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Gale and Slemrod

Rethinking the Estate and Gift Tax

After enduring years of relative neglect, the estate tax has recently become the center of a vociferous policy debate. In 1999 and 2000, both Houses of Congress voted to abolish the tax, but could not override presidential vetoes. President George W. Bush has advocated its abolition. New legislation seems very likely in the near future.

In light of these issues, the Office of Tax Policy Research at the University of Michigan Business School and the Brookings Institution convened a conference in May 2000. The conference—attended by leading economists and lawyers—revolved around ten papers that addressed particular features of the estate and gift tax. The resulting volume, to be published by Brookings later this year, brings together those papers, formal comments by discussants, and an introductory survey. This report summarizes the issues and policy alternatives regarding estate taxes, with special reference to the papers presented at the conference.

Advocates of estate tax abolition see a morally repugnant tax that impairs economic growth, destroys small businesses and family farms, encourages spendthrift behavior, generates huge compliance costs, and leads to ingenious sheltering schemes. As an inefficient, inequitable, and complex levy, the so-called "death tax" is thought to violate every norm of good policy. Supporters of the tax believe the criticisms are overstated or wrong. They note that the tax is only levied on the estates of 2 percent of Americans who die—and only on those with substantial wealth. They believe that a highly progressive tax that patches loopholes, helps provide equality of opportunity, reduces the concentration of wealth, and encourages charitable giving cannot be all bad.

An intermediate strategy would be to reform the tax by raising the exemption, closing loopholes, reducing rates, and indexing for inflation. This strategy could resolve many of the problems that advocates of abolition perceive, while retaining the virtues raised by estate tax supporters.

The debates have increased in intensity and frequency, in part because of the stock market boom, an aging population, the budget surplus, and intensive lobbying, but also because the estate tax raises controversial issues. Besides its association with the rich and the dead, the estate tax epitomizes in extreme form the pervasive trade-off between equity and efficiency in the design of government policy.

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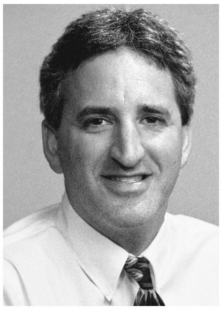

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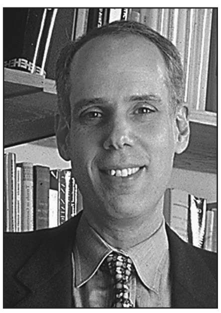

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The Pervasive Trade-Off

In addition, the tax raises issues as private as the nature of relationships between parents and their children, and as politically sensitive as the definition and implementation of equal opportunity and the limitations on the government's role in income redistribution.

Estate Tax Basics

Since 1976, federal law has imposed a linked set of taxes on estates, gifts, and generation-skipping transfers. Under current law, the executor of an estate must file a federal estate tax return within nine months of a person's death if the gross estate exceeds $675,000. Generally, the gross estate includes all of the decedent's assets, his or her share of jointly owned assets, life insurance proceeds from policies owned by the decedent, and gifts made during life in excess of an annual exemption that is currently set at $10,000 per donee per year. It is often possible to discount the valuation of assets by placing them in a mediated ownership form, such as a family limited partnership, rather than holding them on one's own account.

The tax allows deductions for transfers to a surviving spouse, charitable gifts, debts, funeral expenses, and administrative fees. Tax credits are given for gift taxes previously paid, for estate taxes that were recently paid on inherited wealth, and—to a limited degree—for state-levied inheritance and estate taxes. A unified credit currently exempts taxes on the first $675,000 of lifetime taxable transfers, a figure that will rise to $1 million by 2006. For estates above those amounts, the tax rate begins at 37 percent and rises to 55 percent on taxable transfers above $3 million. For estates with taxable wealth between $10 million and about $17.18 million, a 5 percent surtax takes back the benefit of a graduated rate structure and raises the effective marginal rate to 60 percent. Additional information on the history and structure of the tax, as well as the economic characteristics of decedents, may be found in the conference paper by Treasury Department economists Barry Johnson, Jackob Mikow, and Martha Britton Eller.

Transfer taxes raised about $28 billion in federal revenues in 1999 and are projected to raise over $400 billion between 2002 and 2011. Nearly all industrialized countries levy some kind of wealth transfer tax. But other than the United States, only the United Kingdom levies "pure" estate taxes; the others have an inheritance tax or a mixture of inheritance and estate taxes. In 1997, the United States ranked third highest among industrialized countries in terms of transfer taxes as a share of total revenues. But many industrialized countries have annual wealth taxes, which the United States does not.

Between Equity and Efficiency

Why Give Intergenerational Transfers?

An important theme to emerge from the conference is the simple but fundamental point that the effects of transfer taxes will depend on why people give transfers in the first place. Some bequests may be "accidents," in the sense that people accumulate assets to save for retirement, but they do not know how long they will live. Even if they do not plan or desire to give bequests, they may die before they expect to and end up bequeathing assets to descendants. Other bequests may be motivated by parental altruism toward their children. Some people may be motivated by the sheer joy of giving resources away. Finally, some bequests or transfers may represent a sort of payment by parents to their children in exchange for help and attention.

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Equity

Half of all estate taxes are paid by the estates of decedents with $5 million or more in wealth, and all estate taxes are paid by wealthiest 2 percent of decedents. Thus, if the burden of the tax is borne by donors, the tax is extraordinarily progressive. Many people claim, however, that the burden is really borne by the people who receive inheritances. However, as William Gale and Joel Slemrod report in their introductory survey, the recipients of inheritances from estates subject to the estate tax typically have very high-pre-inheritance incomes. Thus, even if the tax is borne by recipients, it is still a very progressive tax.

Another possibility is that the burden is passed along to others in the economy. But the conference paper by University of Michigan economist John Laitner shows that the tax is progressive, even allowing for its economy-wide effects. The estate tax also serves as a backstop to the income tax, taxing components of income—such as unrealized capital gains—that otherwise go untaxed.

Transfer taxes raise difficult issues of horizontal equity. Among donors with the same wealth, the taxes discriminate on the basis of how resources are spent, violating the notion that those with equal means should pay equal taxes. But among recipients with the same (non-inheritance) wealth, transfer taxes reduce the inequality of inheritances and thus ameliorate unequal opportunity. These two perspectives create irreconcilable differences in views concerning whether taxes on transfers are fair in principle.

Another issue is whether taxing at death is appropriate. Death is neither necessary nor sufficient to trigger transfer taxes. It is unnecessary because transfers between living persons can trigger gift taxes. It is insufficient because 98 percent of people who die pay no estate tax. While death may be unpleasant to contemplate, the costs of taxing at death do not appear to be significant, relative to taxation during life. Thus, to the extent that it really is a problem, taxation at death could be avoided by replacing the estate tax with equally progressive taxes imposed during life.

Efficiency

In his conference paper, Harvard University law professor Louis Kaplow shows that whether an estate tax is part of an efficient tax system—one that minimizes the economic cost per dollar raised—depends crucially on several factors, most notably on why people give transfers. For example, to the extent that bequests are "accidental," the estate tax is highly efficient, because the donor had no intention of leaving a bequest in the first place. On the other hand, if parents are altruistic toward their children, Kaplow shows that there may even be a case for *subsidizing* transfers, rather than taxing them. However, if society desires an equitable tax system as well as an efficient one, the case for an estate tax is improved, because the tax is highly progressive, and hence can "buy" a lot of equity. This suggests that simple descriptions of optimal tax policy toward transfers are difficult to establish.

Tax Avoidance and Evasion

Critics argue that the estate tax spawns a host of avoidance schemes and label the levy "voluntary." But it is hard to believe that financially sophisticated, wealthy households voluntarily part with upwards of $30 billion per year. Duke University law professor Richard Schmalbeck surveys a wide range of estate tax avoidance techniques and shows that although it is possible to avoid a significant amount of estate taxes, doing so typically requires people to give up control of their assets, which they are not inclined to do.

Estimates of the costs of complying with the estate tax vary enormously—from 7 percent of revenues to 100 percent—partly because the data and methodologies are flawed; the more reliable estimates are at the lower end of the range. In their contribution to the conference, economists Martha Britton Eller, Brian Erard, and Chih Chin Ho estimate an estate tax evasion rate of about 13 percent, and suggest that the true value is likely to be higher.

Effects on Saving, Labor Supply, and Entrepreneurship

Critics argue that the estate tax significantly reduces the saving, labor supply, and entrepreneurship that are essential to economic prosperity, but little evidence has been available to evaluate this claim. A distinctive feature of the volume is the presence of the three papers on wealth accumulation and the taxation of estates.

The University of Michigan's Laitner provides the most sophisticated simulation model of the economic impact of estate taxes to date, embedding them in an overlapping generations model which features individuals with altruistic bequest motives. He finds that removing estate taxes would have a small positive effect on the long-term ratio of capital to labor. William Gale and Federal Reserve Board economist Maria Perozek show that the impact of transfer taxes on saving, like the efficiency effects, will depend critically on why people give transfers. If bequests are unintentional, for example, estate taxes will not affect saving by the donor. But the reduction in net-of-tax inheritances received will cause recipients to consume less and thus save more. If bequests are motivated by altruism, the effects are ambiguous, but simulations suggest that the estate tax could actually raise saving under many circumstances.

Wojciech Kopczuk and Joel Slemrod, of the University of Michigan, show that in years with high estate tax rates, the total value of reported estates is generally lower than in years with low estate tax rates, holding constant other influences. Using data on specific decedents, they find that the tax rates that prevailed at either age 45 or ten years before death are more clearly (negatively) associated with reported estates than the tax rate prevailing in the year of death. These results could reflect the impact of estate taxes on the donor's saving or avoidance, or both.

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Other empirical work has shown that recipients of large inheritances increase their consumption spending and reduce their labor supply. By extension, if estate taxes reduce net-of-tax inheritances, they should reduce consumption—that is, raise saving—and raise labor supply by the recipient.

The impact of the estate tax on family-held businesses and farms has taken on a hugely disproportionate role in public policy debates. This issue is reviewed extensively in the introductory survey by Gale and Slemrod, but the basic points are straightforward. There is virtually no reliable evidence suggesting that the impact of estate taxes on businesses and farms is significant. Businesses and farms already receive substantial subsidies under the existing estate tax, not to mention subsidies under the income tax. The vast majority of estates have no business or farm assets, and only about 3 percent of estates have more than half of their wealth in businesses and farms. Most of the value of small businesses in estates consists of unrealized capital gains and would never be taxed were it not for the estate tax. These findings suggest that the case for existing business subsidies in the estate tax is weak, the case for expanding those subsidies is weaker still, and the notion that the estate tax should be abolished because of its alleged effect on businesses and farms is completely misguided.

Effects on Gift Giving and Charity

Although estate and gift taxes are said to be "unified," a number of features of the tax code favor gifts over bequests, and evidence suggests that changes in the tax treatment of gifts and bequests affect the composition and timing of transfers. In their paper at the conference, economists Jonathan Feinstein and Chih Chin Ho extend this work by showing that an individual's health status (and by extension, the likelihood of dying and facing estate taxes), has important effects on giving behavior. They document a series of patterns among saving, gift giving, and health that suggest that a significant amount of giving is tax-motivated.

Several analyses find that the estate tax deduction for charitable donations generates a significant increase in contributions at death. The estate tax may also encourage charitable giving during life, too, since this would reduce both income and estate taxes. David Joulfaian's contribution to the volume matches estate tax returns filed between 1996 and 1998 with income tax returns for the same people filed between 1987 and 1996. Joulfaian, a Treasury Department economist, finds that the magnitude of giving during life relative to giving at death changes markedly with wealth, with the extremely wealthy giving a much greater share of their contributions at death. His estimates also document that giving at death is sensitive to the marginal tax rates applied in the estate tax, and so indicate that abolishing the tax would lead to a significant decline in charitable bequests.

Proposals for Change

Policymakers have considered numerous changes to the estate tax in recent years. The most radical reform would be to abolish the tax. This removes the existing problems, but may create serious additional issues. It would eliminate what is by far the most progressive tax instrument in the federal tax arsenal, just after an extended period over which the distributions of income and wealth have become far more skewed. It could hurt non-profit organizations. It may not even raise saving, labor supply, or growth, as its advocates hope, and would probably reduce state tax revenues as well. Finally, abolition would expose a gaping loophole with regard to capital gains in the income tax and would open up other possibilities for tax avoidance—and resulting revenue loss—under the income tax.

Abolition could be coupled with the extension of the capital gains tax to the gains accrued but unrealized at death. This proposal, however, would raise only about a quarter of the revenue of the estate tax, and would be much less progressive, as economists James Poterba and Scott Weisbenner demonstrate. In addition, this option would contain many of the complexities of the estate tax, and so is neither attractive nor likely.

The bill that Congress passed in 2000 tied elimination of the estate tax to another significant change in the taxation of capital gains called "carryover basis." Under the provision, heirs would assume the decedent's basis for capital gains purposes. Exemptions would have applied to transfers below $1.3 million and to interspousal transfers of $3 million. This proposal, however, would raise almost no revenue, and it would be difficult to administer, in part because records would have to be kept for an even longer period of time and across generations. A similar item was passed in the late 1970s, but was repealed before it ever came into effect partly because of anticipated implementation problems.

Another reform would be to replace taxes on estates and gifts given with taxes on gifts and inheritances received, as is the practice in several U.S. states and many foreign countries. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more recipients reduces the total tax burden and thus encourages the splitting of estates. In addition, a unified tax system would tax all sources or all uses of income. Currently, the income tax imposes burdens on sources of income and the estate tax falls on a particular use of income. In contrast, the income tax, combined with a tax on inheritances and gifts received, would cover all major sources of income over the lifetime, and placing the statutory burden of the tax on recipients rather than the donor may reduce some of the moral outrage generated by estate taxes.

Perhaps the most plausible reform would be to follow the strategy invoked for income taxes in the Tax Reform Act of 1986: raise the exemption level, close loopholes, and cut rates. Raising the exemption would reduce the number of people paying the tax while still taxing the "truly wealthy," and chipping away at the concentration of wealth. It would also help smaller family-owned businesses, but without the horizontal equity problems that are involved in giving preferential treatment to business assets. Closing loopholes by treating different assets in a more similar fashion would reduce sheltering opportunities, and thus make the tax simpler and fairer. Modestly reducing rates would reduce the incentive to shelter or change behavior in the first place. In addition to these changes, indexing the effective exemption and the tax brackets for inflation would automatically keep the tax burden at any particular real wealth level constant over time.

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Conclusion

The appropriate role and effects of transfer taxes are still open questions. Any conclusion about the appropriate taxation of intergenerational transfers must take into account transfer motives, the political and technical limitations on other tax instruments, the limited knowledge about such taxes that is currently available, and other factors.

In a real world filled with practical difficulties, political compromises, and economic uncertainties, it may take a variety of taxes to meet social goals, and the estate tax may well play a small but important role in the government's portfolio of tax instruments. It adds to progressivity in a way that the income tax cannot easily do because of capital gains issues, and that society may choose not to do via income taxes, because taxing at death may have smaller costs than taxing during life. The supposed negatives of the estate tax—its effects on saving, compliance costs, and small businesses—lack definitive supporting evidence and in some cases appear to be grossly overstated. Additionally, there are some presumed benefits from increased charitable contributions and improved equality of opportunity.

Nevertheless, it is equally clear that there is a problem. A tax with high rates and numerous opportunities for avoidance is ripe for reform. Even given the goals and constraints noted above, many people feel that transfer taxes could be better structured. Many others feel that having no transfer taxes would be preferable.

Economic analysis cannot fully resolve these issues. What it can do is clarify the various trade-offs involved in tax policy decisions, illuminate which value judgments—about which

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economics has no say—are involved, and identify the crucial conceptual and empirical issues. Compared to many tax questions, the tradeoffs that affect estate taxes are more difficult to analyze, because they involve more than one generation. The value judgments are more difficult, because they involve life-and-death and parent-child issues, about which people have strong opinions. Empirical analysis is more difficult, because the data are more elusive and the relevant behaviors span at least a lifetime.

The studies in the forthcoming conference volume address all of these issues and rethink the estate and gift tax in a rigorous way. It is our hope and expectation that the papers that emerged from the May conference will provide a solid base of knowledge to inform future policy discussions and a springboard to encourage continuing analysis of transfer tax issues.

The conference volume,* Rethinking Estate and Gift Taxation*, edited by William G. Gale, James R. Hines, Jr., and Joel Slemrod, will be published by Brookings later this year. For copies of the papers presented at the conference, contact the Office of Tax Policy Research at (734) 763-3068 or at otpr@umich.edu.

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