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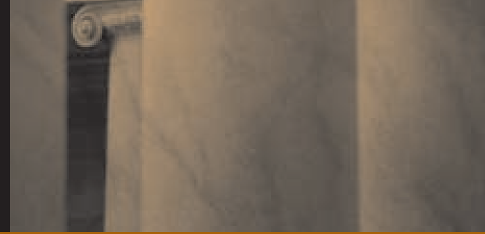

Options to Reform the Estate Tax

Leonard E. Burman, William G. Gale, and Jeffrey Rohaly

Retargeting the estate tax to very wealthy households and lowering its rates would blunt much of the criticism against it while retaining many of its advantages.

Under current law, the estate tax is reduced gradually through 2009, repealed in 2010, and then reinstated in full force in 2011. Few expect things to actually play out that way.

The president and many members of Congress would like to repeal the tax permanently, and many would like to do so before 2010. Repeal would be expensive, however: immediate repeal would reduce revenues by over $400 billion over the next decade. Even making repeal permanent as of 2010 would cost $270 billion in the next 10 years. Repeal would also be regressive, would reduce charitable giving by over $15 billion a year, and would invite significant tax sheltering. It would increase the concentration of wealth, and may increase the political power of a wealthy elite.

Critics of the estate tax counter that it burdens small farms and businesses with confiscatory tax rates, discourages work and thrift, and retaxes money taxed under the income tax. In fact, few small farms and businesses appear to be subject to the estate tax, although many families may undergo costly planning to avoid it. The empirical evidence on saving behavior is ambiguous: The tax may discourage work and saving for people subject to it, but it has the opposite effect on heirs who—expecting smaller bequests—choose to work harder and save more. And while the tax may "double tax" income in some cases, much of the wealth subject to estate tax was earned through untaxed capital gains and so has never been subject to the income tax.

In contrast to repealing the tax, retargeting the estate tax to very wealthy households and lowering its rates would blunt much of the criticism against it while retaining many of its advantages. This brief explains how the estate tax works and examines who is affected by it under current law. It discusses how reform would affect tax revenues, the distribution of tax burdens, farms and small businesses, and charitable giving and bequests. A concluding section discusses ways to reduce the tax's complexity.

Background

According to federal law, the executor of an estate must file a federal estate tax return within nine months of a person's death if the gross estate exceeds an exempt amount—currently $1.5 million. The exempt threshold has been phasing up and tax rates have been phasing down since 2001, when the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) enacted a gradual phaseout of the tax.[1] After a scheduled elimination in 2010, the estate tax returns in 2011 with an exemption of $1 million and a top statutory rate of 55 percent.

The estate tax allows deductions for transfers to a surviving spouse, charitable gifts, debts, funeral expenses, and administrative fees. About 90 percent of married decedents who file estate tax returns avoid the tax entirely, largely because of the unlimited spousal deduction. A unified credit exempts taxes on the first $1.5 million of taxable transfers in 2005 (including gifts made during life and transfers at death), a figure scheduled to rise to $3.5 million in 2009. In addition, the valuation of assets can often be discounted through careful tax planning, so the effective exemption far exceeds the statutory amount for many estates (Schmalbeck 2001).

Family-owned farms and closely held businesses receive especially generous treatment under the estate tax.[2] Farmers and small business owners may reduce the

The estate tax is highly progressive: almost 99 percent of it falls upon the top 5 percent of tax units, and over 33 percent is paid by the richest 1 in 1,000.

value of their real estate using a special formula as long as their heirs maintain its use as a family-owned farm or business and do not sell it to a nonrelative for at least 10 years. Special use valuation can reduce the value of the real property portion of most farms by 40 to 70 percent of its market value. In addition, estates in which farm and business assets make up more than 35 percent of the gross estate may pay their estate tax in installments over 14 years at reduced interest rates. Only interest is due for the first five years. In 2003, the interest rate on the first $493,800 of estate tax was 2 percent; the interest rate on amounts above that was 45 percent of the interest rate that applies to underpayment of tax (which was 4 percent for the third quarter of 2004).

Special Provisions of the Estate Tax

Besides the basic features described above, several special features of the estate tax and related taxes influence the debate over the estate tax. These include the qualified family-owned business interest exclusion, the state death tax credit, and the taxation of capital gains.

Before 2004, certain farms and small businesses were eligible for a qualified family-owned business interest (QFOBI) exclusion of up to $1.3 million. The exclusion incorporated both the unified credit and the QFOBI deduction, so the effective value of the QFOBI deduction was $300,000 in 2003 (when the estate tax exemption was $1 million). To qualify, heirs had to agree to keep the farm or small business going for 10 years.

Until 2005, the federal estate tax included a credit for state death taxes. In 2001, the credit effectively refunded state taxes at rates up to 16 percent of the taxable estate. Almost all states levied estate or inheritance taxes large enough to qualify for the maximum federal credit. EGTRRA phased out the state death tax credit and replaced it with a deduction for state estate taxes paid. Many states reduced or eliminated their state taxes in response. Duncan (2002) estimates that the resulting revenue loss to the states will be almost $5 billion in 2007.

The EGTRRA estate tax provisions also changed the taxation of capital gains, albeit temporarily. Heirs of appreciated property currently benefit from "step-up in basis," which resets the purchase price of inherited assets to their value at death. Effectively, all capital gains accrued up to the time of death are exempted from tax. In 2010, EGTRRA replaces step-up with a limited "carryover basis" regime. Heirs will have to reckon gains relative to the original owner's cost basis. Transfers below $1.3 million and interspousal transfers of $3 million will be exempt, effectively allowing $5.6 million of capital gains per couple to escape tax.[3]

Who Pays the Estate Tax?

About 66,000 estate tax returns were filed in 2003, of which less than half were taxable (Internal Revenue Service [IRS] 2004). Most of these returns reported deaths in 2002 when the estate tax exemption was $1 million. In that year, less than 3 percent of decedents had to file and less than 1.5 percent owed any estate tax.[4]

By 2004, the estate tax exemption had increased to $1.5 million. The Tax Policy Center projects that about 37,000 estate tax returns will be filed for people who die in 2004, of which almost 19,000 will be taxable (table 1). The total estate tax will be an estimated $17.6 billion, or about $935,000 per taxable return. Based on historical averages, about $2.8 billion in gift tax will be paid on *inter vivos* transfers made in 2004.

The estate tax is highly progressive. Almost all of it is paid by the highest-income 10 percent of tax units.[5] Almost 99 percent of the tax falls upon the top 5 percent, and over one-third is paid by the richest 1 in 1,000.

Much of the political debate about the estate tax has centered on its impact on farms and family-owned businesses. Roughly 440 taxable estates—or about 2 percent of all taxable estates—were primarily made up of farm and business assets in 2004. These estates were larger than average, accounting for almost 6 percent of estate tax liabilities. The picture is much different for small farms and businesses, defined as those valued at less than $5 million. Such estates made up less than 2 percent of taxable returns and only about 0.5 percent of estate tax liability.

TABLE 1. *Who Pays the Estate Tax? 2004*

		Income Category				Businesses and Farms	
	All	Top 10 percent	Top 5 percent	Top 1 percent	Top 0.1 percent	All	Small
Number of returns (1,000s)	37.2	36.8	34.7	14.9	1.6	1.1	1.0
Number taxable (1,000s)	18.8	18.6	17.4	6.9	1.0	0.4	0.3
% of taxable returns	100.0	99.3	93.0	36.6	5.1	2.3	1.8
Tax paid ($ millions)	17,579	17,520	17,351	14,632	6,584	985	95
% of tax paid	100.0	99.7	98.7	83.2	37.5	5.6	0.5

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 0304-2).

Options for Change

Reforming, rather than eliminating, the estate tax could meet some concerns of critics while retaining many of the tax's advantages and avoiding the problems repeal would create. For example, relatively minor changes could exempt virtually all small farms and family-owned businesses from the tax. Reform could also provide immediate relief in a more fiscally conservative manner than outright repeal. Although virtually all reform options lose revenue relative to current law after 2010 (when EGTRRA expires), they all lose less revenue than repeal does.

Effects of Options on Revenue

One option would permanently raise the estate tax exemption to $2 million and freeze the top rate at 48 percent (its 2004 level) effective in 2005 (option 1 in table 2). This proposal would reinstate the QFOBI deduction for family-owned farms and small businesses and increase it to $5 million. The proposal would reduce estate tax liability by about $17 billion from fiscal years 2006 to 2015, compared with current law—$81 billion if the state death tax credit were restored.

Like the other options, retaining the estate tax (even with a higher exemption)

TABLE 2. *Static Estimate of Change in Estate Tax Liability Relative to Current Law, Selected Reform Options, Fiscal Years 2006–15*

				Change in Liability ($ billions)			Restore SDTC[b]
Option	Exemption ($ millions)	Top rate	QFOBI[a] ($ millions)	2006–10	2006–15	2015	2006–15
1	2.0	48%	5	8	–17	–14	–81
2a	3.5	45%	0	–27	–113	–29	–165
2b	3.5	45%	5	–27	–114	–29	
2c	3.5	45%	10	–28	–116	–30	
2d	3.5[c]	45%	0	–29	–127	–33	–177
3a	5.0	45%	0	–42	–152	–35	–195
3b	5.0	35%	0	–53	–180	–39	–225
4	10.0[c]	35%	0	–68	–217	–44	
5	repeal	repeal		–90	–271	–52	
Addendum: JCT revenue estimates including behavioral responses							
Repeal as of 2005				–154	–415		
Repeal after 2009				–9	–271		

Sources: Urban–Brookings Tax Policy Center Microsimulation Model (version 0304-2), and Congressional Budget Office (2005) for the JCT estimates.
a. QFOBI = qualified family-owned business interest.
b. Restores full state death tax credit effective 2005.
c. Includes indexing exemption for inflation after 2004.

would curtail much of the income tax avoidance that would occur if the estate tax were eliminated entirely.[6] As a result, Burman and Rohaly (2004) conclude that this plan would be about revenue-neutral relative to current law (that is, the reduced tax avoidance would roughly offset the static revenue loss over the 10-year budget window, although it would reduce tax revenues over the longer run). If option 1 were instead set to expire after 2010, as EGTRRA's provisions do, it would raise revenue slightly relative to current law—by $34 billion if the state death tax credit is not restored and by about $3 billion if it is. (Again, as with all options discussed here, the revenue gain relative to repeal would be larger if tax avoidance responses were considered.)

Several variants of option 2 would accelerate to 2005 the higher exemption and lower rate currently set to take effect in 2009. If permanent, the basic option (2a) would reduce revenues by $113 billion relative to current law, and by $165 billion if the state death tax credit were restored. The option would, of course, be much less expensive if allowed to expire at the end of 2010. Adding a generous QFOBI exemption would be relatively inexpensive. A $5 billion exemption (effectively $10 billion for a couple with minimal estate planning) would add only $1 billion to the cost over 10 years (option 2b); a $10 billion exemption ($20 billion for a couple) would add $3 billion to the cost (option 2c).

Unlike income tax brackets, the parameters of the estate tax are not indexed for inflation. If they were, the number of taxable estates would not increase simply due to general price level increases, although it would if wealth grew faster than inflation. Indexation would add about $14 billion to the cost of permanent reform (option 2d).

Not surprisingly, raising the exemption would increase the revenue loss. A $5 million exemption would reduce static estate tax liabilities by about $152 billion over 10 years (option 3a). If the top estate tax rate were reduced to the top income tax rate of 35 percent, the revenue loss would

Unintended Side Effects of an Unlimited QFOBI Exclusion

Senator Mark Dayton (D-MN) and Congressman Mike Thompson (R-CA) have proposed legislation (S. 135 and H.R. 2513, respectively) that would allow an unlimited estate tax exemption for the value of family-owned farms and small businesses that are kept in family control for at least 10 years. A similar bill sponsored by Senator Blanche Lincoln (D-LA) would require heirs to eventually pay capital gains tax if they sold the property, but it is likely to be no more effective than the general carryover basis provision embodied in estate tax repeal proposals. (See footnote 3 in text.)

Unlimited QFOBI (or COBI, as Lincoln's provision is called) would be a very costly policy option and would affect behavior dramatically and undesirably. It would give wealthy individuals who expect to pay the estate tax a huge incentive to convert assets into qualifying farms or businesses before they died. Ironically, it could endanger many existing small farms and businesses, as wealthy people would bid up the price of such properties to claim their tax benefits. (How much of Iowa could Bill Gates buy with his fortune?) These purely tax-motivated purchases could represent a serious efficiency loss to society. For example, it is unlikely that a billionaire's heirs holding tens of thousands of acres of farmland for tax purposes would manage the resources as effectively as the professional farmers they would displace (and, because of the tax benefits, the heirs would not have to be efficient to make the investment pay off after tax). And how committed would the heirs be to continuing to farm the land (rather than develop it) after the required 10-year holding period?

Even before considering these behavioral responses, unlimited QFOBI would exempt some of the largest businesses in the world, including the international conglomerates Mars and Cargill.

The provision would be very costly because the wealthiest people would have a strong incentive to convert most of their assets into qualifying farms or businesses, and thus skirt the estate tax. People with smaller taxable estates may decide the costs of such estate tax planning are not worth the rewards and would continue to pay the tax, but unlimited QFOBI would make the estate tax essentially voluntary for the very wealthy.

An across-the-board increase in the exclusion can effectively exempt virtually all small farms and businesses without opening the door wide for counterproductive estate tax shelters.

increase to $180 billion (option 3b). If the exemption rose to $10 million, the revenue loss would swell to $217 billion (option 4). By comparison, repeal as of 2005 would reduce static estate tax liabilities by $271 billion (option 5).

The real difference between even a very high exclusion and repeal is likely to be much larger. Including behavioral responses, permanent repeal as of 2010 would reduce revenues (income and estate tax) by more than $270 billion through fiscal 2015, according to the Joint Committee on Taxation (JCT). Our static estimate for estate tax liability alone is $181 billion over the same period, so at least $90 billion of revenue is lost due to tax avoidance, and this avoidance is likely to be concentrated (in dollar terms) among the very wealthy. The JCT scores the cost of repeal as of 2005 at $415 billion, $145 billion above our static estimate.[7]

Effects of Reform on Distribution of Tax Burdens

Table 3 shows the effect of selected reform options on the distribution of estate tax liability in 2004. As noted in table 1, the top 1 percent pays 83 percent of the tax under current law. Raising the exemption to $3.5 million would shift 97 percent of the burden onto the top 1 percent, and almost 58 percent onto the richest 1 in 1,000. Under a $5 million exemption, the top 0.1 percent would pay more than two-thirds of the tax. With a $10 million exemption, that group would pay over 90 percent of the tax.

Raising the exemption level also dramatically decreases the number of family-owned businesses and farms affected by the estate tax. Raising the exemption to $3.5 million would cut the number of farms and businesses by 75 percent, from 440 under current law to 110. Only about 30 small businesses and farms would continue to pay the tax, contributing 0.2 percent of total estate tax revenues. With a $5 million exemption, only about 10 small businesses would be affected (and those only because they hold other assets outside the business). A $10 million exemption would exempt almost all farms and businesses, and all the small ones.

Effect of Reform on Charitable Contributions and Bequests

Current law provides very strong tax incentives for wealthy people to make charitable contributions and bequests. Charitable contributions are generally deductible against the income tax and reduce the size of taxable estates. Bequests can reduce or even eliminate estate tax liability. Lowering estate tax rates tends to reduce philanthropy by raising the after-tax cost of such gifts.[8]

In fact, those with very large estates make most bequests. On 2003 estate tax returns, more than half of charitable bequests were on estates valued at over $10 million, and two-thirds were on estates valued at over $5 million (IRS 2004). Thus, an exemption of $5 million or less would likely have little effect on charitable bequests.

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TABLE 3. Effects of Reform Options by Number of Estate Taxpayers and Distribution of Estate Tax Burden, 2004

	Number of Estate Taxpayers			Percent of Estate Tax Paid by[a]				
	All (1,000s)	Small farms and businesses[b]	All farms and businesses[c]	Top 0.1 percent	Top 1 percent	Top 5 percent	Top 20 percent	Small farms and businesses[b]
Current law baseline	18.8	340	440	37.5	83.2	98.7	99.7	0.5
2a: $3.5M exemption, 45% top rate	4.5	30	110	57.7	97.4	99.6	99.7	0.2
3a: $5M exemption, 45% top rate	2.5	10	90	69.2	98.9	99.6	99.6	0.1
4: $10M exemption, 35% top rate	0.6	0	30	90.6	99.5	99.5	99.5	0.0

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 0304-2).
Note: Figures are for estate tax returns filed for 2004 decedents.
a. Percentiles refer to the distribution of economic income.
b. Estate tax returns where farm and business assets represent at least half of gross estate and these assets are no more than $5 million.
c. Estate tax returns where farm and business assets represent at least half of gross estate.

Taxing Estates at Capital Gains Rates

Some have advocated taxing estates at the same low rates that apply to long-term capital gains and dividends. Although most policymakers viewed the pre-2001 estate tax rates—with effective rates as high as 60 percent—as excessive, cutting them to 15 percent (the top capital gains rate) shares many of the same drawbacks as repeal. Rate reduction would also have very different effects from an exclusion increase that had the same revenue cost. For example,

- it would result in many more taxable estates and would do little or nothing to exempt small family-owned businesses and farms from the tax.
- the tax benefits grow with the size of the estate and would be immense for very large estates (raising the exclusion provides the largest proportional benefits to smaller estates).
- it would invite unproductive tax shelter schemes, much as the differential between tax rates on capital gains and ordinary income does under the income tax (Burman 1999).

But repeal would be devastating. Congressional Budget Office (CBO) economists Robert McClelland and Pamela Greene (2004) estimate that repeal would reduce giving by between 6 and 12 percent. In 2000, that would have translated into a $13 to $25 billion reduction in philanthropy. Based on McClelland and Greene's midpoint estimates of behavioral responses, charitable giving would have fallen by $14 billion and charitable bequests by $4 billion in the absence of the estate tax (table 4).[9] Raising the exemption would have considerably smaller effects; a $3.5 million exemption would have reduced contributions and bequests by about $4 billion. (McClelland and Greene do not estimate the effect of reducing rates and increasing the exemption at the same time.)

TABLE 4. CBO Midpoint Estimates of Effect of Modifying Estate Tax on Charitable Contributions and Bequests in 2000 (amounts in billions of dollars)

	Change in Contributions[a]		Change in Bequests[b]		Total Change	
Estate Tax Option	Percent	Amount	Percent	Amount	Percent	Amount
$2 million exemption	0	$0	–11	–$2	–1	–$2
$3.5 million exemption	–1	–$2	–12	–$2	–2	–$4
Repeal	–7	–$14	–22	–$4	–8	–$17
Addendum: Estimated 2000 amount		$196		$16		$212

Sources: McClelland and Greene (2004) and authors' calculations.
a. Assumes "medium growth" of assets and that large estates respond to tax incentives.
b. Based on midpoint of range of estimates. CBO estimates the range of uncertainty at plus or minus 3 percent for reform and plus or minus 6 percent for repeal.

Conclusion

Repealing the estate tax would exacerbate the national debt, reduce the progressivity of the tax system, and discourage philanthropy. Retaining the estate tax while raising the exemption and reducing tax rates could substantially decrease the revenue loss, retain an important element of progressivity, and maintain incentives for charitable giving and bequests. Raising the exemption could also effectively spare virtually all family-owned farms and small businesses from the tax.

Of course, reform should entail more than simply raising the exemption and reducing rates. The estate tax is full of loopholes that reduce revenues, raise questions about fairness, and make the tax needlessly complex. Reform should attack the loopholes, such as the myriad special trust arrangements and valuation discounts, while making it easier for taxpayers to pay their fair share without complex planning. One simplification would be to allow married couples an exemption equal to twice the exemption for singles, to be allocated between the spouses as they wish. Taxpayers can already accomplish this through tax planning, but it should be automatic. Such a change would likely cost little in terms of lost revenue and would significantly reduce planning complexity. Closing loopholes could increase revenues, either to reduce the national debt or allow a higher exemption than would otherwise be feasible.[10]

A more fundamental reform would be to replace the estate tax with an inheritance tax, as several U.S. states and many foreign countries have already done. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden, encouraging the division of estates into smaller shares—an effective defense against accumulations of extraordinary wealth over many generations. The simplest option would be to treat inheritances and gifts above some lifetime exemption as heirs' taxable income, subject to progressive income tax rates. Very wealthy heirs, or those receiving a very large inheritance, would pay the highest effective tax rates. Placing the statutory burden of the tax on recipients rather than donors may reduce some of the moral outrage generated by taxing decedents (although it would not eliminate the record-keeping and reporting requirements for estates).

Notes

1. Burman and Gale (2001) provide more background on the EGTRRA estate tax changes and the economic issues raised by that legislation.
2. See Durst, Monke, and Maxwell (2002) for a detailed summary of rules that affect farmers. (Most also apply to family-owned businesses.)
3. Although this provision is intended to deter tax avoidance, it is not clear that the IRS will be able to administer it, given the difficulty of tracking asset values from generation to generation and the large exemptions. A married couple will be able to allocate up to $5.6 million to the basis of assets they hold (up to the value of the assets at death). It will be very hard, if not impossible, for the IRS to verify such basis allocation across generations. Indeed, Dodge and Soled (2005) argue that abuse is rampant in determining basis for capital assets under present law (which is much simpler).
4. The Centers for Disease Control estimate that 2,443,387 people died in 2002 (Kochanek et al. 2004).
5. These estimates are based on the distribution of tax units ranked according to economic income and assume that the incidence of the estate tax falls upon decedents rather than heirs. The methodology and assumptions underlying our estimates are in Burman, Gale, and Rohaly (2005). That paper shows the distribution is less skewed if households are ranked by cash income but also explains why economic income is a better measure of economic status.
6. Unlike official revenue estimates, our estimates do not account for behavioral response or any indirect effects of the different options on income or gift tax receipts. Current law would probably cause gift tax receipts to decline in the years approaching 2010 as older people would delay otherwise taxable gifts in the hope that they could be transferred tax-free (either in 2010, or later if the estate tax repeal is made permanent). If repeal is not extended, gifts would surge in 2010 when the gift tax is set to drop temporarily to 35 percent (from a top rate of 55 percent set to take effect thereafter). In addition, older taxpayers would have an incentive to curtail realization of capital gains, especially if they viewed the carryover basis regime set to take effect in 2010 as impossible for the IRS to administer (see Burman 1997). This could substantially reduce individual income tax revenues. On the other hand, charitable contributions can be expected to decline if the estate tax is repealed, as discussed later, which would boost income tax revenues (McClelland and Greene 2004).
7. Most income tax avoidance would involve deferring realization of capital gains, which are concentrated among the wealthy. See footnote 3.
8. Technically, rate reduction has two effects that operate in different ways. On one hand, the higher "price" of giving makes it less attractive. For example, at a 50 percent estate tax rate, every dollar of charitable bequests reduces the after-tax value of the estate by only 50 cents. On the other hand, lower estate tax rates raise after-tax wealth, which can encourage philanthropy. Evidence from many sources (summarized in McClelland and Greene 2004) suggests that the price effect dominates. That is, estate taxes, on balance, encourage philanthropy.
9. Bakija and Gale (2003) estimate a slightly larger response of bequests and a smaller response of charitable contributions to repeal. That paper discusses many sources of uncertainty about these estimates.
10. The Task Force on Federal Wealth Transfer Taxes (2004) presents and discusses a comprehensive set of reform options.

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About the Authors

Leonard E. Burman is a senior fellow at the Urban Institute, codirector of the Tax Policy Center, and a visiting professor at Georgetown University.

William G. Gale is the Arjay and Frances Fearing Miller Chair and deputy director of the Economic Studies Program at the Brookings Institution, and codirector of the Tax Policy Center.

Jeffrey Rohaly is a research associate at the Urban Institute and director of tax modeling at the Tax Policy Center.

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THE BROOKINGS INSTITUTION
1775 Massachusetts Avenue, NW
Washington, DC 20036
Phone: 202-797-6000
Fax: 202-797-6004
E-mail: info@brookings.edu
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THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037

Phone: 202-833-7200
Fax: 202-467-5775
E-mail: pubs@ui.urban.org
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