THE HAMILTON PROJECT
Advancing Opportunity, Prosperity and Growth

POLICY BRIEF NO. 2007-07 JUNE 2007

Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax

THE ESTATE TAX, a fixture of the federal tax system for more than ninety years, is set for repeal under a 2001 law, but in a bizarre way: it will disappear in 2010, only to return one year later with a different rate structure. This situation creates vast uncertainty, but also provides a window of opportunity for reforming this much-debated tax.

In a discussion paper for The Hamilton Project, Lily Batchelder of the New York University School of Law calls for seizing this moment to revolutionize the gift and bequest taxation system. Her revenue-neutral proposal would replace the estate tax with an inheritance tax. The tax would apply to lifetime inheritances exceeding $2.3 million, and it would be paid by heirs instead of donors, at a rate equal to the heir's marginal income tax rate plus 15 percentage points. Batchelder argues that this new approach would better reflect a taxpayer's ability to pay, encourage broader sharing of wealth, and simplify the tax law. The number of people affected by the inheritance tax would continue to be miniscule. In fact, the number of heirs who see their inheritances reduced by the tax on bequests each year would decline from twenty-two thousand to fourteen thousand a year.

Although the number of people affected is small, the estate tax has played an important role in contributing to the equity of the U.S. tax system. Adhering to this philosophical foundation, Batchelder argues that her proposal would further enhance the fairness, efficiency, and simplicity of the wealth transfer taxation system.

THE BROOKINGS INSTITUTION 1775 Massachusetts Avenue NW, Washington, DC 20036

THE CHALLENGE

Enacted in 1916, the estate tax currently imposes a tax of 45 percent on lifetime gifts and bequests that exceed $2 million (although transfers to spouses and charities are not taxed at all). Under current law, the estate tax will disappear in 2010 and reappear in 2011 with a $1 million exemption and a top marginal tax rate of 55 percent. The related gift tax applies to wealth transfers made during a donor's life to prevent donors from avoiding the estate tax by giving during their lifetimes. Combined, the estate and gift taxes have generally accounted for 1 to 2 percent of annual federal revenues, and they totaled $28 billion in 2006.

Batchelder begins with the premise that there are compelling reasons to tax large wealth transfers, especially in light of today's stark realities. Inequality in the United States is extensive and rising, and wealth disparities are even more extensive than income disparities: the wealthiest 1 percent of individuals own one-third of all assets. Inherited wealth represents 15 to 30 percent of all wealth, suggesting that inheritance is a significant source of inequality. Batchelder argues, however, that the current gift and estate tax (collectively referred to here as the estate tax) could be reformed to be simpler, more efficient, and more true to its philosophical premise of taxing privilege.

> The current system privileges gifts and bequests over all other income received—whether from work, saving, or lottery winnings—by exempting them from the income tax.

Batchelder outlines how the current system, as it stands today, could be strengthened:

Equity. While an estate tax accomplishes the basic purpose of taxing large transfers, Batchelder argues that it could be better at distinguishing between heirs who receive ordinary gifts and bequests and those who receive the largest transfers, as well as distinguishing between heirs who are less well off and those who are affluent. Despite levying taxes on wealth transfers, the current tax system still effectively privileges gifts and bequests over all other income received: from the heir's perspective, gifts and bequests are technically tax free. Even when the estate tax burden is taken into account, inherited income is taxed at an average rate of 2.5 percent, much less than the tax rate on income from nearly all other sources—whether from work, saving, or lottery winnings.

Efficiency. A first set of inefficiencies stems from the estate tax's treatment of accrued gains. Normally, if a person sells an asset like a stock, she has to pay taxes on the capital gain, which is the difference between the price for which she sells the stock and the price at which she bought the stock (i.e., the basis of the stock). But if she holds on to the asset until death, all of the gain in value escapes capital gains taxes. If her heirs eventually sell the asset, they only pay taxes on the capital gain relative to the value of the asset on the date of death (i.e., the "stepped-up basis"). By contrast, if the asset is transferred during the donor's lifetime, rather than at death, the full increase in the asset's value since the donor acquired it will be carried over. The heirs will eventually have to pay taxes on this full capital gain. As a result, the treatment of capital gains, in conjunction with the estate tax, distorts behavior by creating an incentive for donors near death to hold on to appreciated assets purely for tax reasons.

> All the evidence suggests that inheritance is a significant driver of economic and wealth disparities in America, with inherited wealth representing 15 to 30 percent of all wealth.

Consistency and simplicity. The current system assesses different taxes based on when wealth is transferred (e.g., during life or after death), who is making the transfer (e.g., one parent transferring everything or each parent transferring a part), or how the transfer is made (e.g., directly or through a contingent trust), even if economic differences are negligible. Batchelder points out that these complicated and superficial distinctions reward tax planning and leave taxes substantially affected by how sophisticated taxpayers are in structuring their affairs. The myriad rules and regulations necessary to manage this confusing system add complexity to the tax code and impose a greater compliance burden on taxpayers. Meanwhile, attempts to close the loopholes in the current system inevitably open up others.

A NEW APPROACH

In response to these shortcomings, Batchelder proposes a simple yet fundamental change in how wealth transfers are taxed—replacing the estate tax with an inheritance tax. In addition, she proposes repealing stepped-up basis for bequests, giving heirs the responsibility to pay taxes on any capital gains for which the donor was never taxed. Batchelder argues that focusing on the economic status of the heir rather than that of the donor in determining tax burdens enables her proposed tax to be more efficient, simpler, and more equitable than the estate tax. But while Batchelder's plan marks a major change, it also deliberately maintains a large degree of stability relative to current law and incorporates components that have all been successfully implemented in the United States and abroad.

Replacing the Estate Tax with an Inheritance Tax

As opposed to the current estate tax, which is assessed on the donor and based on the size of the bequest, Batchelder proposes taxing the value of the inheritance at a rate linked to the heir's income tax bracket. The inheritance tax would only apply when cumulative lifetime inheritances exceeded $2.3 million. Inherited amounts above that threshold would be included as taxable income and would be subject to a surtax of 15 percentage points. The inheritance could be spread out over the current year and the previous four years to smooth out the income spike and the corresponding tax burden. In addition, each year an heir could receive $5,000 in gifts and $25,000 in bequests that would be exempted from the $2.3 million threshold. (All these thresholds would be adjusted for inflation.) Tax exemptions for transfers to spouses and charities would remain as they are today.

To illustrate, imagine a person who receives a bequest of $3 million and has not received inheritances exceeding the annual bequest exemption ($25,000) in any prior year. The heir would have to include only $700,000 of the bequest in her taxable income (i.e., $2.3 million would be exempted). The $700,000 would be taxed under the same rate structure as her other ordinary income plus the 15 percentage point surtax. Because the income tax brackets rise with income, this might mean that the taxable portion of her bequest would fall within a higher tax bracket than, for example, her income from working, because she received it all at once. In order to limit this effect, the taxpayer could elect to file as if she received only $140,000 of taxable inheritance in the current year and in each of the previous four years.

The $2.3 million threshold is a high one, and only a small fraction—estimated to be fewer than 0.2 percent of

Key Highlights

The Context

The current estate tax helps to enhance the progressivity of the U.S. tax system and promote opportunity for all, but the proposed inheritance tax could achieve this goal in a simpler, more efficient, and more equitable way.

Main Features

Batchelder's inheritance tax proposal:

- Replaces the estate tax with an inheritance tax and substantially equalizes the treatment of gifts made during life and bequests occurring at time of death
- Taxes cumulative lifetime inheritances in excess of $2.3 million at an heir's income tax rate plus 15 percentage points
- Is revenue neutral relative to 2009 law
- Exempts up to $5,000 in gifts and $25,000 in bequests annually

Principal Advantages

Batchelder's proposal would:

- Make the tax system better attuned to an heir's level of privilege and ability to pay
- Encourage broad sharing of wealth, as donors could lower the overall tax burden on their estates by giving more broadly and to those more in need
- Increase efficiency and simplicity by reducing tax planning opportunities and the rules needed to contain them, aligning tax policy with positive incentives for work and giving, and eliminating distortions to behavior caused by loopholes in capital gains taxation

heirs annually—would be subject to the tax. Moreover, an analysis of her proposal provided by the Tax Policy Center (TPC) shows that this high threshold would raise the same amount of tax revenue as the 2009 law, while limiting the tax's reach to the vast inheritances that undermine American ideals of equal opportunity.

An especially notable benefit identified by Batchelder is that her proposal would be better attuned to the heir's unearned advantages and ability to pay, because the tax would be based on how much the heir had inherited and her income tax bracket. Though Batchelder notes that the estate and inheritance taxes generally affect only privileged and well-off members of society, and that both are ultimately borne by the recipient for the most part, she also finds that differences between the two taxes emerge at the level of the individual: the estate tax rate depends on how successful and generous the heir's donor was, while the inheritance tax rate depends on the value of gifts and bequests inherited by the heir and her level of need. Because of this difference, Batchelder argues that the inheritance tax strengthens the fairness of the tax system.

Batchelder's proposal also addresses other difficult aspects of the current system such as the politically thorny issue of illiquid assets, including family businesses and farms. Batchelder suggests that the taxes on such assets surpassing the value of the liquid assets received could be deferred—though with interest at a market rate—until the illiquid assets were sold. This would eliminate the possibility that an heir would need to sell an inherited family business in order to pay the taxes on it, while minimizing incentives or disincentives to hold wealth in illiquid forms.

Repealing Stepped-Up Basis

Imagine an asset originally valued at $1 million whose value rises to $3 million by the time of its owner's death. Under the current estate tax, the bequeathed asset would have a stepped-up basis, meaning that no income tax would ever be due on the $2 million

> Only a small fraction of heirs—estimated to be fewer than 0.2 percent of people receiving a bequest in a given year—would have to pay the inheritance tax.

capital gain. If the asset had been given as a gift during the donor's life, the recipient instead would have received a carryover basis, meaning he would owe tax on the entire capital gain upon the eventual sale of the asset.

Batchelder's proposal would replace stepped-up basis with carryover basis, treating all bequests the same as it treats gifts made during life. The potential revenue at issue is substantial. Unrealized capital gains represent 36 percent of the total expected value of all estates and 56 percent of the value of estates worth more than $10 million. Moreover, an efficient tax system should not distort investment decisions, such as when to sell an asset; such decisions should be made based on risk and return characteristics, not based on potential tax breaks. Batchelder argues that replacing stepped-up basis with carryover basis furthers this goal. While the change could encourage heirs to hold on to appreciated assets, she argues that this outcome would be less distorting than today's system, which encourages donors to hold on to unproductive assets purely for tax reasons. Batchelder also asserts that the new system would be fairer: repealing stepped-up basis would treat all gains on assets equally—in other words, taxing them once—and would not grant privileges to donors simply because of their superior tax know-how.

Likely Effects and Benefits

Batchelder finds that shifting from the current estate tax system to the proposed inheritance tax system would have several important effects, in addition to simplifying the tax system. Even under revenue-neutral implementation (as Batchelder proposes), the new taxation system would—among other things—shift the burden of taxes on gifts and bequests between heirs and potentially affect donor and heir incentives for work, saving, and giving.

In order to evaluate these effects, Batchelder draws on academic literature as well as on a revenue and distributional analysis of her proposal provided by the Tax Policy Center (TPC). The TPC analysis takes data from individual income tax returns to model what bequests would be made, how they would be distributed, and how they would be taxed, both under the current law and under Batchelder's proposal. Though data limitations lead to a substantial margin of error, this analysis provides a useful indication of the proposal's likely effects. The model's focus is the replacement of the estate tax with the proposed inheritance tax and does not include the proposal's other provisions, such as those regarding illiquid assets or replacing stepped-up basis with carryover basis.

Revenue and Distributional Analysis: Distributing tax burdens more fairly. Batchelder's proposal would raise the same amount of tax revenue as would be raised by the 2009 law, but the distribution of the tax burden would likely change considerably, most notably because taxation would be sensitive to the size of the heir's inheritance as well as her ability to pay. To see how the two systems would differ and encourage broader giving, consider the following example. If an heir received all of a $3 million estate, there would be no estate tax liability (the current law exemption level rises to $3.5 million in 2009), but the heir would pay inheritance tax on $700,000 of the inheritance (the difference between $3 million and the $2.3 million exemption in Batchelder's proposal). By contrast, if a person bequeathed a $10 million estate

> Because the inheritance tax would be based on the heir's income tax bracket and the inheritance size, it would be better attuned to the heir's ability to pay and her level of privilege.

to five heirs, the estate tax would be levied on the entire $10 million and thus reduce the size of each inheritance, but each heir would pay no inheritance tax (since one-fifth of $10 million falls below the $2.3 million exemption). The distributional shift represented by this example is not just theoretical. The TPC analysis confirms that on the individual level, heirs would face quite different tax rates under the estate tax and the proposed inheritance tax.

Both the estate tax and the inheritance tax are highly progressive overall, but the TPC analysis shows that Batchelder's proposed inheritance tax is even more progressive on two main counts: it assigns higher taxes to heirs receiving bigger inheritances, and it assigns higher taxes to heirs with higher incomes. Heirs with economic income (defined as the heir's adjusted gross income plus one-fifth of the inheritance) of less than $500,000 pay lower taxes on inheritances under the proposed system, while those with more than $500,000 pay higher taxes. In addition, the TPC analysis finds that roughly two-thirds of heirs would have lower taxes under Batchelder's proposal. Finally, to the extent that the inheritance tax actually changes donor behavior—by creating incentives for donors to give more widely and to those with lower income—it would be even more progressive.

In total, the inheritance tax would affect only a small fraction of all heirs (similar to the estate tax). According to the TPC, however, the percentage of heirs bearing some tax burden from bequests would decline under the proposal: from 0.3 percent (twenty-two thousand heirs) under the estate tax to 0.2 percent (fourteen thousand heirs) under the inheritance tax.

Effects on Work, Saving and Giving: Improving efficiency. Based on an analysis of the empirical literature, Batchelder predicts that relative to the estate tax her proposal would have a limited effect on heir labor supply, as well as donor levels of work, saving, and giving, largely because the proposal is revenue neutral. But theory also suggests that the inheritance tax could induce somewhat more work, as donors would not face a perceived tax burden (which they might interpret as a tax reduction). Although donors should rationally respond the same regardless of whether the tax on bequests is paid by them or their heirs, evidence shows people are influenced by who actually pays the tax and not just who bears the ultimate tax burden. Finally, Batchelder believes her proposal would lead to changes in giving patterns, notably by inducing donors to give more broadly and to those who are more in need.

Effects on Compliance and Administrative Burdens: Improving efficiency and simplicity. Batchelder also looks at the effect the new tax system would have on taxpayer compliance costs. Although there could be a small increase in direct compliance costs because more taxpayers would have to provide information about inheritances even if no tax were ever owed, she argues that these costs would be swamped by the many ways that the proposal would curtail tax-planning incentives and corresponding economic inefficiencies. By curbing tax-planning opportunities, Batchelder's proposal could also reduce the rules needed to constrain them, simplifying the tax code and reducing the government's burden. Batchelder

also argues that the inheritance tax would further simplify the wealth taxation system by eliminating some of the difficult valuation problems plaguing the estate tax system, under which tax burdens must often be determined before inheritances are actually transferred to beneficiaries.

Does the Proposal Go Far Enough?

According to the revenue estimates in Batchelder's paper, the average tax rate on inheritances under the proposal (and 2009 estate tax law) is only 2.5 percent. Relative to the average tax rate on noninherited income of 8.7 percent, this may seem unduly low. While revenue neutrality is useful for minimizing political opposition to the reform, Batchelder notes that her proposal could be used to raise tax revenues, or even to cut taxes on noninherited income, if the specifications of her proposal were changed.

CONCLUSION

Economic inequality is a major problem in the United States. Batchelder's proposal is grounded in a belief that wealth transfer taxes are a crucial component of a fair income tax system. She moves the traditional estate tax debate forward, however, by seeking to present an alternative way of taxing wealth transfers. Her plan determines tax allocations based on an heir's income and inheritance level rather than on a donor's decision to save or give. Switching to an inheritance tax would put the largest tax burdens on those most able to afford them just like all other personal income, whether from wages or from lottery winnings. Batchelder believes that this new tax system could reinvigorate public support for the taxation of wealth transfers while providing a simpler, more efficient, and more equitable end result that expands opportunity in America.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax,* which was authored by:

LILY L. BATCHELDER
Associate Professor of Law and Public Policy, New York University School of Law

Batchelder specializes in income taxation, wealth transfer taxation, income volatility, and social insurance. She received her J.D. from Yale Law School, her M.P.P. from the John F. Kennedy School of Government, and her A.B. from Stanford University.

Additional Hamilton Project Proposals

Additional Hamilton Project discussion papers and policy briefs on tax reform can be found at www.hamiltonproject.org, including:

- **Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment**
  This proposal addresses the perverse incentives and potential for abuses created by the current international tax system by using "formulary apportionment" to tax worldwide rather than country-specific income. The goal is to reduce complexity, close loopholes, and either lower corporate tax rates or raise tax revenues.
- **Rehabilitating the Business Income Tax**
  The current system for taxing business income is riddled with inefficient incentives, potential for abuses, and complexity. This proposal would address these problems and ensure that all capital income is taxed once and only once.
- **Achieving Progressive Tax Reform in an Increasingly Global Economy**
  As inequality has widened, the tax system has become less progressive, due to both recent policy changes and the failure to modernize taxation in light of the challenges posed by globalization and financial innovation. This strategy paper offers six principles to guide progressive tax reform in today's global economy.

The views expressed in this policy brief are not necessarily those of The Hamilton Project Advisory Council or the trustees, officers or staff members of the Brookings Institution.

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving economic policy in recent years—calls for fiscal discipline and for increased public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

The Hamilton Project Update

A periodic newsletter from The Hamilton Project is available for e-mail delivery. Subscribe at www.hamiltonproject.org.

The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

THE BROOKINGS INSTITUTION
1775 Massachusetts Avenue NW, Washington, DC 20036
info@hamiltonproject.org ■ 202.797.6279

Copyright © 2007 The Brookings Institution

THE HAMILTON PROJECT ADVISORY COUNCIL

GEORGE A. AKERLOF
Koshland Professor of Economics, University of California, Berkeley
2001 Nobel Laureate in Economics

ROGER C. ALTMAN
Chairman, Evercore Partners

HOWARD P. BERKOWITZ
Managing Director, BlackRock
Chief Executive Officer, BlackRock HPB Management

ALAN S. BLINDER
Gordon S. Rentschler Memorial Professor of Economics, Princeton University

TIMOTHY C. COLLINS
Senior Managing Director and Chief Executive Officer, Ripplewood Holdings, LLC

ROBERT E. CUMBY
Professor of Economics, School of Foreign Service, Georgetown University

PETER A. DIAMOND
Institute Professor, Massachusetts Institute of Technology

JOHN DOERR
Partner, Kleiner Perkins Caufield & Byers

CHRISTOPHER EDLEY, JR.
Dean and Professor, Boalt School of Law – University of California, Berkeley

BLAIR W. EFFRON
Partner, Centerview Partners, LLC

JUDY FEDER
Dean and Professor, Georgetown Public Policy Institute

HAROLD FORD
Vice Chairman, Merrill Lynch

MARK T. GALLOGLY
Managing Principal, Centerbridge Partners

MICHAEL D. GRANOFF
Chief Executive Officer, Pomona Capital

GLENN H. HUTCHINS
Founder and Managing Director, Silver Lake Partners

JAMES A. JOHNSON
Vice Chairman, Perseus, LLC and Former Chair, Brookings Board of Trustees

NANCY KILLEFER
Senior Director, McKinsey & Co.

JACOB J. LEW
Managing Director and Chief Operating Officer, Citigroup Global Wealth Management

ERIC MINDICH
Chief Executive Officer, Eton Park Capital Management

SUZANNE NORA JOHNSON
Senior Director and Former Vice Chairman, The Goldman Sachs Group, Inc.

RICHARD PERRY
Chief Executive Officer, Perry Capital

STEVEN RATTNER
Managing Principal, Quadrangle Group, LLC

ROBERT REISCHAUER
President, Urban Institute

ALICE M. RIVLIN
Senior Fellow, The Brookings Institution and Director of the Brookings Washington Research Program

CECILIA E. ROUSE
Professor of Economics and Public Affairs, Princeton University

ROBERT E. RUBIN
Director and Chairman of the Executive Committee, Citigroup Inc.

RALPH L. SCHLOSSTEIN
President, BlackRock, Inc.

GENE SPERLING
Senior Fellow for Economic Policy, Center for American Progress

THOMAS F. STEYER
Senior Managing Partner, Farallon Capital Management

LAWRENCE H. SUMMERS
Charles W. Eliot University Professor, Harvard University

LAURA D'ANDREA TYSON
Professor, Haas School of Business, University of California, Berkeley

WILLIAM A. VON MUEFFLING
President and CIO, Cantillon Capital Management, LLC

DANIEL B. ZWIRN
Managing Partner, D.B. Zwirn & Co.

JASON FURMAN
Director

Printed on recycled paper.