Backgrounder

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Estate Taxes: An Historical Perspective

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Until recently, estate taxes (also known as death taxes) were the almost exclusive headache of the super rich, their tax attorneys, and their estate planners. But a strong economy, an ever-widening distribution of wealth—both good things—coupled with tax policy that has failed to keep up with economic growth have extended the reach of estate taxes well into middle-class America.

A Brief History of the Estate Tax

Estate taxes are not a new phenomenon; they date back almost three thousand years. As early as 700 B.C., there appears to have been a 10 percent tax on the transfer of property at death in Egypt.[1] In the first century A.D., Augustus Caesar imposed a tax on successions and legacies to all but close relatives.

Transfer taxes during the Middle Ages grew out of the fact that the sovereign or the state owned all assets. Although the king owned all real property in feudal England, he would grant its use to certain individuals during their lifetimes. When they died, the king would let the estate retain the property upon payment of an estate tax.

In the United States, the tradition of taxing assets at death began with the Stamp Act of 1797. While the

Talking Points

- The estate tax (also known as the death tax) is one of the most inefficient features of the current tax system. Once the headache of the wealthy, it now reaches well into middle-class America.
- Because the estate tax falls on assets, it reduces incentives to save and invest and, therefore, hampers growth. It also unfairly hits owners of small businesses, family farms, and savers who amass wealth through hard work and thrift.
- The Economic Growth and Tax Relief Reconciliation Act of 2001 was the first step toward eliminating the death tax. Unfortunately, its provisions sunset in 2011. Congress should make estate tax repeal permanent.

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1. More on the history of estate taxes is available in John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995, and Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992–1995," *SOI Bulletin*, Winter 1996–97.

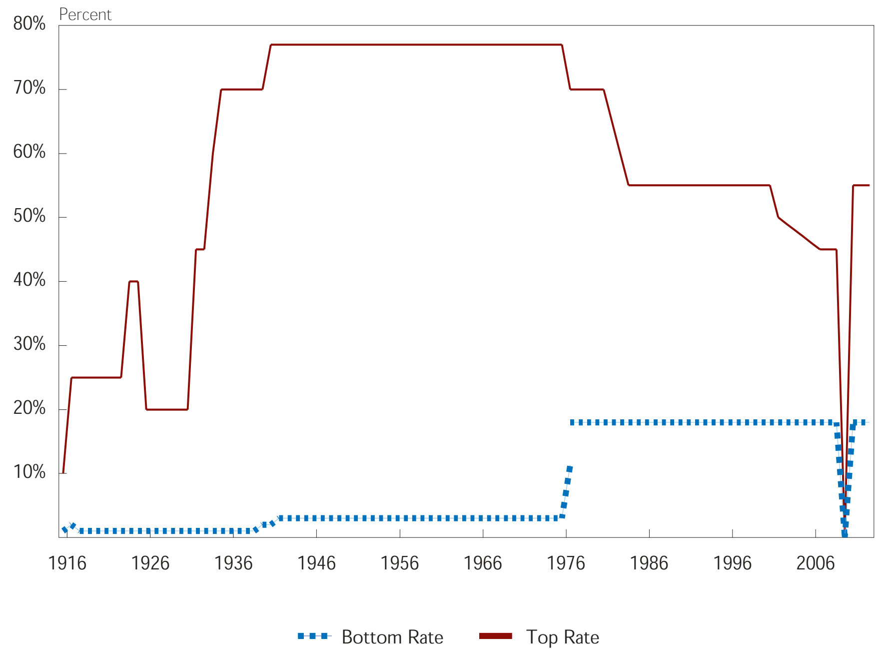
first Stamp Act on tea helped precipitate the Revolutionary War, the second was far less dramatic. Revenues from requiring a federal stamp on wills in probate were used to pay off debts incurred during the undeclared naval war with France in 1794. Congress repealed the Stamp Act in 1802.

That set a pattern for the next hundred years or so in which estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.

To help finance the Civil War, the Tax Act of 1862 imposed a federal inheritance tax. As costs mounted, the Congress increased the inheritance tax rates and added a succession tax in 1864. When the need for added revenue subsided after the war, the inheritance tax was repealed in 1870.

Chart 1 B1719

Estate Tax Rates, 1916-2013



Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.

In 1874, a taxpayer challenged the legality of the Civil War estate taxes, arguing they were direct taxes that, under the Constitution, must be apportioned among the states according to the census. The Supreme Court disagreed saying that direct taxes pertained to capitation taxes and taxes on land, houses, and other permanent real estate.[2]

Another legal decision bearing on, but not directly related to, estate taxes concerned the Income Tax Act of 1894, which included gifts and inheritances as income subject to tax. The Supreme Court struck down the whole bill because the tax was imposed on, among other things, real estate gains and, therefore, was considered a direct tax.[3] This decision is particularly notable because it set the stage for the Sixteenth Amendment that allows the federal government great latitude in the types of taxes it can collect.

The Modern Estate Tax Evolves: 1916 to 1975. In the early 20th century, worldwide conflict cut into trade tariffs—a mainstay of federal revenues—and Congress turned to another revenue source. The Revenue Act of 1916, which introduced the modern-day income tax, also contained an estate tax with many features of today's system. After an exemption of $50,000 (over $11 million in terms of today's wealth), tax rates started at 1 percent and climbed to 10 percent on estates over $5 million (over $1 billion in terms of today's wealth). Estate taxes were increased in 1917 as the U.S. entered World War I.

However, this time the estate tax did not go away after the war ended. Despite sizable budget surpluses, Congress increased rates and introduced a gift tax in 1924. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. During the 1920s through the 1940s, estate taxes were used as another way to attempt to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of

2. *Scholey v. Rew,* 23 Wall. (90 U.S.) 331 (1874).

3. *Pollock v. Farmers' Loan and Trust Company,* 158 U.S. 429 (1895).

a few. Chart 1 shows the starting and top estate tax rates since 1916.

While the Internal Revenue Code of 1954 overhauled the federal income tax, it made a seemingly minor structural change to estate taxation. Specifically, it expanded the tax base to include most life insurance proceeds, which could substantially raise an estate's tax bill.

Reshaping Federal Transfer Taxes: 1976 to the Present. During the late 1960s and early 1970s loophole closing preoccupied tax reformers. These efforts culminated in a 1976 tax bill that overhauled estate taxation, giving us the system we still have today. Perhaps the biggest change was combining the previously separate exemptions for estate and gift taxes and transforming them into a single, unified estate and gift tax credit.

The 1981 tax bill brought some relief. The top rate went from 70 percent to 50 percent, and an increase in the unified credit took a lot of smaller estates—those under $600,000—off the tax rolls. But, after that, the search for revenue to close budget deficits led to more than a decade of bills that largely increased estate taxes.

In 1997, Congress provided some relief with the first increase in the unified credit since 1987. Gradual increases, which began in 1999, are slated to raise the unified credit to $1 million by 2006.

The Economic Growth and Tax Relief Reconciliation Act of 2001 was the first step toward totally eliminating the death tax. It provides for a scheduled phase-out of rates and an increase in the unified credit, finally repealing the tax for calendar year 2010. Unfortunately, the provisions sunset in 2011 and the estate tax reverts back to the 1997 law with a top rate of 55 percent and a unified credit of $1 million.

Estate Taxes and the Economy

The estate tax has a large dead-weight loss. Because the estate tax falls on assets, it reduces incentives to save and invest and, therefore, hampers growth. Along with income taxes, estate taxes help raise the tax rate on income from assets relative to income from working. This unequal treatment of income leads to an inefficient mix of capital and labor.

The size of the dead-weight loss depends on how much of a nation's assets are subject to the tax and the amount of distortion. The estate tax exemption determines the proportion of wealth covered and the rate structure determines the degree of the distortion.

A rough measure of the distortion is the ratio of marginal to average rates for those paying the tax. The average rate is a proxy for the amount of revenue raised, while the marginal rate is a proxy for the overall price distortion. Under a uniform tax, the ratio would be one and the amount of distortion would be minimized. The greater the difference between the marginal and average tax rates, however, the greater the distortion and, therefore, the larger the dead-weight loss.

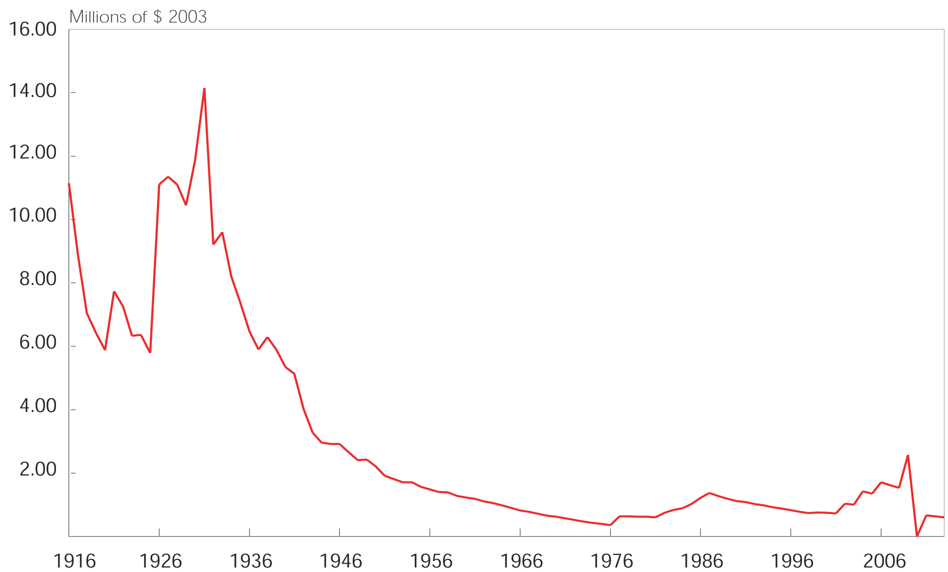
Currently, the marginal estate tax rate is nearly three times higher than the average. Even though the estate tax rate structure is progressive, the high ratio is due mostly to the unified credit. In 1916, the statutory exemption was $50,000. Adjusting the exemption for the growth in wealth between 1916 and 2003 indicates that estates under $11 million (in today's wealth) would not be taxed. In 1931, the exemption was worth even more—$14.1 million (in today's wealth). As Chart 2 shows, however, since then the real value of the exemption has fallen dramatically. The low of about $356,000 was reached in 1976.

Tax bills in 1981 and 1997 provided modest increases in the exemption. However, the exemption of $675,000 in 2001 is still a far cry from its $11 million counterpart in 1916. This failure of the estate tax exemption to keep up with rising wealth is the main reason increasing numbers of average Americans face the prospect of having their heirs presented with an estate tax bill. A middle class family that owns a home and has IRAs, 401(k)s, or other retirement accounts could easily have assets exceeding $675,000 today or even $1 million five years from now.

While the eroding exemption has greatly expanded the estate tax base, both the lowest and highest tax rates also have gone up significantly since 1916. As a result, more of a taxable estate is taxed at the highest marginal rate. As Chart 3 shows, in 1916, only estates over $1 billion (in today's wealth) would have been taxed at the top

Chart 2 B 1719

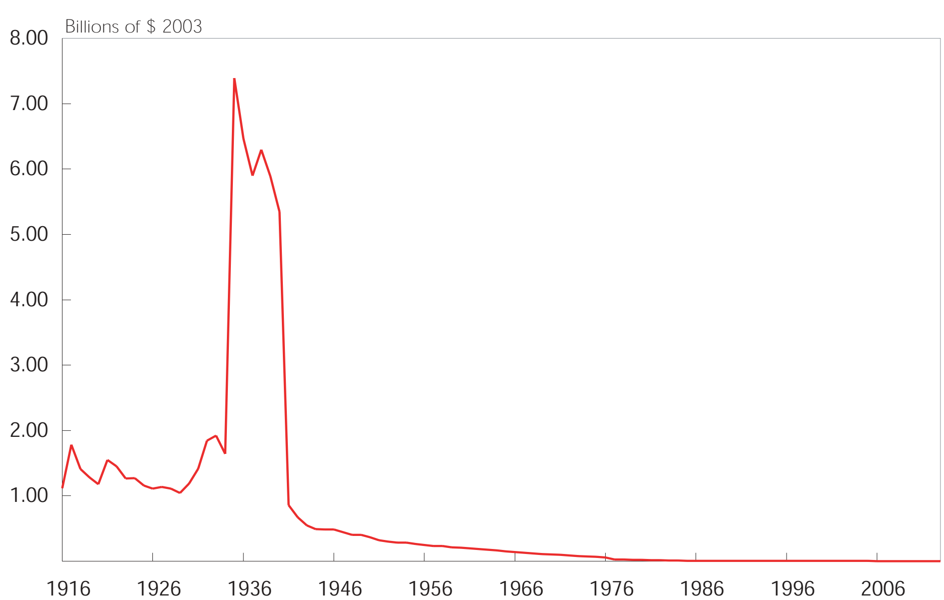
Estate Tax Exemption, 1916-2013 Adjusted for Economic Growth



Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.

Chart 3 B 1719

Estate Tax Top Bracket, 1916-2013 Adjusted for Economic Growth



Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.

rate of 10 percent. Contrast that with the top rate of 55 percent on estates of $3 million in place in 2001 (and possibly again in 2013).

The applicable rates are more compressed than Chart 1 suggests because of the unified credit. Under an exemption system, the estate would begin paying tax at the lowest statutory rate. Under the credit, however, the effective bottom rate is not the statutory 18 percent shown in the graph, but 39 percent. While effective tax rates under the 1997 law ranged from 39 percent to 55 percent, as the credit continued to erode in value, the lowest effective rate rose to 41 percent by 2002 and will appear again in 2011.

Effect on Family Business

The estate tax is particularly harmful to families that own businesses or farms. Even though the amount of the tax is based on asset value, the simple fact is that the tax must be paid out of income.

Let us look at two small business examples. Take a family-run store yielding a 10 percent return each year. Taxes reduce the return to 5 percent.[4] If the owner dies and his estate is subject to the 55 percent estate tax rate, how do the heirs pay the bill? They could send 55 percent of the store's inventory or other physical assets to Washington, except Treasury does not accept payment-in-kind, only cash. Devoting the entire 5 percent annual return, the heirs could pay off the estate tax in only 11 years, except Treasury wants the money now. The heirs could borrow from the bank at 9 percent (4.5 percent after tax) and pay off the loan in 50 years, but rather than run the store for 50 years for free, they probably would sell.

This example is not as outlandish as one might think. Consider the small farmer who owns land near an urban area. His farm would yield a 10 percent return only when it is valued as farmland. But tax law requires that the asset be valued at its "best use," lowering the pre-tax return to 5 percent (2.5% after tax). In this case, even the 50-year bank loan will not save the farm.

The lesson to be learned here is that all taxes are paid out of income. Even if the estate tax is a "rare" event, only one chance in a lifetime, its average impact is very large—large enough that for some the combined effects of income and estate taxes approach 100 percent.[5] The prospect is that as much as 55 percent of the principal of any investment will be taken in estate taxes on top of income taxes. In cases like these, the clear message is "don't invest, consume."

The Congress has tried to address the hardship circumstances for farmers and small business in general. But the remedy effectively has the government standing in for the bank. The final result is the same—heirs are left with a choice of owning a nonperforming asset for a number of years or simply selling. What is more, the IRS has taken these half measures as an excuse to raise appraised estate values, thereby reducing the tax relief.

The investment decision becomes even more complicated if there are ways to organize holdings to pass the income stream to heirs. Tax planning can significantly mitigate the effect of the estate tax. Because amounts involved tend to be large, estate planning richly rewards taxpayers who can anticipate that they might be subject to the tax. Those that do not plan or cannot anticipate are caught and pay the tax. This is simply unfair.

That is one reason why the largest estates do not pay the highest tax rates. Who does? Typically they are owners of small businesses, family farms, and savers who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax.

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4. A tax rate of 50 percent might seem high, but we calculate the economy-wide, marginal tax rate on private business capital at roughly 67 percent.

5. The impact of a tax imposed on assets must be multiplied by one divided by the after-tax rate of return. Thus, the impact of the estate tax is magnified by 10 for an asset with an after-tax return of 10 percent and by 20 for an asset with a 5 percent return.

Conclusion

The estate tax is one of the most inefficient features of the current tax system. Its sheer complexity results in high compliance costs—as much as estate taxes raise by some estimates. High compliance costs along with distortions to economic activity warrant outright elimination of estate taxes before the sunset occurs.[6]

Failing repeal after 2010, the exemption should be raised significantly. Increasing the exemption to the range of $5 million to $10 million would restore eroded value and reduce the proportion of wealth subject to tax to be more in line with the 1920s and 1930s.

This would only partially address the impact of the tax, however. Under the unified credit structure, raising the exempt amount above $3 million would make the lowest marginal rate 55 percent, meaning the tax would be even less efficient than current law. While the amount of wealth subject to tax would be reduced, the rate structure would be harsher, increasing the ratio of marginal to average rates. The way to avoid this result is to convert the exemption from a credit to a deduction.

Another desirable change would be to expand the rate brackets and lower rates. As we have seen the current rate brackets have become compressed when compared to prior law. Expanding the brackets would reduce the marginal rate relative to the average and produce a more efficient system. Similarly, reducing estate tax rates would also help to improve the system. The best solution, however, would be to eliminate the estate and gift tax altogether before the sunset.

—Gary Robbins is Visiting Fellow in Tax Policy at The Heritage Foundation and president of Fiscal Associates. This study is based on a presentation at a Department of the Treasury Roundtable on Jobs, Growth, and Abolition of the Death Tax, November 6, 2003.[7]

6. The 108th Congress has the chance to permanently repeal this burdensome and inefficient tax in the current session. The House already has voted to do so, and the Senate should not let this opportunity to build on the momentum of the 2001 tax cuts slip away.
7. The presentation was heavily based on Gary and Aldona Robbins, *The Case for Burying the Estate Tax,* Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 150, March 1999. This report is available at the Web site *www.ipi.org*.

Appendix

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History of Estate Tax Filing Requirements and Tax Rates, 1916Ð1948

	Exemption Amount					Top Bracket Amt		
	Statutory (1)	$2003 (2)	2003 Wealth (3)	Initial Rate (4)	Top Rate (5)	Normal (6)	$2003 (7)	2003 Wealth (8)
1916	50,000	625,713	11,146,566	1%	10%	5,000,000	62,571,264	1,114,656,569
1917	50,000	503,930	8,913,562	2%	25%	10,000,000	100,785,928	1,782,712,327
1918	50,000	447,826	7,046,847	1%	25%	10,000,000	89,565,228	1,409,369,431
1919	50,000	392,433	6,409,275	1%	25%	10,000,000	78,486,603	1,281,855,054
1920	50,000	344,429	5,883,925	1%	25%	10,000,000	68,885,795	1,176,784,968
1921	50,000	413,315	7,735,332	1%	25%	10,000,000	82,662,954	1,547,066,445
1922	50,000	449,614	7,265,575	1%	25%	10,000,000	89,922,774	1,453,115,041
1923	50,000	439,097	6,326,429	1%	25%	10,000,000	87,819,317	1,265,285,835
1924	50,000	439,954	6,356,306	1%	40%	10,000,000	87,990,840	1,271,261,211
1925	50,000	434,020	5,782,805	1%	40%	10,000,000	86,804,065	1,156,560,951
1926	100,000	881,630	11,100,600	1%	20%	10,000,000	88,163,033	1,110,060,047
1927	100,000	901,026	11,346,241	1%	20%	10,000,000	90,102,620	1,134,624,073
1928	100,000	886,837	11,100,600	1%	20%	10,000,000	88,683,681	1,110,060,047
1929	100,000	890,342	10,443,824	1%	20%	10,000,000	89,034,209	1,044,382,391
1930	100,000	924,663	11,866,827	1%	20%	10,000,000	92,466,304	1,186,682,724
1931	100,000	1,032,164	14,148,254	1%	20%	10,000,000	103,216,365	1,414,825,369
1932	50,000	584,244	9,210,114	1%	45%	10,000,000	116,848,830	1,842,022,806
1933	50,000	600,214	9,595,167	1%	45%	10,000,000	120,042,702	1,919,033,449
1934	50,000	568,518	8,204,517	1%	60%	10,000,000	113,703,639	1,640,903,391
1935	50,000	557,940	7,388,520	1%	70%	50,000,000	557,940,173	7,388,519,614
1936	50,000	551,590	6,467,855	1%	70%	50,000,000	551,589,621	6,467,855,174
1937	50,000	529,270	5,895,760	1%	70%	50,000,000	529,270,010	5,895,760,222
1938	50,000	545,319	6,294,086	1%	70%	50,000,000	545,319,486	6,294,086,292
1939	50,000	551,338	5,885,318	1%	70%	50,000,000	551,338,081	5,885,318,105
1940	50,000	543,550	5,345,442	2%	70%	50,000,000	543,550,231	5,345,441,944
1941	60,000	611,076	5,130,156	2%	77%	10,000,000	101,845,921	855,026,001
1942	60,000	566,608	4,018,133	3%	77%	10,000,000	94,434,749	669,688,789
1943	60,000	537,936	3,275,951	3%	77%	10,000,000	89,655,925	545,991,881
1944	60,000	525,885	2,958,933	3%	77%	10,000,000	87,647,576	493,155,481
1945	60,000	511,686	2,914,407	3%	77%	10,000,000	85,281,078	485,734,421
1946	60,000	456,389	2,923,714	3%	77%	10,000,000	76,064,910	487,285,744
1947	60,000	412,197	2,658,975	3%	77%	10,000,000	68,699,425	443,162,465
1948	60,000	389,994	2,411,091	3%	77%	10,000,000	64,999,033	401,848,550

Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.

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History of Estate Tax Filing Requirements and Tax Rates, 1949Ð1981

	Exemption Amount						Top Bracket Amt	
	Statutory (1)	$2003 (2)	2003 Wealth (3)	Initial Rate (4)	Top Rate (5)	Normal (6)	$2003 (7)	2003 Wealth (8)
1949	60,000	390,503	2,428,405	3%	77%	10,000,000	65,083,907	404,734,222
1950	60,000	386,228	2,208,572	3%	77%	10,000,000	64,371,307	368,095,358
1951	60,000	360,294	1,914,415	3%	77%	10,000,000	60,048,947	319,069,247
1952	60,000	354,658	1,812,381	3%	77%	10,000,000	59,109,743	302,063,490
1953	60,000	350,148	1,710,831	3%	77%	10,000,000	58,358,057	285,138,451
1954	60,000	346,697	1,705,547	3%	77%	10,000,000	57,782,872	284,257,796
1955	60,000	340,768	1,565,393	3%	77%	10,000,000	56,794,700	260,898,774
1956	60,000	329,473	1,484,101	3%	77%	10,000,000	54,912,236	247,350,210
1957	60,000	318,919	1,408,406	3%	77%	10,000,000	53,153,167	234,734,272
1958	60,000	311,484	1,388,989	3%	77%	10,000,000	51,913,935	231,498,243
1959	60,000	307,978	1,280,851	3%	77%	10,000,000	51,329,602	213,475,113
1960	60,000	303,711	1,232,442	3%	77%	10,000,000	50,618,515	205,406,954
1961	60,000	300,366	1,191,152	3%	77%	10,000,000	50,060,980	198,525,310
1962	60,000	296,316	1,108,157	3%	77%	10,000,000	49,386,067	184,692,835
1963	60,000	293,062	1,050,566	3%	77%	10,000,000	48,843,724	175,094,304
1964	60,000	288,737	978,299	3%	77%	10,000,000	48,122,853	163,049,806
1965	60,000	283,426	902,594	3%	77%	10,000,000	47,237,688	150,432,323
1966	60,000	275,574	823,479	3%	77%	10,000,000	45,929,026	137,246,443
1967	60,000	267,307	779,266	3%	77%	10,000,000	44,551,211	129,877,744
1968	60,000	256,282	713,110	3%	77%	10,000,000	42,713,627	118,851,720
1969	60,000	244,268	659,641	3%	77%	10,000,000	40,711,306	109,940,232
1970	60,000	231,928	625,162	3%	77%	10,000,000	38,654,659	104,193,737
1971	60,000	220,807	575,919	3%	77%	10,000,000	36,801,157	95,986,446
1972	60,000	211,803	523,993	3%	77%	10,000,000	35,300,445	87,332,097
1973	60,000	200,563	469,110	3%	77%	10,000,000	33,427,136	78,185,065
1974	60,000	184,037	433,019	3%	77%	10,000,000	30,672,772	72,169,752
1975	60,000	168,336	397,492	3%	77%	10,000,000	28,055,976	66,248,678
1976	60,000	159,314	356,357	3%	77%	10,000,000	26,552,300	59,392,790
1977	120,000	299,362	639,922	18%	70%	5,000,000	12,473,429	26,663,437
1978	134,000	312,085	632,253	18%	70%	5,000,000	11,644,960	23,591,546
1979	147,000	316,023	620,486	18%	70%	5,000,000	10,749,095	21,104,973
1980	161,000	317,023	623,872	18%	70%	5,000,000	9,845,450	19,374,916
1981	175,000	315,178	605,405	18%	70%	5,000,000	9,005,097	17,297,299

Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.

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History of Estate Tax Filing Requirements and Tax Rates, 1982Đ2013

	Exemption Amount						Top Bracket Amt	
	Statutory	$2003	2003 Wealth	Initial Rate	Top Rate	Normal	$2003	2003 Wealth
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1982	225,000	381,444	747,837	18%	65%	4,000,000	6,781,219	13,294,885
1983	275,000	448,458	842,733	18%	60%	3,500,000	5,707,652	10,725,697
1984	325,000	511,001	895,218	18%	55%	3,000,000	4,716,934	8,263,553
1985	400,000	609,679	1,028,503	18%	55%	3,000,000	4,572,594	7,713,775
1986	500,000	745,683	1,216,384	18%	55%	3,000,000	4,474,099	7,298,303
1987	600,000	868,724	1,370,523	18%	55%	3,000,000	4,343,620	6,852,613
1988	600,000	840,160	1,272,364	18%	55%	3,000,000	4,200,798	6,361,822
1989	600,000	809,312	1,184,110	18%	55%	3,000,000	4,046,559	5,920,549
1990	600,000	778,979	1,120,003	18%	55%	3,000,000	3,894,893	5,600,013
1991	600,000	751,624	1,085,771	18%	55%	3,000,000	3,758,119	5,428,855
1992	600,000	733,761	1,028,599	18%	55%	3,000,000	3,668,804	5,142,997
1993	600,000	716,563	978,520	18%	55%	3,000,000	3,582,814	4,892,600
1994	600,000	701,951	921,372	18%	55%	3,000,000	3,509,753	4,606,862
1995	600,000	686,969	878,268	18%	55%	3,000,000	3,434,844	4,391,339
1996	600,000	673,925	831,884	18%	55%	3,000,000	3,369,625	4,159,420
1997	600,000	661,051	781,361	18%	55%	3,000,000	3,305,256	3,906,804
1998	600,000	653,000	740,150	18%	55%	3,000,000	3,265,000	3,700,751
1999	650,000	697,388	759,224	18%	55%	3,000,000	3,218,716	3,504,112
2000	675,000	709,296	744,262	18%	55%	3,000,000	3,152,427	3,307,832
2001	675,000	692,917	725,253	18%	55%	3,000,000	3,079,630	3,223,345
2002	1,000,000	1,015,000	1,037,000	18%	50%	3,000,000	3,045,000	3,111,000
2003	1,000,000	1,000,000	1,000,000	18%	49%	3,000,000	3,000,000	3,000,000
2004	1,500,000	1,479,290	1,424,501	18%	48%	3,000,000	2,958,580	2,849,003
2005	1,500,000	1,448,864	1,351,519	18%	47%	3,000,000	2,897,728	2,703,039
2006	2,000,000	1,892,085	1,709,702	18%	46%	3,000,000	2,838,127	2,564,553
2007	2,000,000	1,853,168	1,622,108	18%	45%	3,000,000	2,779,752	2,433,162
2008	2,000,000	1,815,052	1,539,002	18%	45%	3,000,000	2,722,578	2,308,503
2009	3,500,000	3,107,966	2,567,449	18%	45%	3,000,000	2,663,971	2,200,670
2010	NA	NA	NA	0%	0%	NA	NA	NA
2011	1,000,000	850,171	665,358	18%	55%	3,000,000	2,550,514	1,996,073
2012	1,000,000	831,870	633,674	18%	55%	3,000,000	2,495,610	1,901,022
2013	1,000,000	813,963	603,499	18%	55%	3,000,000	2,441,889	1,810,497

Source: U.S. Department of the Treasury, Internal Revenue Service; U.S. Department of Commerce, Bureau of Economic Analysis.