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The Estate Tax and Housing

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The conventional argument for estate tax reform focuses on several tax policy arguments. These include the fairness of a tax assessed at death, the economic inefficiency created by the tax on small business, and the negative impacts these effects have on capital accumulation and macroeconomic growth.

This paper suggests another reason for estate tax reform is looming on the horizon. In 2011, the exemption amount for the estate tax returns to only $1 million, after previously increasing to $3.5 million in 2009. This change in 2011 will increase the number of homeowners who are subject to estate tax liability. Indeed, without significant reform, the estate tax could become the new Alternative Minimum Tax (AMT) problem due to the expanding influence of the tax on middle-class homeowners.

The present law version of the estate tax is counter to the otherwise housing-supportive tax policies in the nation's tax code (see footnote *). A general policy consensus exists to promote homeownership due to its documented benefits for American families and neighborhoods [1]. Homeownership is an important source of wealth creation for families, particularly for middle-class households. Furthermore, homeownership transforms residents into community stakeholders and generates spillover social and economic benefits for the neighborhoods in which they reside.

The following points are discussed in this paper:

• The estate tax exemption amounts falls significantly in 2011.

• Housing prices have increased dramatically in recent years.

• The burden of the estate tax includes tax liability and administrative/preparation costs.
• Increasing numbers of marginal estate taxpayers report housing-related wealth.

• 3.443 million homes will have a market value in excess of the exemption amount in 2011
As a result, in 2011 the estate tax will be an issue for the wealthy, small businesses, and homeowners.

Background

Under present law, estates are taxed on the value of the estate, which is generally equal to its fair market value (see footnote **). The effective tax rate for estate tax purposes is equal to the Federal estate tax rate [2]. In general, the tax rate applies to estate value in excess of the exemption amount less certain deductions for charitable contributions, funeral expenses, administrative expenses, claims against the estate, and some taxes. As modified by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the exemption amount increases each year and the prevailing estate tax rate declines according to the following schedule.

Table 1: Present Law Estate Tax		
Year	**Exemption**	**Estate Tax Rate**
2002	$1.0 million	50%
2003	$1.0 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2.0 million	46%
2007	$2.0 million	45%
2008	$2.0 million	45%
2009	$3.5 million	45%

For calendar year 2010, EGTTRA repeals the estate tax.

An important issue in estate taxation is the tax treatment of accumulated but unrealized gain on capital assets. Proponents of the estate tax argue that the tax insures taxation of assets that otherwise would not be taxed due to inheritance transfer of the property. However, a powerful argument against such taxation is that the ability to leave wealth to one's heirs is an important economic motivation for wealth accumulation, which encourages growth of the overall economy.

Under present law, accumulated gain on assets transferred at death are generally not subject taxation, as inherited assets receive an increase in basis to fair market value. Thus, inherited assets are subject to gains taxation only on those gains accumulated after the date of inheritance. However, in 2010 this "step-up-in-basis" regime is replaced by a less favorable "modified carryover basis" regime. Under this regime, assets transferred to heirs do not automatically receive a full step up in basis to fair market value. Instead, the step up is limited to $1.3 million of accumulated gains of transferred assets. An additional $3 million of gains exemption exists for assets transferred to a surviving spouse.

Strategic tax planning thus allows a couple to increase the basis of transferred assets by a total amount equal to $5.6 million: $4.3 million upon the death of the first spouse and additional $1.3 million upon the death of the surviving spouse. All other transferred assets maintain original basis and are subject to full gains taxation upon sale by the heir.

The EGTRRA estate tax provisions, including the modified carryover basis regime, sunset at the end of calendar year 2010. For calendar years 2011 and beyond, the pre-EGTRRA estate tax regime applies. In general, for 2011 this sunset establishes a 55% rate and a $1 million exemption amount.

The Housing Market

In recent years, the residential housing market has witnessed dramatic increases in housing prices. Indeed, the Federal Government's Office of Federal Housing Enterprise Oversight (OFHEO) House Price Index indicates that on average national housing prices have increased

114% from 1995 to the present. In contrast, the most common measure of inflation, the Labor Department's Consumer Price Index (CPI), is up only 32% over the same period. This period of housing price appreciation illustrates the importance of housing as a means of wealth accumulation for Americans. Indeed, a sizeable research literature in economics and the other social sciences demonstrates this and other benefits of homeownership.

However, increasing housing prices also increase the likelihood of estates being subject to the estate tax. This is particularly true for housing located in high cost metropolitan areas, such as those on the west coast or the northeast region of the United States.

The following analysis estimates the effect home price appreciation will have on estate taxes in 2011 and beyond.

Analysis

Residential Real Estate and Estate Tax Liability

The best source for estate tax data is the Statistics of Income (SOI) produced by the Internal Revenue Service. The following table is based on SOI data and shows the amount of revenue collected by the estate tax, the aggregate taxable estates, total number of estates, and number estates with personal residence wealth during the 1995 to 2004 period. Net estate tax liability refers to total estate taxes paid. The measure of aggregate taxable estates is the sum of all wealth subject to the estate tax. The count of total taxable estates is the number of estate taxpayers with positive tax liability, while the number of estates with personal residences is the subset of estate taxpayers who report housing wealth as part of their estate [3].

Table 2: Estate Tax Data

Year	Net Estate Tax Liability ($M)	Aggregate Taxable Estates ($M)	Total Taxable Estates	Taxable Estates with Personal Residences
1995	$11,841	$67,185	31,563	17,367
1996	$14,456	$80,373	37,711	19,738
1997	$16,637	$97,650	42,901	24,272
1998	$20,349	$103,012	47,475	26,760
1999	$22,915	$119,158	49,863	28,110
2000	$24,399	$130,371	52,000	29,429
2001	$23,519	$123,757	51,584	29,612
2002	$21,349	$117,221	44,406	21,797
2003	$20,650	$109,841	30,626	17,140
2004	$21,510	$107,680	30,276	18,248

Source: IRS Statistics of Income

As seen in Table 3, the share of estate taxes due to homes nearly doubled between the years 1995 and 2003. The share then fell in 2004. The reasons for this decline are discussed below.

Table 3: Residence Share	
Year	**Residence Value as a Share of Total Estate**
1995	5.7%
1996	5.7%
1997	5.6%
1998	6.1%
1999	5.7%
2000	6.2%
2001	7.3%
2002	8.9%
2003	9.6%
2004	7.9%

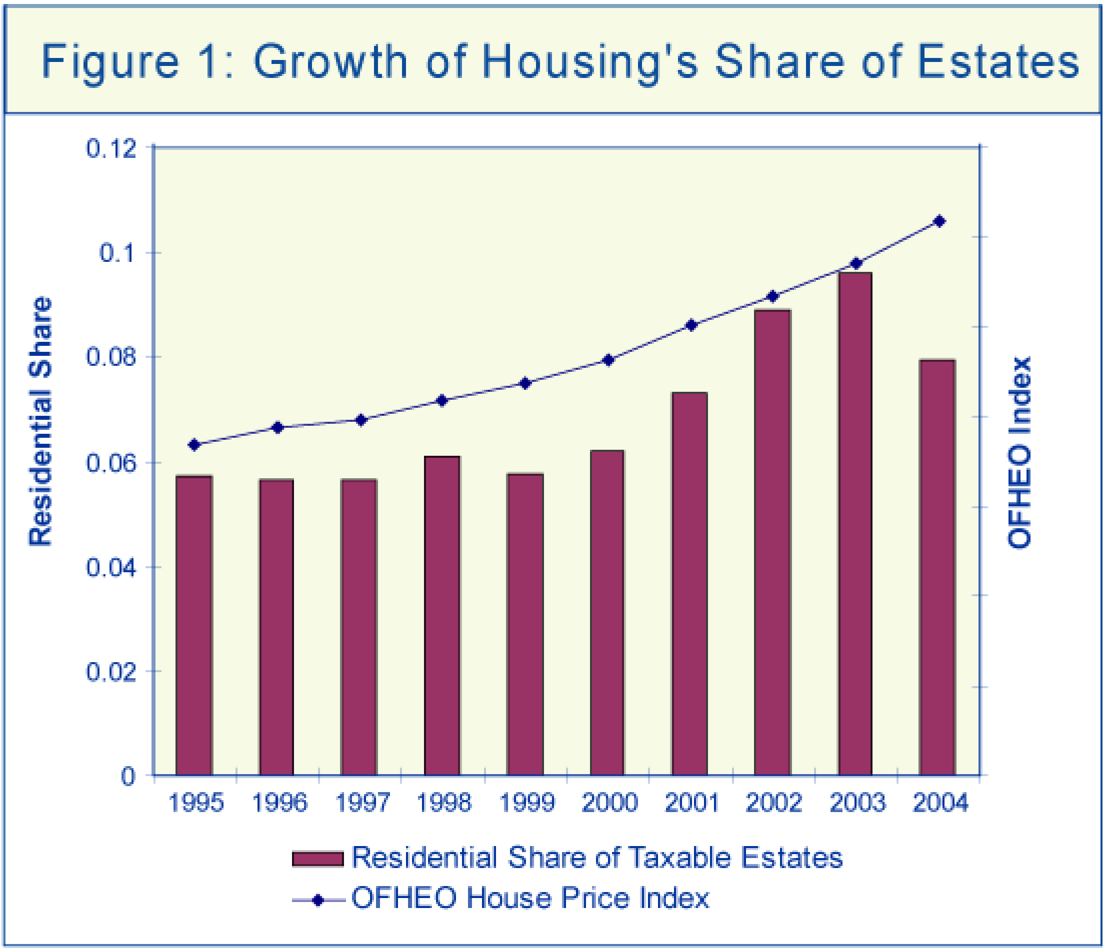
Source: IRS Statistics of Income

Employing the IRS SOI data, NAHB estimated the amount of estate tax liability that is due to personal residences within an estate. In general, these dollar amounts represent taxes on homes in the same manner as any other property tax. The estimates in the Table 4 indicate that taxes on residences nearly tripled between 1995 and 2003.

Table 4: Residence Liability	
Year	**Estate Tax Liability due to Personal Residences ($ Millions)**
1995	$678
1996	$818
1997	$939
1998	$1,243
1999	$1,317
2000	$1,509
2001	$1,716
2002	$1,896
2003	$1,981
2004	$1,708

Source: IRS Statistics of Income

The preceding tables clearly indicate the growing role of housing as a determinant of estate tax liability. Graphing these data against the OFHEO House Price Index reveals one reason for this growth has been the recent substantial increases in the price of owner-occupied housing.



As noted earlier, housing's share of taxable estates fell in 2004. There are two possible explanations for this effect. First, the housing share increases from 2000 to 2003 were not in fact due to any housing-related reason, but rather were due to the decline of stock prices that accompanied the 2001 recession [4]. According to this explanation, the decline in stock prices reduced the overall share of estates allocable to financial wealth and correspondingly increased the share due to housing, especially as housing prices were increasing during this period. However, this explanation would require the estimated dollar amount of estate taxes due to housing to increase or at least remain constant in 2004 (See Figure 2 in the next page).

However, as seen in Figure 2, the total estimated estate tax liability associated with housing also fell in 2004. This decline is likely due to a second potential explanation: EGTRRA estate tax policy changes and how they affected home-owning marginal estate taxpayers. EGTRRA increased the 2004 estate tax exemption amount from $1 million to $1.5 million. This increase prevented certain marginal estate taxpayers from incurring estate tax liability. For both the share and level of estate revenue allocable to housing to fall, it must be the case that these marginal taxpayers held a greater share of their wealth in housing than larger taxpaying estates. Indeed, from 2001 to 2002, after the first increase in the exemption amount due to EGTRRA, the number of estate taxpayers fell 14%. However, the number of estates reporting housing wealth fell 21%.

Housing and the Estate Tax in 2011

Due to the sunset associated with the EGTRRA provisions, in 2011 only a $1 million exemption amount will apply to taxable estates. Given the recent history of house price appreciation, as well as price appreciation expected between now and 2011, this set of estate tax rules will place many homeowners at increased risk of estate tax liability simply due to the appreciation in the value of their homes.

To determine how many households this will affect, this paper estimates the number of homes expected to exceed $1 million in market value in 2011. Homes with market value of at least $1 million will not automatically be subject to estate taxes, as the amount of wealth transferred will be reduced by the amount of mortgage debt allocable to the home. However, for high-income and senior households, the mortgage amount is likely to be relatively small. Indeed, according to the

Census Bureau's 2005 American Community Survey (ACS), 24% of all homes with market value in excess of $500,000 have no mortgage or home equity loan debt at all.

This analysis begins with the distribution of home values from the 2005 ACS. Table 5 reports the national count of homes by market value. State values may be found in the appendix of this paper.

Table 5: House Values	
House Market Value	**Number of Homes**
Less than $10,000	1,030,363
$10,000 to $14,999	614,061
$15,000 to $19,999	592,424
$20,000 to $24,999	644,550
$25,000 to $29,999	675,944
$30,000 to $34,999	763,386
$35,000 to $39,999	784,831
$40,000 to $49,999	1,689,938
$50,000 to $59,999	2,026,743
$60,000 to $69,999	2,364,598
$70,000 to $79,999	2,749,363
$80,000 to $89,999	3,194,185
$90,000 to $99,999	3,081,275
$100,000 to $124,999	6,626,895
$125,000 to $149,999	6,272,881
$150,000 to $174,999	5,787,331
$175,000 to $199,999	4,359,340
$200,000 to $249,999	7,336,716
$250,000 to $299,999	3,858,309
$300,000 to $399,999	7,067,409
$400,000 to $499,999	4,385,243
$500,000 to $749,999	5,121,026
$750,000 to $999,999	1,803,757
$1,000,000 or more	1,488,414
Total	74,318,982

Source: 2005 American Community Survey

According to these data, nearly 1.5 million households own a home with a market value in excess of $1 million. To provide the corresponding estimate for 2011, we use the 20-year average of the OFHEO House Price Index and the short-term NAHB forecast of the index to model nominal price appreciation for housing. NAHB forecasts that the OFHEO index will increase 8.1% for 2006, 0.0% for 2007, and 1.2% for 2007. The index increased 13.3% for 2005. For price appreciation after 2007, we use the 20-year OFHEO index average, which is equal to 5.6% [5]. Together, these yield an expected average annual price increase of 5.6%. Consequently, we adopt a conservative assumption of 5% nominal annual price increase.

Under this assumption, homes in the $750,000 to $1,000,000 range in 2005 will be worth at least $1 million in 2011. An accounting must also be made for the net increase in the housing stock. NAHB forecasts that the annual net increase in the housing stock will be 1.07% (1.47% increase in gross stock). Again we adopt a conservative 0.75% annual increase due to the focus at the high end of the market for the purpose of this analysis. The production of high priced homes is subject to greater variation during downturns in the homebuilding market.

Using these parameters and the 2005 ACS data, NAHB predicts 3.443 million housing units will exceed $1 million in market value in 2011. As detailed below, while the estate tax will not be an immediate issue for most of these households, the fact that these households are in the range of the estate tax in part due to housing wealth, suggests that these households will need to consider the consequences of the estate tax rules. This consideration requires expenditure on estate planners or accountants. Hence, a common criticism made even by economists who favor a strongly progressive tax system is that the estate tax is a particularly poor method of raising revenue for the government in economic efficiency terms.

It is common for proponents of the estate tax to cite estimates regarding the relatively small number of actual estate taxpayers. What these estimates ignore is the fact that the estate tax imposes a very real economic cost in terms of administrative expenses and investment decisions in order to minimize future tax liability. These costs are borne by individuals who in the case of their death might be subject to the estate tax. This is the complete set of individuals who bear those economic and tax costs directly related to the estate tax. This group is considerably larger than the actual number of estate taxpayers, and it will grow sharply in 2011 due to, in part, housing.

To estimate the number of estates in 2011 for which our analysis will apply requires estimating the number of deaths for that year. Center for Disease Control (CDC) data indicate that the 2003 U.S. mortality rate is 8.4 per 1000 residents [6]. Using the CDC and 2005 American Housing Data, reported in Table 6, we calculate the corresponding mortality rate for homeowners is 14.8 per 1000.

Table 6: Homeowner Mortality Rates

Age	Mortality Rate per Thousand	Householders
Under 25	0.8	1,436,605
25 - 34	1.0	9,191,330
35 - 44	2.0	15,416,151
45 - 54	4.3	17,310,180
55 - 64	9.4	13,791,074
65 - 74	22.6	9,150,947
75 - 84	54.4	6,648,438
85 and above	145.9	2,005,243

Sources: 2003 CDC data and 2005 American Housing Survey

Consequently, we forecast that approximately 50,850 total estates will own a home with a market value of $1 million or more in 2011. Mindful that the Joint Committee on Taxation (JCT) estimates that there will be approximately 110,000 estate taxpayers in 2011; our estimate indicates that 46% of estate taxpayers owe their estate taxpaying status to housing wealth alone. Indeed, if Congress does not reform the estate tax, 2011 will see a wave of estates for which housing wealth serves as a tipping point for the purpose of determining estate taxpaying status. Just as the AMT is increasingly, and unexpectedly for some, an issue for middle-class taxpayers, so the estate tax will be an unwelcome surprise in 2011 and thereafter. For example, JCT forecasts the number of taxpayers affected by the AMT will quadruple from 3.6 million in 2005 to 14.8 million in 2011. Over the same period the number of estate tax payers whose tax status may be determined by housing wealth alone will increase by a factor of five, from perhaps 10,000 to 50,850.

Non-Housing Wealth Considerations

Our analysis thus far understates the impact of housing by not factoring in all other household wealth for the purpose of determining the number of affected estates. In general, households distribute their wealth across housing, financial holdings and other asset categories. To examine these holdings in total, we use the Federal Reserve's 2004 Survey of Consumer Finances to report the median net worth of households as classified by the market value of their home. Average net worth is the median of total net wealth for households [7]. This measure includes assets, such as housing, and all debts including any mortgage debt. Table 7 demonstrates the importance of both homeownership and financial investments to household wealth.

Table 7: House Value and Net Worth

Primary Residence Market Value	Households (millions)	Average Net Worth
Less than $50,000	8.1	$31,100
$50,000 to $100,000	14.5	$86,000
$100,000 to $150,000	14.9	$132,500
$150,000 to $200,000	11.1	$205,100
$200,000 to $250,000	6.7	$265,000
$250,000 to $350,000	8.4	$388,200
$350,000 to $450,000	5.2	$566,900
$450,000 to $550,000	2.9	$605,000
$550,000 to $650,000	1.3	$1,017,250
$650,000 to $750,000	1.0	$1,180,800
$750,000 to $1,000,000	2.0	$1,374,800
$1,000,000 to $1,500,000	0.6	$2,895,700
$1,500,000 to $2,000,000	0.3	$4,725,190
$2,000,000 to $2,500,000	0.1	$8,959,400
$2,500,000 to $5,000,000	0.2	$9,168,800
$5,000,000 and higher	0.1	$16,458,300

Source: 2004 Survey of Consumer Finances

From these data, given historical returns to wealth, many homeowners with houses valued between $450,000 to $550,000 will be at risk of estate tax liability in 2011 due to their total household wealth. We forecast at least 7.05 million households will be in this range, with perhaps 104,000 actual estate taxpayers, which is close to the JCT estimate of 110,000 estate taxpayers in 2011.

This table illustrates the central point of this paper: for estates, with close to $1 million in total wealth, housing wealth will increasingly be the decisive determinant of estate tax liability. The estate tax is not just for the wealthy; upper middle-class homeowners are at risk as well.

Footnotes:

[1] Robert D. Dietz and D. Haurin. 2003. "The Social and Private Micro-Level Consequences of Homeownership." Journal of Urban Economics 54(3) 401-50.

[2] A credit is available for state estate taxes paid.

[3] The billions of dollars allocable to personal residences reported within taxable estates should eliminate the incorrect view that personal residences are not commonly part of estates, whether due to life-cycle related sales of homes or complicated and perhaps expensive estate planning techniques. Indeed, due to the Internal Revenue Code Section 121 principal residence exclusion, the effective benefit offered by the step up in basis is smaller for personal residences than for other forms of wealth, thus making it more likely that homes will be held until death.

[4] As an example, from January 1, 2000 to January 1, 2003, the Dow Jones Industrial Average declined 20%.

[5] Note this is the low value for similar statistics. The 30-year average is 6.3% and the 10-year average is 7.4%.

[6] CDC/NCHS, National Vital Statistics System, Morality. 2003 Data.

[7] Average net worth, as calculated by the mean, provides a larger estimate than the median. Use of the mean would be appropriate if we were examining the total dollars involved, as would be the case for a revenue estimate. However, for the present analysis we are interested in examining the number of households affected. Use of the mean would overstate the number of households exceeding the exemption amount by providing too much weight to households at the top of each category.

[*] For more analysis regarding these policies, consult Local Use of the Mortgage Interest and the Real Estate Tax Deductions and Mortgage Revenue Bonds and Mortgage Credit Certificates.

[**] For more discussion regarding the estate tax, consult NAHB's tax issues webpage.