the two major parties are in the midst of their quadrennial festival of political theater. This season’s blockbuster is the “Death Tax Elimination Act.” In this morality play, the Republicans propose to do away with the Estate and Gift Tax, which they renamed the “Death Tax” for dramatic effect.

As a subject for election year theatrics, the Estate and Gift tax presents an easy target -- it is complicated (at least by the standards of non-tax lawyers), it is imposed at an awkward time (upon the taxpayer’s death), it effects relatively few people (less than 2% of all estates incur liability), and it accounts for a relatively small amount of federal tax revenue (about 1.5% of federal tax receipts). All these factors suggest that few people will go to the mat to fight for the tax. Even better, the few taxpayers who really care about it are very wealthy and might be especially generous campaign fundraising donors if they think they are backing the Congress that will eliminate this burden.

It is little wonder, then, that the Estate Tax has taken center stage this year. But it is merely a show, as a moment’s reflection reveals. In accordance with the classical form of political theatre, the estate tax legislation developed in three acts: Rhetoric, Legislation and Deadlock.

**Act I: Rhetoric.** In the first act, the players recited the well-worn arguments for and against the tax. Proponents noted that the estate tax helps make the overall tax burden more progressive, and helps prevent the United States from becoming a country ruled by the “idle rich” like some European countries. In the minds of estate tax supporters, an inheritance that
would otherwise be a windfall to the children of the wealthy may be a more appropriate source of tax revenue than income earned by a worker through employment.

On the other hand, detractors insisted that the tax creates a disincentive to work hard and save because it erects obstacles to passing wealth to the next generation, that its complexity undermines the legitimacy of the tax code, and that the government already taxes too much and too often. These critics think imposing a tax upon the taxpayer’s death is ghoulish and that the wealth taxed at death has already been taxed as it was accumulated through the income tax.

**Act II: Legislation.** Once the rhetoric was in place the second act – offering corrective legislation – developed on cue. The Republicans proposed to get rid of the federal estate and gift tax altogether by 2010. Their bill -- H.R.8, the “Death Tax Elimination Act” --recently passed both the House and the Senate. The Democrats unsuccessfully countered with legislation to reform the tax by increasing the unified credit and the special tax breaks available to farmers and small business owners.

**Act III: Deadlock.** With principled but diametrically opposed legislative positions set out, the stage was set for the third act – politically advantageous deadlock. The denouement came in the form of a presidential veto. The Republicans passed H.R.8 knowing that President Clinton would veto it and that they would not override. This is exactly what everyone wanted. Now both parties have the estate tax issue available for use in their upcoming election campaigns.

As the play nears the final curtain, should the voters in the audience hiss or cheer? Let’s take an intermission to consider the pros and cons. At first, one’s reaction is likely to be that eliminating the tax makes more sense than tinkering to improve it. Although fewer than 2% of taxpayers’ estates ever incur estate tax liability, many more avoid incurring the tax only after
costly and emotionally difficult tax planning. In the current prosperity, more taxpayers will find themselves subject to the tax. Indeed, the tax has become more widely applicable than was originally intended and has made some policy makers wonder if imposing a wealth transfer tax on taxpayers who are not “obscenely wealthy” is bad policy.

That is really the heart of the matter. In order to support the Republican position, one needs to be convinced by the rhetoric being offered as a justification for ending the tax. Their leading argument, however – that the tax discourages hard work – is a non-starter. The Republicans have not produced one businessperson willing to testify that the Estate Tax dampened their work ethic. The other Republican arguments (complexity, rate of tax, etc.) seem to make at least as strong a case for reform as for repeal. On the other hand, the Democrats’ arguments about progressivity and distributive justice are not obviously correct either.

Nevertheless, one could think of several good policy reasons why outright elimination might be bad policy. For example, elimination of the estate tax will have a major effect on fiscal federalism, since no state will be able to impose an estate tax without the federal estate tax infrastructure to piggyback on. In addition, elimination of the tax is likely to have a catastrophic effect on charitable giving. Yet the most compelling argument in favor of reform, as opposed to elimination, is an argument that only lawyers and accountants will appreciate: the ramifications of eliminating stepped-up basis.

The problem arises from the fact that the estate tax is a wealth transfer tax, not an income tax. To make the estate tax mesh properly with the income tax, §1014 of the Internal Revenue Code increases the taxpayer’s basis in property owned at time of death to fair market value. This is necessary because the Estate Tax is imposed on the fair market value of the estate’s assets at time of death and without stepped-up basis the appreciation in the assets’ value would be taxed.
Section 1014, therefore, is an extremely important estate-planning tool. The trick is to pass the taxpayer’s estate to the heirs without triggering either estate tax liability or income tax liability. For modest sized estates this can be done with relative ease. With the unified credit now at $675,000, a couple can pass along assets of $1,300,000 without creating estate tax liability. Section 1014 allows the assets to pass to the heirs with a basis equal to fair market value at the time of the decedent’s death instead of the historical basis that the assets had in the hands of the decedent. If those assets are sold shortly after the decedent’s death the heirs should incur little or no income tax because the sale price will be close to fair market value at time of death. If the estate was valued at less than $1,300,000 (for a couple) the heirs should escape both income and estate taxes.

The price of getting rid of the estate tax, however, is to eliminate Section 1014, since there will no longer be a need to coordinate the income tax with the estate tax. While H.R.8 saves the idea of stepped-up basis for estates valued at less than $1,300,000, it nevertheless does away with stepped-up basis generally. If H.R.8 becomes law, heirs will not receive assets with a stepped-up basis, but rather with a carry-over basis. For assets that have been in the family for generations, like the family farm, figuring out historical basis will be difficult. When the heirs sell the assets received from the decedent they will be liable for capital gains on the difference between historical basis and sale price, in contrast to the current situation of paying tax only on the difference between sale price and the stepped-up basis.

Therefore, the Republican approach may create liability for people who never were intended to be subject to the Estate Tax. For the vast majority of taxpayers who never would have been liable for estate tax anyway, H.R.8 creates the possibility of capital gains tax liability
on assets received by bequest. The Democrats’ approach of raising the unified credit and the special provisions for farms and small businesses will preserve the idea of stepped-up basis – well beyond the $1,300,000 level -- and will be much easier to comply with.

Stepped-up basis aside, the political arguments for and against the Estate Tax will be blunt and unsophisticated. The Democrats’ refusal to repeal the tax will be used by the Republicans as evidence of the how Democrats love to tax. Few voters will appreciate that the Democrats’ plan to reform the tax will likely save more money for more people than outright repeal. The Democrats can’t debate this measure on the merits – no audience is going to sit through a discussion of the pros and cons of stepped-up basis.

Instead, the Democrats will point to the Republican desire to abolish the tax as evidence of how the party is beholden to the wealthy. Few voters will notice that the wealth transferred will still be taxed when assets are sold even if the Estate Tax is repealed. Granted, the gain on those assets will be taxed at capital gains rates instead of the higher Estate Tax rates, but H.R.8 gives wealthy families a tax cut, not complete relief from wealth transfer taxes.

Whether the Estate Tax is repealed or merely reformed you can be certain that the changes will be complicated and clients will need advice to avoid paying more than what is absolutely required. So, sit back and enjoy the show! No matter how it turns out, there will be a happy ending for the tax bar.