The Cost of Compromise: Impact of the 2011-2012 Estate Tax

Antony Davies, Ph.D

December, 2010

A Study by the American Family Business Foundation

Executive Summary

On December 18, 2010, President Obama signed H.R. 4853, the Middle Class Tax Relief Act, which among other provisions, raises the estate tax for two years from a rate of zero to a rate of 35 percent on estates over $5 million per individual, or $10 million per couple. In 2013, without legislative action, the estate tax increases even further, to 55 percent on estates with over $1 million in assets.

This study, authored by Duquesne University Associate Economics Professor Antony Davies, reports on the number of small businesses, farms and households that will be impacted under the new law. The key findings include:

- Up to 67 percent of estates susceptible to paying the estate tax will include farm and small business assets;
- Up to 22,000 farms, 14,000 real estate partnerships, and 29,000 privately-held corporations will be susceptible to the tax in 2011;
- 170,000 total households will be susceptible to estate taxes in 2011;
- 8,500 households will owe estate taxes in 2011; and
- By 2048 (when today's 20-year-olds reach retirement), half of U.S. households are projected to have sufficient assets to trigger the estate tax.

Ultimately these findings reveal why the best estate tax is no estate tax, and why Congress should work toward passage of a bill that permanently repeals the tax. Increasing the estate tax exemption to $5 million will still leave multiple thousands of households hit with the tax, many of whom will be farmers and small and family business owners, the engines of job growth in America.

Supporters of the estate tax[i] often claim that the tax hits only a few people. This argument fails on at least two counts. First, it is not the number of people who are hit by the tax, but the number of people whose businesses, employees, and overall economic behaviors are impacted by the tax that is important. Second, while few people are hit by the estate tax today, if current trends continue, the reach of the estate tax will quickly grow to encompass the middle class.

This report explains how even with the new estate tax law, tens of thousands of people will be susceptible. Furthermore, and more important, the law remains particularly harsh for small business owners and farmers. Finally, the report shows that while the estate tax is technically indexed for inflation, the impact of the estate tax is growing faster than inflation, resulting in many more households owing the tax than were likely intended when the estate tax was enacted.

History of the AMT and Its Relationship to the Estate Tax

We begin our discussion of the estate tax with a look at the Alternative Minimum Tax (AMT). Why? It turns out that the growing impact of the estate tax is very similar to that of the AMT, which over the last 40 years has hit many more Americans than was initially intended. If Congress does not address the growing impact of the estate tax, it will soon hit roughly half of all U.S. households.

In 1969, the Alternative Minimum Tax was enacted to capture the highest income taxpayers who avoided paying income taxes. At the time the AMT was enacted, it applied to fewer than 1% of the wealthiest Americans. Because the AMT exemption was not indexed for inflation, as Americans' incomes grew, more and more people became subject to the AMT. From

1983 to 2005, for example, the number of tax returns subject to the AMT grew almost 1,400%, from 265,000 to over 4 million. Despite its unpopularity, the AMT has become unstoppable because it has grown to represent a significant portion of tax revenues.[ii] When the AMT affected only a few taxpayers, legislators did not stop the tax because there was no groundswell of opposition. Perversely, by the time the number of ensnared taxpayers grew large enough to constitute a groundswell of opposition, the revenue the AMT generated had become so large as to make it too costly to eliminate. Therein lies the lesson and warning for the estate tax.

Growing Household Wealth Results in Unintended Estate Tax Liabilities

The Census Bureau defines a "household" as a group of people, whether related or not, who occupy the same housing unit.[iii] From 1983 through 2007, median household wealth among householders aged 65 to 74 grew 3% faster than inflation.[iv] Among householders aged 75 and over, median household wealth grew almost 4% faster than inflation. While the estate tax is indexed for inflation, the wealth of post-retirement Americans tends to grow faster than inflation.

From 1983 to 2007~~1989~~, the estate tax exemption averaged ~~seven~~ six times the median net household wealth for an elderly householder. With no change in the current law, the estate tax exemption will be just over three times the median net household wealth for an elderly householder in 2013~~1~~. If the net household wealth among the elderly continues to rise at this pace, by 2048, one-half of the households headed by those 65 or older will be susceptible to the estate tax (Figure 1).

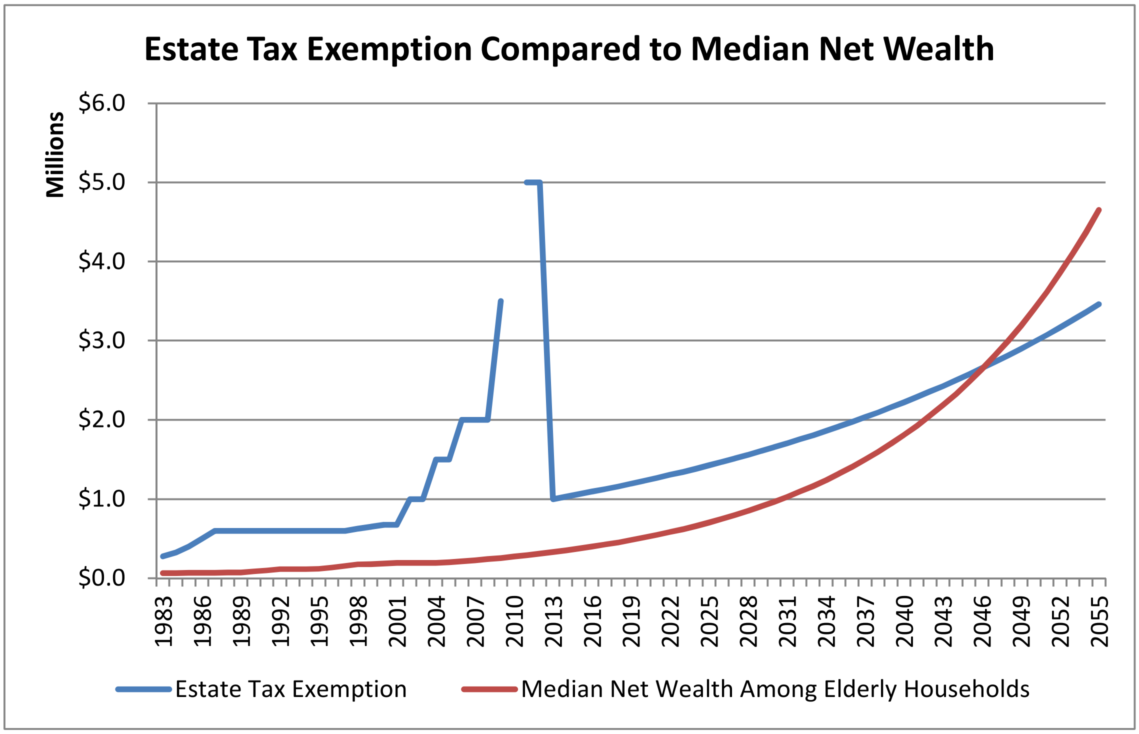

Figure 1. In the 1980s, the estate tax exemption averaged 7 times median wealth among the elderly versus 3.4 times in 2011. By 2048, one-half of elderly households will be susceptible to the estate tax.

It is important not to confuse those who pay the estate tax with those who are susceptible to the estate tax. To pay the estate tax, a householder must die. To be susceptible to the estate tax, the householder must have enough assets to trigger the estate tax *when* the householder dies. With a $1 million exemption, half of today's 20-somethings will be susceptible to the estate tax by the time they reach retirement. These Americans will be hitting retirement age post-2048, when half of elderly US households are projected to trigger the estate tax.

A comparison of changes in the number of taxable estates to changes in the estate tax exemption from 1995 to 2009 suggests that, under the new $5 million exemption, 8,500 households will owe and 170,000 households will be susceptible to estate taxes in 2011.[v] Under the new law, the exemption is set to revert to $1 million in 2013. In that year, 1.3 million households will be susceptible to the estate tax.[vi]

New Exemption Still Hits Small Businesses and Farms

Perhaps of greater concern is that the same wealth-growth phenomenon has been affecting small businesses. The estimated value of small business assets subject to the estate tax rose from $9 billion in 1995 to $26 billion in 2008 before falling to $17.5 billion in 2009 (Figure 2).[vii]

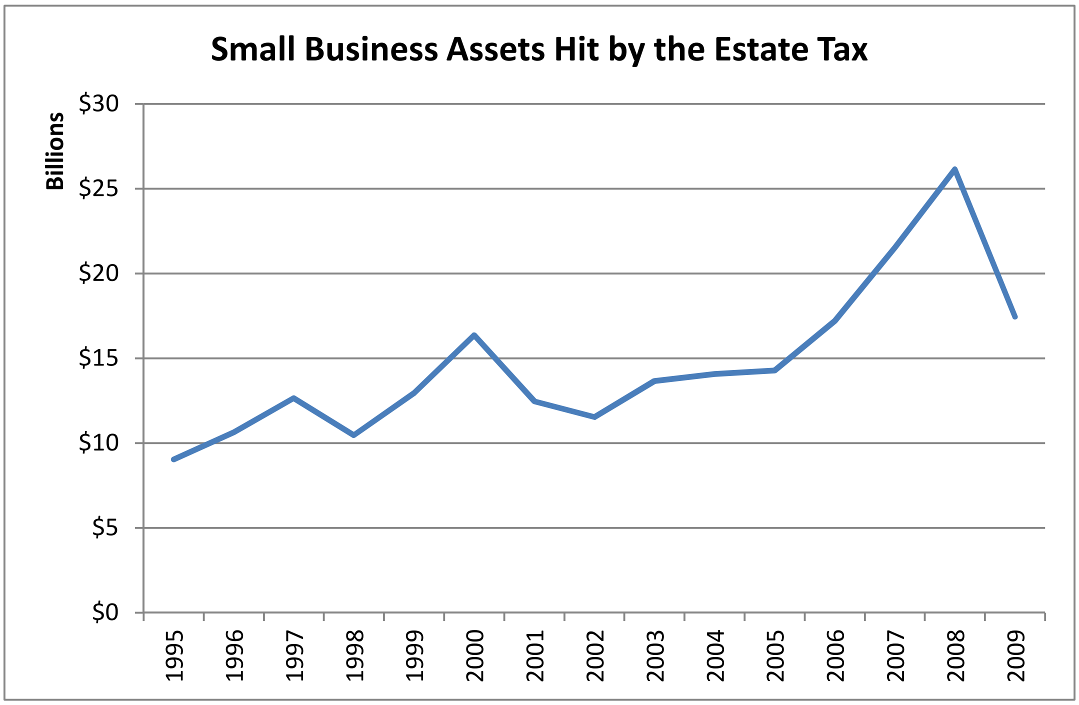

Figure 2. The estimated value of small business assets subject to the estate tax has been growing more than 4% faster than inflation.

While real estate and limited partnerships have accounted for the lion's share of the growth, even farms – traditionally the hardest hit of small businesses – have shown asset growth that exceeds inflation by two percentage points (Figure 3).

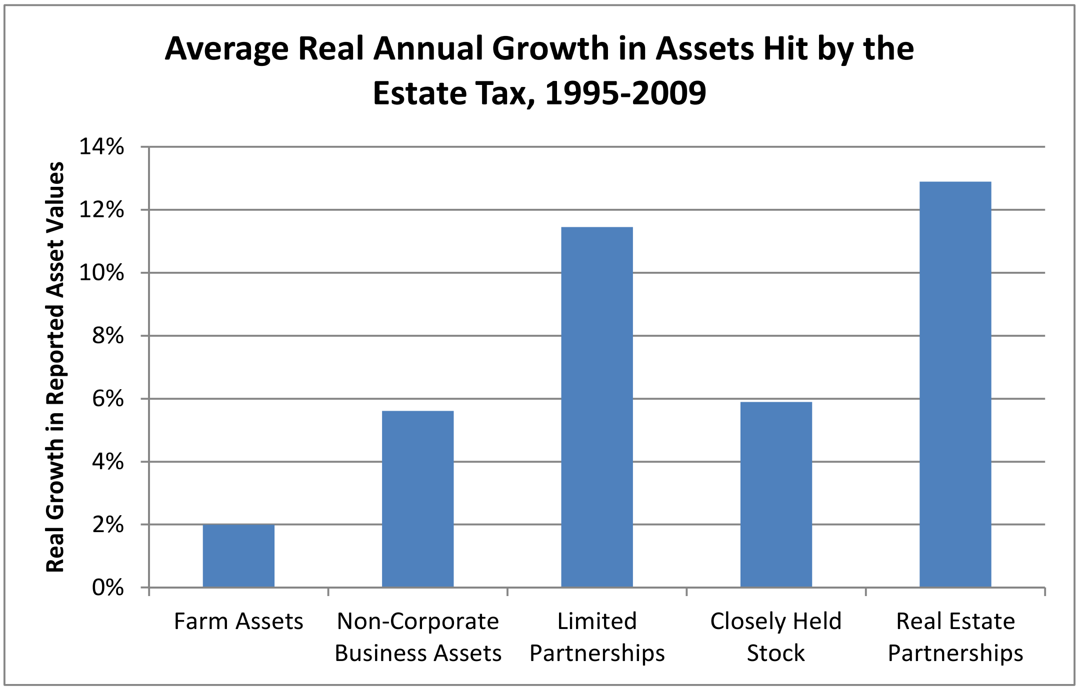

Figure 3. Real growth in the value of small business assets reported on taxable estate tax returns.

For 2011 and 2012, the exemption ~~will~~ temporarily rises to $5 million (and the rate decreases to 35%). Even this exemption will leave many small businesses unprotected. In 2009, if the exemption had been $5 million instead of $3.5 million, of the small businesses that paid the estate tax that year, 25% of farms, 37% of limited partnerships, and 48% of real estate partnerships would have still been hit by the estate tax under the higher exemption.

The phenomenon is more insidious when applied to small businesses as the estate tax burden affects not merely heirs, but also the employees of the small businesses. The more assets the small business needs to redirect toward preparing for the impact of the estate tax, the fewer assets the business has to create jobs.

If we compare the size of small business assets owned by taxable estates to the size of taxable estates, we see an average increase over the period in which the estate tax exemptions increased. This data is consistent with the belief that higher exemptions encourage entrepreneurs to shift assets into small businesses rather than reserving the assets to protect against estate tax liabilities (Figure 4). Consistent with this result is evidence that the face value of insurance comprised a smaller portion of taxable estate assets during years in which the estate tax exemption was rising (Figure 5).

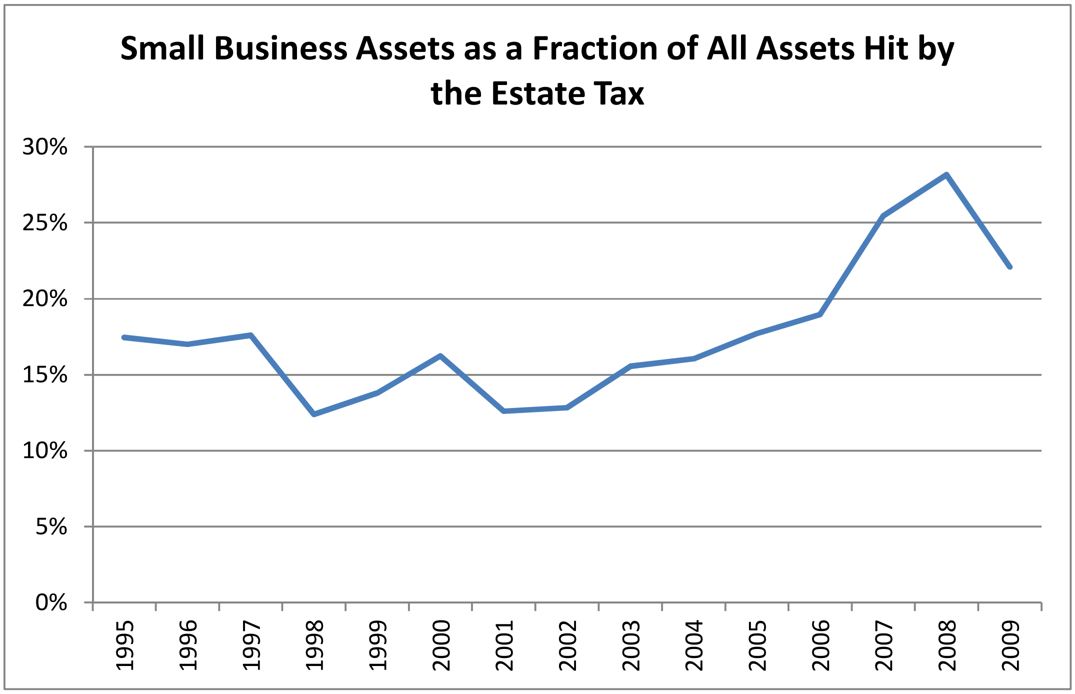

Figure 4. For taxable estates, small business assets comprised a growing fraction of total estate assets during years in which the estate tax exemption was rising.

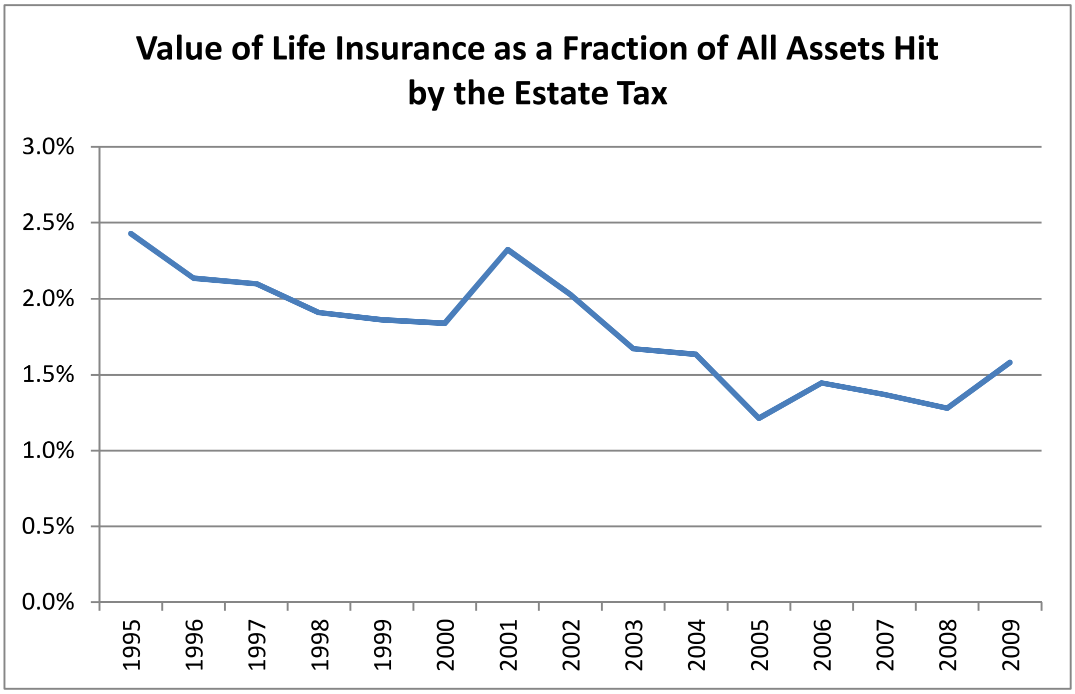

Figure 5. For taxable estates, the face value of insurance comprised a smaller fraction of total estate assets during years in which the estate tax exemption was rising.

The weight of the estate tax appears to be falling ever more heavily on small businesses as time progresses. In 1995, 18% of all taxable estates owned either farm assets or limited partnerships. By 2009, 31% of all taxable estates owned either farm assets or limited partnerships (Figure 6).[viii] Of 2009's taxable estates, 11% owned non-corporate business assets, 17% owned closely held stock, 8% owned real estate partnerships, 13% owned farm assets, and 18% owned limited partnership assets. Adding these figures together and assuming no overlap in asset ownership, small businesses could have comprised up to 67% of taxable estates in 2009.

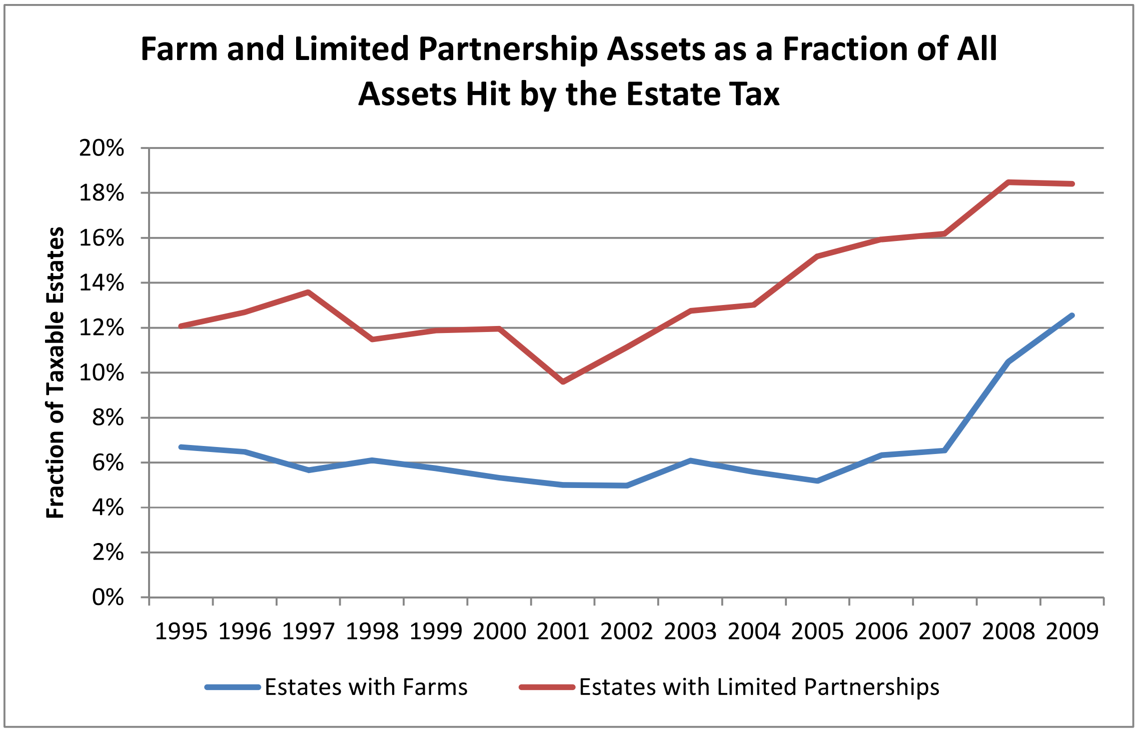

Figure 6. The number of taxable estates owning farms grew from 7% of all taxable estates in 1995 to 13% of all taxable estates in 2009. The number of taxable estates owning limited partnerships grew from 12% of all taxable estates in 1995 to 18% of all taxable estates in 2009.

As the estate tax exemption falls, even small businesses that generate relatively little income may become subject to the estate tax. For example, consider a family business that has $6 million in net assets. At a 7.5% return on equity, the firm generates $450,000 in income for the owners annually. Suppose a parent and two adult children run the firm and evenly split the profits, but that the parent is the legal owner. Splitting the $450,000 three ways yields a per-household income of $150,000. At the ~~proposed~~ 2011 tax rate~~s~~ and exemption, upon the parent's death, the children will owe $3~~5~~50,000 in estate taxes, or almost 80~~125~~% of the annual income the firm generates. At the 2013 tax rate and exemption, the children will owe $2.75 million, or more than six times the annual income the firm generates. If in 2013, the heirs had~~ve~~ no significant assets of their own, they ~~will~~ would be forced to sell off almost 5~~1~~0% of the firm's assets to pay the tax bill.

In summary, a firm that generates a mere $150,000 in income for its owners is not only subject to the estate tax, but ~~the~~ its heirs will be~~are~~ forced to reduce the size of the firm by up to 5~~1~~0% to pay off the estate tax bill. The fact that the $1 million exemption doesn't apply until 2013 is irrelevant. Because the owner does not know when he will die, he will take action now to prepare the firm for his eventual death. That means that the mere threat of a reduced exemption in 2013 will cause the owner to reserve assets to aid the heirs in paying off the estate tax rather than investing that money in growing the business and creating jobs. The owner will behave as if the exemption were already $1 million.~~If the firm were twice the size, with net assets of $12 million, the estate tax would equal almost 430% of the firm's annual income and the heirs would have to sell off more than 30% of the firm's assets to pay the estate tax.~~

If these small business assets continue to account for the same fraction of estate tax filings as they did in 2009, we can expect as many as 22,000 farms, 14,000 real estate partnerships, and 29,000 privately held corporations to be susceptible to the estate tax in 2011.

Conclusion The impact of the estate tax impact is large and growing. The impact of the tax is particularly important for the increasing number of small businesses and farms which are hit by the tax. The two-year, $5 million exemption will leave many of these businesses – and their employees – vulnerable. The best way to protect small businesses and encourage job growth is to repeal the estate tax.

About the Authors

Dr. Antony Davies is associate professor of economics at Duquesne University and Mercatus Affiliated Senior Scholar at George Mason University. His areas of research include econometrics, consumer behavior, public policy, and mathematical economics.

Dr. Davies has lectured at numerous venues including the Econometric Society, the American Economic Association, the American Psychological Association, the International Conference on Panel Data, the International Forecasting symposium, the Department of the Treasury, the House of Representatives, and many state capitals. In addition to teaching at the undergraduate, masters, and Ph.D levels, Dr. Davies was an equities analyst for the Burney Company (Falls Church, VA), Chief Analytics Officer and Acting Chief Financial Officer for Parabon Computation (Fairfax, VA), President and co-founder of Paragon Software (now Take-Two Interactive), and co-founder of Repliqa (now Zoo Entertainment).

His research has appeared in the Journal of Econometrics, the Journal of Consumer Psychology, the Journal of Economic Psychology, the International Journal of Forecasting, Clinical Cancer Research, Applied Economics, and the Journal of Socioeconomics. His popular press writings have appeared in BizEd, World & I, Religion and Liberty, and the International Journal on World Peace. Most recently, Dr. Davies presented a lecture on the future of Social Security for the Mercatus Center's Congressional Chiefs of Staff Retreat.

Dr. Davies earned his B.S. in Economics from Saint Vincent College, and Ph.D. in Economics from the State University of New York at Albany.

About the American Family Business Foundation

The American Family Business Foundation (AFBF) is the research and education voice of America's family business owners and farmers. Established in 2008, the Foundation publishes reports that examine critical policy questions about the impact of the estate tax on capital accumulation, family businesses, employment, income mobility and wealth disparity, federal revenues and the general economy. In addition to academic research, the Foundation hosts educational events to contribute to the public debate about the estate tax. Finally, the Foundation's principals are policy experts that are frequently called upon to provide insight on estate tax issues.

Endnotes

[i] There is disagreement as to whether the tax should be called an "estate tax" or a "death tax". While "estate tax" is more sterile, "death tax" is the more accurate description. It is death, not asset ownership, which triggers the tax. Calling the tax an "estate tax" is akin to calling a sales tax an income tax. People are hit by sales taxes not because they have money, but because they spend money. It is the spending, not the owning, of the money that triggers the sales tax – hence, the name. Similarly, it is not the owning of wealth, but the death of the owner that triggers the estate tax – hence, "death tax" is a more accurate and honest name.

[ii] Over the same period, the revenue the government collected from the AMT grew more than 500% from $2.5 billion to $16 billion.

[iii] A housing unit is a house, apartment, mobile home, group of rooms, or single room that is occupied as separate living quarters. Separate living quarters are those in which the occupants live and eat separately from others and for which occupants have access to the outside either directly or through a common hall.

[iv] Estate tax return data come from the Internal Revenue Service, www.irs.gov/taxstats.

[v] The estimated model is $R = \alpha + \beta_1 E + \beta_2 E^{-1} + \beta_3 Y$, where for years 1995 through 2009, R is the number of taxable estates, E is the estate tax exemption in constant dollars, and Y is the year. This model explains 82% of the variation in the number of taxable estates over the sample period. The average probability of a householder between the ages of 65 and 85 dying in a given year is 5%. Therefore, for every 1 household that is hit by the estate tax, there are another 19 that would have been hit by the tax if only their owners had died. This estimate is conservative because it ignores householders under the age of 65 and ignores the fact that mortality rates among higher income people are lower than average.

[vi] Spectrem Group estimates that there were 7.8 million families with net worths of at least $1 million, excluding primary residences, in 2009.

[vii] The value of small business assets is estimated from taxable estate tax returns and includes the values of farm assets, non-corporate business assets, limited partnerships, closely held stock, and real estate partnerships.

[viii] This estimate assumes no significant overlap in ownership (i.e., it assumes that estates that owned farm assets did not own limited partnership assets and vice-versa).