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Before the Select Revenue Measures Subcommittee
Hearing on the Burden of the Estate Tax on Family Businesses and Farms
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Chairman Reichert, Ranking Member Neal, Members of the Subcommittee, thank you for inviting me to testify today and for holding this hearing. My testimony today will focus on (1) the importance of the estate tax, particularly in supporting the fairness of our tax system and (2) the significant societal costs that would result from repeal of the estate tax.

As an introductory matter, it is important to keep in mind that, in one form or another, the estate tax has been with us since this country's earliest days. The first estate tax was enacted in 1797, long before the income tax. Our modern estate tax was enacted in 1916, a mere three years after the enactment of the income tax.[2] Any tax that has stood the test of time for so long should not be repealed without due attention to the role that it plays in our society, and the negative repercussions that could result from its repeal.

The Importance of the Estate Tax

The estate tax plays an essential role in our tax system because (1) it promotes fairness in the tax system; and (2) it provides an important source of revenue for the government.

Promoting Fairness. The estate tax promotes fairness by providing an essential counterweight to the extraordinary benefits conferred on inherited wealth under our income tax system. Our current income tax system favors inherited wealth in two significant ways:

First, inherited wealth is entirely excluded from income taxes. No matter how much wealth an individual inherits, whether it is $100, $100,000 or $100 million, she is treated the same for income tax purposes as a person who inherits nothing.[3] The failure to tax inherited wealth is particularly glaring in comparison to the taxes imposed on wages of working Americans, who are subject to income taxes of up to 39.6% and payroll taxes of up to 15.3%.

For example, a self-employed construction worker earning $60,000 a year building bridges, will owe federal income taxes of $7,159 and self-employment taxes of $8,468, resulting in a take home pay of only $44,363 (and for many taxpayers this will be further reduced by several thousand dollars of state income taxes.) By contrast, a person who inherits $60,000—even from a distant relative-- will enjoy the full $60,000 undiminished by taxes.[4] This decision to exclude inheritance from the income tax base while subjecting wages to taxes imposed at the highest tax rates, effectively shifts the tax burden from heirs to wage earners.

Second, those with inherited wealth enjoy special benefits with respect to taxation from sales of property. Normally, when an individual sells property, she is subject to tax on the difference between the amount she receives from the sale and the purchase price (called "basis"). If the property is passed on by gift, the recipient has the same basis in the property that the donor had (thus passing on any built-in gains to the recipient.) However, there is a special basis rule that applies to property passed on at death: in that case, the heir receives the property with a basis equal to the fair market value of the property at the time of the decedent's death (called "stepped-up basis.") The effect of stepped-up basis is that an heir can sell inherited property and pay no capital gains taxes, even if the decedent had significant untaxed built-in gains at the time of death.

Thus, if a decedent had invested $20,000 in Apple stock in the 1980's, and died in 2015 the stock would be worth well over $4 million at the time of death. But neither the decedent nor the decedent's heir would ever pay tax on that $4 million of gain since death is not a taxable event under the U.S. income tax law and the heir would receive the stock as if he had purchased it for its $4 million fair market value. Since this amount is less than the unified credit exemption amount for estate tax purposes, it is quite likely that this transfer will avoid estate taxes as well. Thus, the heir receives over $4 million tax-free and no one ever pays taxes on the $4 million of inherent capital gain.

This rule not only unfairly benefits heirs, but also interferes with the efficiency of the market by creating a lock-in effect. Owner are reluctant to sell capital assets because to do so would be to incur capital gains taxes that could be avoided simply by holding on to the property until death. If the owner needs access to funds during life, she can obtain that access in a tax-free way by simply borrowing against the assets. This ability to avoid capital gains taxes through borrowing is so well known that the simple advice to "buy, borrow and die" is referred to by one tax scholar as "Tax Planning 101."[5]

The preferential treatment of inherited wealth under the income tax system is often justified under the theory that property passed on at death is subject to estate taxes. Indeed, the relationship between the income tax benefits and the estate tax are so intertwined that if Congress were to repeal the estate tax, fairness would dictate that it should only do so only in conjunction with significantly restricting the benefits for inherited wealth provided under the income tax system.

Raising Revenue: In addition to promoting fairness, estate taxes provide an important source of revenue for the federal government. This revenue pays for valuable programs and allows the government to reduce the tax burden on other taxpayers. According to the most recent estimates, the estate tax will generate about $294 billion over the next 10 years. While this amount is small in relation to the amount raised by the income tax, it would still be enough to finance 100% of school nutrition programs which provide nutritious meals to 31 million children every day

for 10 years; or it could finance free community college tuition for more than 9 million students over 10 years, 5 times over. Alternatively, these funds could be used to reduce corporate tax rates, which some say have put U.S. companies at a competitive disadvantage and encouraged some companies to go abroad.

One reason for the relatively small amount of income generated by the estate tax is legislative policy changes over the last decade that have eroded the value of the estate tax. Policies could be adopted to turn that trend the other way. First, the estate tax could be easily fortified by closing existing loopholes, especially those allowing manipulation of valuation. The decision to leave those loopholes in place reduces revenue and encourages taxpayers to game the system. The integrity of the system could easily be improved by making some simple changes to the Code. [6] Second, in recent years, Congress has acted to weaken the estate tax by steadily increasing the exemption amount and decreasing maximum tax rates.[7] This has significantly reduced the number of individuals subject to the estate tax as well as the amount of revenue generated by the tax.

If the estate tax were to be repealed, then, in order for repeal to be revenue neutral, the government would need to replace this foregone revenue by imposing a higher tax burden on other taxpayers. It's worth asking the where the lost revenue would come from. Would that revenue come from corporate tax increases? From individual tax increases? From excise tax increases? Additionally, any of these options would have to be examined in terms of their levels of progressivity (or regressivity) to ensure that tax burdens remain fair. Given that the estate tax is imposed on the wealthiest taxpayers, the impact of repeal would most likely result in shifting the tax burden down to those with fewer resources. If Congress were to choose to not to replace the revenue lost through repeal, we must question whether it is appropriate for Congress to add to the deficit in order to finance a major tax cut for the wealthy.

A Red Herring: Family Farms and Businesses

The strongest rhetorical argument in favor of repealing the estate tax is its potential impact on family farms and businesses. As a society, we value the idea of businesses staying within families. If the estate tax were to significantly limit that ability, then that could be a strong argument in favor of a legislative fix.

However, despite the rhetorical appeal of the family farm and business argument, it ultimately does not support estate tax repeal because (1) given the large exemption amount currently in effect (combined with the ability of spouses to combine their unified credit exemptions), the vast majority of family farms and businesses will fall within the exemption amount and therefore not be subject to the estate tax at all; (2) to the extent that a family farm or business is not covered by the $5/$10 million exemption there are statutory provisions designed to mitigate the impact of the estate tax; and (3) if Congress is still concerned about the potential impact of the estate tax on a family's ability to pass a family business on to the next

generation, it need not repeal the estate tax, but rather could easily carve out a targeted exception that would exempt family farms and businesses from the estate tax.

Large Exemption Amount. Beginning in 2012 the estate tax exemption was increased to $5 million per person, adjusted for inflation. In 2015 each taxpayer can pass up to $5,430,000 free of estate taxes. Moreover, for married taxpayers the unified credits of both spouses can be combined, resulting in a married couple's ability to pass on well over $10 million of assets free of estate taxes. The vast majority of family businesses will fall well within this exemption amount.

Moreover, for family businesses that are larger than $10 million, the estate tax is only a problem if there are no other liquid assets with which to pay the tax. In many cases with estates of that size the beneficiaries will have enough other non-business assets with which to pay the estate tax liability.

Statutory Relief. For those businesses that are larger than $10 million and where there are insufficient non-business assets with which to pay the estate tax, there is statutory relief in the form of Section 6166 which permits the executor of an estate with a closely held business to pay estate taxes over a 15 year period, including paying only interest on the deferred tax for the first 5 years. Moreover, interest on these payments is generally charged at a below market basis. This provision allows for estate taxes to be paid over time out of the business's operating income.

A Targeted Benefit. If Congress wants to provide greater protections to family farms and businesses, it can do so by providing an outright exemption. This provision would be easy to draft because the statutory language was already drafted in connection with Section 2057, which provided an exclusion for a portion of a family farm or business passed on to family members. Although this provision was repealed in 2013 in connection with the overall increase in the estate tax exemption amount, it could easily be used as a template on which to fashion an exemption from estate taxes for farms and businesses being passed on to family members.

Another Red Herring: The Estate Tax Discourages Hard Work

Proponents of repeal argue that estate taxes discourage hard work because it limits the ability of an individual to pass on property at death. However, this argument misconstrues the true beneficiaries of estate tax repeal. While repeal of the estate tax may provide some *emotional* benefit to those individuals who have earned wealth and want to pass it on to their heirs, the *financial* benefit of repeal flows entirely to the heirs of individuals passing on more than $5 million (or $10 million if married) of wealth. Rather than encouraging hard work, the failure to tax inherited wealth discourages hard work because it facilitates the creation of effortlessly wealthy heirs.

The Cost of Estate Tax Repeal

Repealing the estate tax would impose considerable burdens on society that go well beyond the loss of revenue that the estate tax raises. In particular: (1) repeal of the estate tax would cause even greater concentration of wealth among the wealthiest Americans, resulting in an aristocracy of wealth that threatens our most cherished democratic ideals and harms our economy; and (2) repeal of the estate tax could result in a significant reduction in charitable giving which would in turn have a devastating effect on the charitable sector and the people it serves.

Wealth Concentration. One thing we know for certain is that the repeal of the estate tax would result in greater concentration of wealth among heirs of wealthy individuals who, as a result of repeal, would receive greater inheritances because they would be undiminished by taxes. Moreover, through the use of dynasty trusts, this inherited wealth will be able to be protected from creditors and taxes in perpetuity. The combined effect of this will be to create an aristocracy of wealth based on birth that was just the type of thing that our forefathers tried to get away from in establishing the rules governing these United States.

Thomas Jefferson was particularly concerned about the effect of this type of aristocracy on democracy. As Jefferson wrote to John Adams on October 28th, 1813:

> For I agree with you that there is a natural aristocracy among men. The grounds of this are virtue and talents… There is also an artificial aristocracy founded on wealth and birth, without either virtue or talents; for with these it would belong to the first class. The natural aristocracy I consider as the most precious gift of nature for the instruction, the trusts, and government of society. And indeed it would have been inconsistent in creation to have formed man for the social state, and not to have provided virtue and wisdom enough to manage the concerns of the society. May we not even say that that form of government is the best which provides the most effectually for a pure selection of these natural aristoi into the offices of government? The artificial aristocracy [i.e. that founded on wealth and birth] is a mischievous ingredient in government, and provision should be made to prevent its ascendancy.[8]

John Adams expressed this same concern when he wrote: "When economic power became concentrated in a few hands, then political power flowed to those possessors and away from the citizens, ultimately resulting in an oligarchy or tyranny."[9]

This same idea was reflected in the 20th century by Supreme Court Justice Louis Brandeis when he said: “We can have concentrated wealth in the hands of a few or we can have democracy. But we can’t have both.”[10]

Wealth concentration is also a problem from the point of view of the economic health of the country. As Nobel-prize winning economist Joseph Stiglitz has written: "Widely unequal societies do not function efficiently, and their economies are neither stable nor sustainable in the long term."[11] It should not be surprising that every empirical study that has examined the impact of inequality on long-term growth has shown that high concentrations of wealth correlate with poor economic performance.[12]

Finally, greater inequality of wealth has also been shown to correlate with other social problems including life expectancy, social mobility, rates of imprisonment and mental health. This correlation between wealth inequality and social problems exists regardless of the overall level of wealth in the country (that is, richer countries do not achieve better results if they have greater inequality.)[13]

Wealth concentration is not simply a product of an unfettered market, but rather is the product of government policies, including taxation, that allocate society's resources. For example, wealth concentration was significantly reduced in this country from the 1930's to the 1980's as a result of progressive estate and income tax rates, along with other policies designed to build a strong middle class (such as the G.I. bill, federal mortgage assistance programs and loans to small businesses). However, beginning in the 1980s, and accelerating through the early part of this century, this trend reversed and wealth concentration again became a prominent feature of our economic landscape.[14]

A recent paper by Emmanuel Saez and Gabriel Zucman tracking wealth distribution from 1913-2012 quantifies this trend (graphs attached as Appendix A).[15] This paper shows how, over the past century the wealth of the wealthiest 0.1% of Americans has followed a U-shaped pattern: in the roaring 20's the wealthiest Americans controlled 25% of the country's wealth. By the mid-1970s (with the growth of the middle class), the wealthiest owned only 7% of the country's wealth. However, since then, the concentration of wealth among the wealthiest Americans has increased and today the wealthiest 0.1% of the population (those families with $20 million or more) own 22% of the country's wealth.

During this same period, the wealth of the remaining 90% of the population has followed the opposite trend. From the mid-1920's to the mid-1980's there was a great democratization of wealth and the amount of wealth owned by 90% of the population went from 15% to 36%. However, since then the amount of wealth owned by 90% of the country has fallen dramatically to 23%.

We are now coming close to full circle in terms of wealth inequality. Today, the wealthiest 0.1% of Americans own roughly the same amount of wealth as that which is owned by 90% of the population. Repeal of the estate tax would further accelerate this alarming trend.

Charitable Giving. The charitable sector plays a central role in the United States. Unlike many other countries that finance education, health care, scientific research, arts, and social safety nets primarily through direct government expenditures, the United States supports these important activities largely through private donations subsidized indirectly by the government through tax deductions for charitable giving. As such, society is deeply dependent on charitable giving, even more so in a world where vital national interests are forced to compete for scarce government resources.

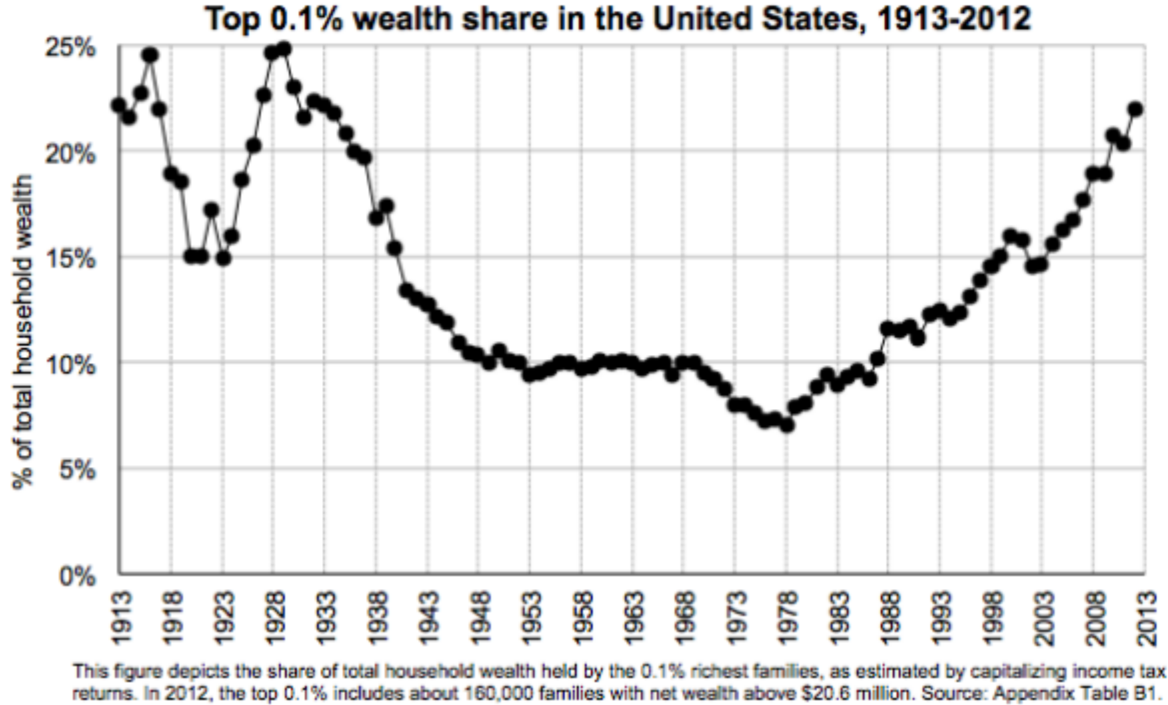
The estate tax charitable deduction plays an important role in encouraging charitable giving. Unlike the income tax deduction, which is limited to no more than 50% of a donor's income, the estate tax provides an unlimited charitable deduction that allows all individuals subject to the estate tax to essentially opt out of the tax by committing their resources to charitable ends. Many estates take advantage of this such that over 8% of all charitable giving is in the form of bequests at death. In addition, much lifetime giving is likely motivated by estate tax savings as well, as property transferred to a charity during life is also exempt under the gift and estate tax system.

The estate tax charitable deduction has been with us since the inception of the estate tax almost 100 years ago. Therefore, it is very difficult to predict the effect of repeal on charitable giving. However, given our reliance on the charitable sector to provide our most essential services, even a small reduction in charitable giving arising from repeal could prove devastating for the sector and the individuals that it serves.

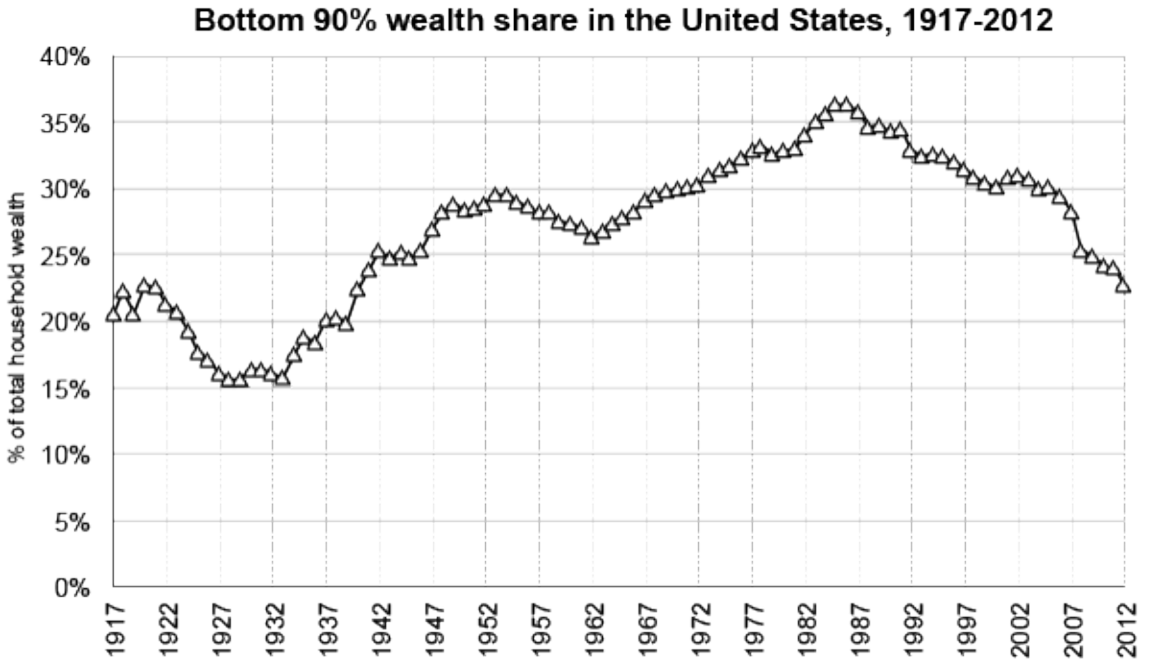
Conclusion

Thank you again for inviting me to testify today. I hope that my perspective on these issues helps the Committee as it thinks about whether to repeal the estate tax.

Appendix A



This figure depicts the share of total household wealth held by the 0.1% richest families, as estimated by capitalizing income tax returns. In 2012, the top 0.1% includes about 160,000 families with net wealth above $20.6 million. Source: Appendix Table B1.



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[2] The history of the wealth transfer tax system is described in: STAFF OF JOINT COMM. ON TAXATION, HISTORY, PRESENT LAW, AND ANALYSIS OF THE WEALTH TRANSFER TAX SYSTEM, JCX-108-07, at 1-10 (2007).

[3] I.R.C. § 102 (2015). This rule also applies to property received by gift and through life insurance.

[4] The argument that inherited wealth has already been subject to income taxes when earned by the decedent is in most cases false and in any event irrelevant. First, most inherited wealth is in the form of capital assets and, as explained in the text, capital gains evade taxation when passed on at death. Second, even if some income had been taxed when earned by the decedent, that does not mean that it should avoid taxation when received by the heir. Taxes are imposed on individuals, not on dollars. Therefore, the fact that money was taxed when acquired by one person has no bearing on whether it should be taxed when acquired by another. When a person uses post-tax income to hire a mechanic to fix his car, the mechanic cannot avoid taxation on that income on the grounds that the funds have already been subject to tax. Finally, even single individuals are commonly subject to multiple types of taxes on the same money. Wages are subject to income and payroll taxes and if those post-tax funds are used to purchase houses and cars, they are then subject to sales taxes and property taxes. There is no recognized tax policy against multiple types of taxes being imposed on the same funds.

[5] Edward J. McCaffery, *Distracted from Distraction by Distraction: Reimagining Estate Tax Reform*, 40 PEPPERDINE LAW REVIEW 1235, 1250 (2013).

[6] James R. Repetti, *Revitializing the Estate Tax: Five Easy Pieces*, 142 TAX NOTES 1231 (2014).

[7] RAY D. MADOFF, CORNELIA R. TENNEY, MARTIN A. HALL & LISA N. MINGOLLA, PRACTICAL GUIDE TO ESTATE PLANNING §5.04 (2015).

[8] http://press-pubs.uchicago.edu/founders/documents/v1ch15s61.html

[9] WILLIAM H. GATES & CHUCK COLLINS, WEALTH AND OUR COMMONWEALTH: WHY AMERICA SHOULD TAX ACCUMULATED FORTUNES 29 (2004).

[10] Ibid., p. 17.

[11] JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE 83 (2013).

[12] Paul Caron and James R. Repetti, *Occupy the Tax Code: Using the Estate Tax to Reduce Inequality and Spur Economic Growth*, 40 PEPPERDINE LAW REVIEW 1255 (2012)

[13] RICHARD WILKINSON AND KATE PICKET, THE SPIRIT LEVEL: WHY GREATER EQUALITY MAKES SOCIETIES STRONGER (2009).

[14] GATES & COLLINS, *supra* note 9, at 15; EDWARD B. WOLFF, TOP HEAVY: A STUDY OF THE INCREASING INEQUALITY OF WEALTH IN AMERICA, 8-13 (1995).

[15] Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States since 1913: Evidence from Capital Income Tax Data* (Nat'l Bureau of Econ. Research, Working Paper No. 20625, 2014), *available at* http://gabriel-zucman.eu/files/SaezZucman2014.pdf.