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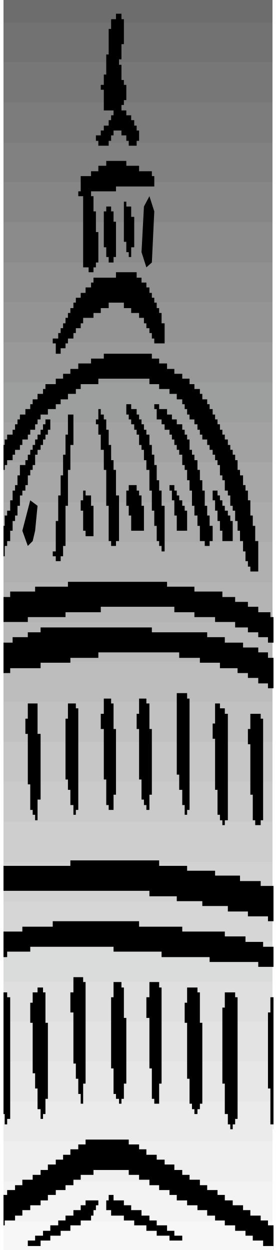

Undercutting the American Dream: Estate Tax Repeal Would Harm Latinos*

By Eric Rodriguez and Luisa Grillo-Chope**

Introduction

On April 13, 2005, the House of Representatives voted 272-162 to repeal permanently the federal estate tax, also referred to as the "death" tax. Last fall, the Senate decided to delay consideration of the legislation until 2006, and many expect the Senate to act shortly.

The estate tax is unique in that it is highly targeted to wealthy individuals and provides significant revenue to the federal budget to fund programs important to American families. That said, few fully understand the structure, purpose, and impact of the estate tax. For instance, almost half of Americans report believing that most families have to pay the estate tax.[1] Similarly, one-third of small business owners believe that they would be subject to paying the estate tax.[2] The reality is that almost all of the tax falls on the top 5% in the income distribution of U.S. households.

As a public policy measure, however, the estate tax lies at a critical juncture for the nation's Latinos. The tax garners critical revenue that federal and state governments use to provide public goods and services that Latinos – like all other American families – need and consume (e.g., defense, education, and health care). This is especially critical given the current federal budgetary climate which is characterized by a precipitous decline in tax revenue resulting from tax cut policies, coupled with growing federal expenses at home and abroad. The result is a substantial annual federal budget deficit and a call by lawmakers to balance the budget by cutting public services.

The estate tax has also inhibited the transfer of wealth between generations. The measure has helped somewhat to temper the growth of the wealth gap between Latino and White households. That said, similar to other Americans, many Latinos remain unaware of the impact of federal tax policy in general, and the estate tax in particular, on their economic security.

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* The terms "Hispanic" and "Latino" are used interchangeably by the U.S. Census Bureau to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, and Spanish descent; they may be of any race.

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The budgetary landscape notwithstanding, lawmakers continue to consider options to reform or repeal the estate tax. The outcome of this debate could have far-reaching implications for the nation's Latinos. As the fastest-growing demographic and a growing share of the nation's workers, Latinos have a major stake in federal tax policy debates. Accordingly, this white paper provides background information on the estate tax, provides the Latino perspective on efforts to repeal the tax, and suggests a course of action for lawmakers.

BACKGROUND

In 1916, the federal government enacted a tax on estates valued at or above $50,000. One important goal of the tax was to reduce the concentration of American wealth while another was to help pay for increased federal responsibilities. Congress revised the estate tax and raised the exemption rates to $120,000 in 1976, to $225,000 in 1981, and to $600,000 in 1986.[3] More recently, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 (PL 107-16) established a gradual increase in the estate tax exemption levels and a lowering of the tax rates until equaling full repeal for one year (2010). In tax year 2005, the amount of wealth exempted from the estate tax was $1.5 million for individuals ($3 million for couples) and will rise to $3.5 million for individuals ($7 million for couples) by 2009 with a top tax rate of 45%. However, unless Congress acts by passing new legislation, the estate tax will be restored to an exemption of $1 million and a top tax rate of 55% in 2011.[4]

Opponents of the estate tax have argued, among other things, that it is an unfair and unnecessary tax that burdens many American families, placing family-owned businesses in jeopardy. Some of these arguments seem to resonate with Latinos, particularly Hispanic business owners. Latino workers prioritize caring for their families financially, and the notion of the government taxing half of their wealth upon death is disconcerting. However, the evidence belies the critics' arguments and suggests that the tax is an important and beneficial policy measure for all Americans, especially Latinos.

A Fair and Necessary Tax

The estate tax is a governmental means of ensuring that the opportunities afforded by wealth can be shared more evenly among American families, that individuals and families cannot concentrate massive amounts of wealth over generations, and that the government can raise enough revenue to pay for needed public services.

The estate tax is fair for a number of reasons, including the following;

- **Federal policy provides the greatest amount of tax benefits to the wealthiest Americans**. The more wealth one has the more federal tax benefits they may receive; the U.S. tax code rewards the wealthy at progressively higher levels. For instance, tax deductions for mortgage interest are greater for those with larger mortgages and those with the greatest amount of tax liability (generally those with high incomes). Low-income homeowners, on the other hand, receive the least amount of benefit from this wealth-building tax incentive. The same holds true for incentives for retirement savings and investing. Although high-income earners are eligible for these tax advantages because of their larger incomes, low- and moderate-income workers are given fewer incentives to save within the tax code and experience many disincentives to save.

- **Wealthy individuals and families continue to benefit disproportionately from the economy and governmental policies**. A study by the Center on Budget and Policy Priorities, using data from the Congressional Budget Office (CBO), found that from 1979 to 2003, the top 1% of the population experienced a total after-tax income increase of $395,700, or 129%. This means that the average after-tax income more than doubled, increasing from $305,800 to $701,500. Over the same 24-year period, the average after-tax income of the middle fifth of the population rose a relatively modest 15%, and the average after-tax income of the poorest fifth of the population rose just 4%, or $600.[5]
- **Estate tax payments do not result in double taxation.** Very few estates actually pay the estate tax, and those that do pay the tax tend to be largely made up of assets which have never been taxed. A significant proportion of estate assets consists of untaxed capital gains. Overall, unrealized capital gains consist of more than one-third (36%) of the value of all estates.[6] Wealthier estates especially tend to have their assets held in the form of unrealized capital gains. For estates worth more than $10 million, more than half (56%) are made up of unrealized capital gains.[7]
- **There are numerous ways that wealthy taxpayers minimize their estate tax burden**. There are a number of exclusions and other provisions in the tax code which directly address family wealth-building issues, and effective estate planning strategies can also mitigate the tax impact and maintain the financial security of the family. One provision allows significant transfers to a surviving spouse. Other estate tax rules also reduce the impact on family-owned businesses. The exemption and the so-called qualified family-owned business interest exclusion help to limit exposure to the estate tax. These businesses and farms also benefit from valuation discounts which significantly reduce the value of farm or business assets for estate tax purposes. In 2004, 1.8% of all taxable estates were from small businesses and family farms, which accounted for less than half of 1% of all estate taxes paid.[8] For those considered "small" businesses (valued under $5 million), only about .5% of the total estate tax paid to the Treasury that year came from these estates.[9] Individual taxpayers can and do pass on wealth and privilege during their lifetime. In addition, each year taxpayers can provide up to $12,000 (in 2006) in cash or property tax-free, which can be used to transfer wealth and privilege by assisting relatives financially with down payments on home purchases, educational expenses, paying off unsecured credit card and other debt, and in many other ways. The college savings plan (529 plan) can also pay for more than $200,000 in higher education expenses for a relative and remains exempt from the estate tax. These transfers place relatives on stronger financial footing and place them at a considerable wealth advantage over others. Thus, typically families are not placed

in significant financial distress due to the estate tax and taxpayers can and do take steps to secure their family's financial future while they are living and after they have passed.

- **Few American families pay estate tax**. Though it may seem that the tax would affect many wealthy American households, few upper-income households pay the tax. The top 5% of households in the income distribution pay almost all (99%) of the estate tax, and the richest one in 1,000 households pays more than one-third of the estate tax.[10] The estate tax includes a number of important exceptions to tax liability. For instance, there is an exclusion of all estate tax if it is passed on to a surviving spouse. These and other provisions allow for more than half of estates that would be subject to the estate tax to pay no taxes at all. In 2003, for example, about 66,000 estate tax returns were filed, of which less than half actually paid any taxes on their estate.[11] Under current law, the number of households expected to pay the estate tax is projected to drop from 50,800 in 2001 to about 7,200 by 2009.[12] In 2004, the share of White non-Hispanic households that reported total money income above $100,000 was more than double that of Hispanic households (18.0% vs. 8%, respectively).[13] The data suggest that of those American households subject to estate tax annually, a small number are likely to be Latino.

On the whole, the estate tax helps to ensure that the federal tax structure is progressive; in other words, that the nation's income tax is based on an individual's ability to pay.[14] The estate tax is also critical for addressing important social policy and governmental challenges. Specifically:

- **Wealth inequality and the race/ethnic wealth gap**. The gap in wealth between minority and White households is staggering. According to a 2004 study by the Pew Hispanic Center, the median net worth (wealth) of Hispanic households in 2002 was $7,932, compared to $88,651 for White non-Hispanic households.[15] That year, a Latino household maintained nine cents for every dollar in wealth that a non-Hispanic White household possessed. An important contributing factor to the current race-ethnic wealth gap is the ability of taxpayers to pass on substantial sums of wealth and privilege to their heirs.

- **Federal budget**. The tax revenue from the estate tax is projected to amount to more than $17 billion in 2006. To put that amount in perspective, revenues from the estate tax would almost cover the combined budgets for Head Start ($6.9 billion) and Pell Grants ($12 billion), important programs for working families.[16] In 2011, when the tax is restored to 2000 levels, as under current law, annual revenue from the tax is projected to reach nearly $40 billion. With an estimated budget deficit in 2006 of $336 billion, rising costs associated with rebuilding efforts in the Gulf Coast, military operations abroad, and rising health care entitlement costs, these resources are vital.

- **Charitable giving**. Money that is donated to charity is not counted for tax purposes and can significantly reduce the size of an estate subject to the tax. Contributions to charities among estate tax returns accounted for about $14 billion in 1997.[17]

Latino-serving nonprofit organizations do receive charitable contributions, which provide critical support to education, health care, job training, and homeownership programs, substantively improving life opportunities for Latinos. One study by the Greenlining Institute found that Latinos receive 28.3% of minority grants from independent foundation grants, but a mere 1.21% of total grants.[18] Latinos could be adversely affected if the charitable deductions in the estate tax are removed by repeal.

Accordingly, the estate tax is fair, adversely impacts few families, helps to minimize wealth disparities and intergenerational wealth transfers, and assists the government to meet public needs for goods and services.

ESTATE TAX RATE LOWER THAN TOP RATE

Concerns abound about the unfairness of high estate tax rates. In 2009, the estate tax will have a $3.5 million exemption for an individual and $7 million for a couple with the remainder of the estate taxed at rates up to 45%. By 2011, the estate tax will return to pre-EGTRRA levels – a $1 million exemption and a 55% top tax rate. Although these rates sound high, estates are taxed at progressive rates; most are taxed at rates below the top rates. Moreover, there are many deductions, credits, and estate tax planning methods that lower tax liability. As a result, the average effective tax rates are only a fraction of the top rate. Thus, in 2003, taxable estates had an average effective tax rate of 18.8%.* For estates worth more than $20 million, the largest taxable estates, the average effective tax rate was even lower, 16.5%.** The difference in the effective tax rates is explained by the increased size of charitable bequests.

Another way to see how this works is to consider a family with a large estate of about $50 million. If the entire estate were subject to the top 55% rate, total tax liability would be $27.5 million. However, when the value of the deductions, exemptions, and credits is considered, the actual tax liability decreases substantially. Taxed at the average effective rate of 16.5%, the overall tax liability would decrease to $8.25 million.***

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* Joel Friedman and Arloc Sherman, *House to Vote on Permanent Repeal of Estate Tax: Estate Tax Reform, Rather Than Repeal, Could Preserve Much Needed Revenues and Help Restore Social Security Solvency.* Washington, DC: Center on Budget and Policy Priorities, April 12, 2005. Available at http:///www.cbpp.org/4-12-05tax.htm

** *Ibid.*

*** Ruth Carlitz and Joel Friedman, *An Estate Tax With A 15 Percent Tax Rate Does Not Represent Reasonable Compromise.* Washington, DC: Center on Budget and Policy Priorities, September 22, 2005. Available at http://www.cbpp.org/9-22-05tax.htm

ESTATE TAX REFORM: IMPLICATIONS FOR LATINOS

In early 2005, the House of Representatives passed H.R. 8, the "Death Tax Repeal Permanency Act of 2005," which permanently repeals the federal estate tax.[19] Lawmakers have also introduced several other estate tax measures that would largely have the effect of shielding more taxpayers from liability (e.g., raising exemption rates).

The data suggest that few American families are subject to the estate tax. Moreover, because of low income and wealth levels, as well as the spousal exemption, an insignificant share of Latinos are directly impacted by the tax. That said, with respect to Latinos, a full repeal of the estate tax would:

- **Reduce federal revenues when more resources and targeted investments are needed**. Immediate repeal would reduce federal revenue by more than $400 billion over the next decade.[20] The estate tax will already take a one-year hiatus in 2010, and if Congress repeals the estate tax permanently, the Joint Committee on Taxation estimates it would cost $252 billion from 2012 through 2015.[21] The revenue lost in 2012 alone would stand at $55 billion, which reflects the CBO baseline estimate of $43 billion and $12 billion in the decrease in capital gains receipts. Additionally, the repeal will affect state revenues; many states impose an estate tax tied to the federal estate tax. The current budget deficit is a result of significantly declining tax revenue due, in large part, to the enactment of tax cuts since 2001. Lawmakers have responded by proposing cuts in programs that serve a large number of Latinos. Less federal revenue means less money for key Latino priorities, such as education, health care, and improving asset development programs.
- **Diminish charitable giving**. As currently designed, the estate tax provides a strong incentive to donate to charities, not just at the point of death but also throughout life. A recent study estimated that full repeal would reduce charitable giving by more than $15 billion per year.[22] This would mean that each year the nonprofit sector would lose resources equivalent to the total grants currently awarded the largest 110 foundations in the U.S.
- **Expand the race-ethnic wealth gap**. Latino wealth levels have grown in recent years, largely attributable to rising homeownership levels, but Hispanics still maintain less than 10% of the wealth of their non-Hispanic White counterparts. American families already employ innumerable methods to transfer wealth and privilege to their heirs. The estate tax is one means of preventing unfettered intergenerational wealth transfers that help to polarize American families economically. The permanent repeal of the estate tax would aggravate racial wealth inequalities by exacerbating the wealth gap that already exists between White, Latino, and Black households.
- **Make the federal tax system increasingly unfair**. The federal income tax system is largely tied to the principle of ability to pay; individuals pay more progressively as their resources increase. A repeal would upset the progressivity of the tax system, placing a heavier tax burden than under current law on income from earnings rather than from wealth.

Congress should cease attempts to repeal the estate tax. If Congress must consider reform options that limit tax liability for family farms and small businesses, they should ensure that changes are cost neutral and offset by modifications elsewhere. There are various options for reforming the estate tax which include modest increases in the exemption levels that would reduce the number of people subject to the tax. For example, raising the exemption level to $3.5 million would reduce the number of taxable estates by 84%.[23]

Given the budget outlook, lawmakers also need to consider tax revenue-raising options. Tax cut legislation explains about half of the current budget deficit. As in the 1990s, a balanced budget is only achievable if revenue is also on the table.

Finally, Congress must do more to address the race-ethnic wealth gap. Lawmakers need to consider developing a comprehensive policy agenda that establishes new, and strengthens existing, wealth-building efforts targeted to asset-poor families. A broad-based initiative should include expansions and improvements to existing programs, such as the Saver's Tax Credit which encourages retirement savings for low-wage workers; pre-purchase housing counseling programs that are creating thousands of new low-income homeowners each year; and the highly-regarded Individual Development Accounts program which builds savings for 20,000 low-income individuals. These programs help to narrow the wealth gap but currently reach few individuals and are limited by lack of federal resources.

CONCLUSION

After years of hearing such well-placed and strategically-framed stories, almost half of Americans believe that most families have to pay the estate tax.[24] Similarly, one-third of small business owners believe that they would be subject to the estate tax.[25] Some Latinos seem to agree with these statements. However, in 2004, 1.8% of all taxable estates were from small businesses and family farms, which accounted for less than half of 1% of all estate taxes paid.[26]

There is much confusion about the structure, purpose, and impact of the estate tax. Few Latinos are aware of the importance of the tax in supporting government programs, encouraging charitable giving, and restricting growth in the race-ethnic wealth gap.

The repeal of the estate tax will hurt the budget and exacerbate the wealth gap. For these reasons, Congress should not repeal the tax. Rather, lawmakers should concentrate on raising needed revenue to balance the budget and institute stronger policies that assist asset-poor families in building wealth.

ENDNOTES

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