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

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The Brookings Institution

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Abstract

The repeal of the estate tax for one year only in 2010 creates vast uncertainty but also provides an opportunity to reconsider the taxation of gifts and bequests. This paper proposes replacing the estate tax with an inheritance tax. Heirs receiving lifetime inheritances greater than $2.3 million would include in income and pay a 15 percentage point surtax on the excess. The proposal would also replace stepped-up basis with carryover basis for bequests. As under the estate tax, the fraction of heirs affected would be miniscule, falling from three to two in 1,000.

The proposal has a number of advantages relative to the estate tax. It would reward donors who give more broadly. It would enhance efficiency and reduce compliance costs by curbing tax planning and the rules needed to contain it. Cross-national experience also suggests it would be administrable. Most importantly, the proposal would lower taxes on heirs receiving smaller inheritances and those with moderate incomes, making the tax system better attuned to unearned advantage and ability to pay. At an individual level, the distribution of tax burdens would change considerably: only 5 percent of the estate tax rate for an heir is accounted for by her inheritance tax rate, and vice versa, and each tax would raise 14 percent of revenue from heirs facing no tax burden under the other. The proposal is revenue-neutral relative to 2009 law. A lower exemption would raise more revenue and bring the tax rate on inherited income closer to the income tax rate on non-inherited income, which is about three times higher.

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1. Introduction

The estate tax has been a fixture of the federal tax system for more than ninety years. Together with the gift tax, it has been a fairly stable revenue source over time, generally raising between 1 and 2 percent of federal revenues, as illustrated in Figure 1. For example, in 2006, the estate and gift taxes raised $28 billion (Office of Management and Budget tbl. S-8 2007).

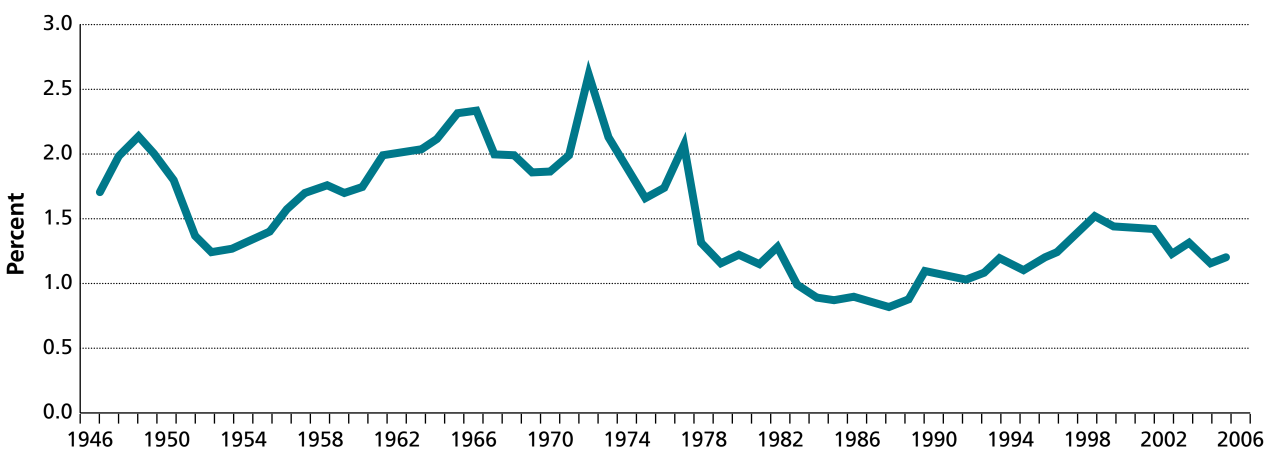
Nevertheless, in 2001, opponents of the estate tax succeeded in repealing it in a bizarre way. Currently, the estate tax is scheduled to disappear in 2010 and then return one year later. This situation is untenable, creating vast uncertainty and gruesome incentives for prospective heirs on the eve of 2011. It does, however, create a window of opportunity to learn from the concerns voiced by repeal advocates, and to revisit the structure of the estate tax, and, more generally, the taxation of gifts and bequests.

This paper proposes seizing this political moment to transform our current system for taxing gifts and bequests into an inheritance tax. Unlike the estate and gift taxes, which base tax rates on the amount a donor gives, the proposed inheritance tax would base tax rates on the amount an heir has inherited as well as her other income. Indeed, the proposal would be integrated with the income tax, and the tax would be paid by the heir. Heirs would not be taxed on lifetime inheritances of less than $2.3 million. Inheritances above this amount would be taxed at the income tax rate plus 15 percentage points. In addition, carryover basis would replace stepped-up basis for bequests. The proposal is estimated to be revenue neutral relative to 2009 law if the $2.3 million exemption were adopted. A lower exemption level would raise more revenue that could be used for deficit reduction or other pressing fiscal needs.

Transforming our current system into an inheritance tax would represent a fundamental shift in the way we tax wealth transfers: It would be more efficient. It would substantially simplify wealth transfer tax planning. Most importantly, it would be more equitable. Both the estate tax and an inheritance tax appear to be largely borne by the recipients of wealth transfers, not donors. In light of this reality, it is hard to argue that the tax should depend on how much the donor has given rather than on how much a fortunate heir has received. A

FIGURE 1

Estate and Gift Taxes as a Share of Federal Revenues, 1946–2006



Source: Office of Management and Budget 2006.
Note: Federal revenues include on- and off-budget receipts. Figure for 2006 is estimated.

wealth transfer tax should tax heirs on the privilege that extraordinarily large inheritances represent at least at the same rate as income earned through hard work, and potentially at a somewhat higher rate. Because an inheritance tax taxes privilege directly and an estate tax does not, only an inheritance tax necessarily can achieve this goal.

These theoretical differences between estate and gift taxes and the inheritance tax have important real-world consequences. At an aggregate level, the economic burdens of both are borne almost exclusively by the most affluent and privileged heirs in society because the heirs of large estates typically receive large inheritances and are relatively high-income themselves. But this is not always the case. Some heirs of very large estates are not that well-off or receive small inheritances; some heirs of smaller estates are very privileged and affluent. As a result, at an individual level, the two systems hit very different people. The inheritance tax allocates tax burdens much more precisely based on the amount inherited and the heir's other income—and to a surprisingly large degree.

This paper does not consider changes to ancillary aspects of wealth transfer taxation, such as the taxation of charitable transfers, transfers of education and human capital, or state wealth transfer taxes. Instead, it simply explains how these aspects of our current wealth transfer taxes could easily be replicated within the context of an inheritance tax.

In addition, this paper generally focuses only on the choice between the estate tax and an inheritance tax as two different methods for taxing large wealth transfers. To the extent that large wealth transfers are taxed, it argues that an inheritance tax is the better approach. Nevertheless, this paper is also motivated by the view that large gifts and bequests should be taxed to mitigate widening economic disparities, promote equality of opportunity, and make our tax system better attuned to an individual's ability to pay. The estate tax does a good job at accomplishing all of these objectives. But an inheritance tax would do an even better job—and might be more politically sustainable as well.

The paper is organized as follows: Section 2 explains in more detail the advantages of shifting from an estate tax to an inheritance tax. Section 3 provides a brief overview of current law. Section 4 describes the proposal, explains the rationale for its basic provisions, and addresses potential objections to them. Section 5 discusses the proposal's likely effects, including its estimated revenue and distributional effects (§5.1); and its likely effect on work, saving, and giving (§5.2); the identity of recipients of gifts and bequests (§5.3); tax planning and compliance burdens (§5.4); administrative burdens (§5.5); and state wealth transfer taxes (§5.6). Section 6 addresses some further questions and concerns. Section 7 concludes by discussing why we should continue taxing wealth transfers—and thus why an inheritance tax is also a better way to tax wealth transfers than to not tax them at all.

2. Advantages of Shifting from an Estate Tax to an Inheritance Tax

There are three traditional ways of taxing wealth transfers, as illustrated in Table 1. One method is an estate and gift tax (collectively referred to as an estate tax) paid by the donor, where the rate depends on the amount that the donor transfers. An alternative method is an accessions tax. Under an accessions tax, the recipient (referred to as the heir) is taxed, and her tax rate depends solely on the amount of gifts and bequests (collectively referred to as inheritances) that she has received. Finally, a third method of taxing wealth transfers is to require the heir to include inheritances in her income tax base (an inclusion tax). All three approaches have been implemented at some point within the United States and are presently in place in other jurisdictions (see §3.1 and §5.5, this paper).

There have been a variety of proposals to replace the estate tax with an accessions or inclusion tax, both of which are inheritance taxes (e.g., Alstott forthcoming; MacGuineas and Davidoff 2006; Becker 2005; Dodge 1978; Andrews 1967; Simons 1938; Roosevelt 1938; Seligman 1916). The inheritance tax proposed here is a hybrid of the two. While some commentators have favorably alluded to this possibility (e.g., Becker 2005; Dodge 554, 559 2003), to my knowledge such an inheritance tax has never been proposed or enacted. This type of inheritance tax has several fairness and efficiency advantages relative to a pure accessions or inclusion tax. Most importantly, there are a number of compelling reasons to shift the estate tax to this approach.

2.1. Fairness

First, such a shift would strengthen the fairness of the tax system as a whole by making the income tax better attuned to the individual circumstances that affect a taxpayer's ability to pay. Currently, the income tax covers nearly all income received, whether from work, saving, or a successful night of gambling. A major exception is inherited income.

Intuitively, if two people have the same economic income and are similar in all respects except that one worked for the money and one inherited it, it doesn't seem fair that we should tax only the one who worked and not the heir (e.g., Murphy and Nagel 147 2002). Nevertheless, that is exactly what we do under current law because we allow recipients to exclude gifts and bequests from taxable income.

The amount at stake is large. The model used for the estimates in this paper suggests that in 2009 nonspousal heirs will inherit close to $700 billion. Even when the estate tax burden is taken into account, this inherited income will be taxed at an average rate of less than 3 percent (§7, this paper), much less than the income tax rate on income from other sources, which is more than 8 percent (Congressional Budget Office [CBO] 8 2005; CBO 2006).

The proposed inheritance tax can begin to rectify this inequity through its inclusion tax aspects. Just as those who do not receive inheritances are generally taxed on all of their income, those who receive

TABLE 1
Traditional Types of Wealth Transfer Taxes

	Payor	Amount subject to tax	Base of tax rate schedule
Estate and gift tax	Donor	Amount transferred	Amount transferred
Accessions tax	Heir	Amount inherited	Amount inherited
Inclusion tax	Heir	Amount inherited	Total amount of income including amount inherited

very large inheritances would be taxed under the income tax on a portion of their inheritances.

Opponents of counting inheritances as taxable income may argue that the unfairness of the income tax exemption of inheritances for heirs is offset by the fact that donors are taxed on income used for wealth transfers to nonspousal heirs, which occurs because donors cannot take an income tax deduction for such transfers (e.g., Kahn and Kahn 468 2003). But this policy toward donors is fair regardless of whether inherited income is taxed by the income tax. It simply ensures that two people with the same income are treated as having the same ability to pay, regardless of whether one chooses to spend her money on gifts and bequests and one chooses to spend her money on market consumption.

Perhaps we should encourage spending money on gifts and bequests in order to promote voluntary redistribution or resource conservation. But even if we should, few would argue that the fairest way to encourage wealth transfers is through a deduction for gifts and bequests. Doing so provides the largest subsidy to the wealthiest donors, whose heirs are typically the most privileged people in society. Instead, if anything, wealth transfers to the disadvantaged should be more encouraged.

This suggests a second way in which an inheritance tax would strengthen the fairness of the tax system: it reduces differences in economic and political opportunity. Indeed, many of the established equity arguments for the estate tax are actually more applicable to those who receive inheritances than to those who give them. Traditionally, estate tax supporters have argued that taxing gifts and bequests helps level the playing field between a few lucky heirs of large fortunes and all other Americans (e.g., Ascher 73 1990; c.f., Alstott 369 1996; Rudick 158–59 1950). Those supporters have also argued that the estate tax can reduce concentrations of wealth and power in family dynasties (c.f., Boskin 65 1977; Rudick 158–59). For instance, Alexis de Tocqueville described laws regulating inheritance as part of the "moving and impalpable cloud of dust, which signals the coming of Democracy" (Fleischer forthcoming (a), citing de Tocqueville 48 1835). Franklin D. Roosevelt memorably maintained that "inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government" (Roosevelt 1938). But if the goal of an estate tax is to reduce inequalities of economic and political opportunity among heirs who have not personally earned their power and advantages, then it seems more appropriate to further this goal by directly taxing the receipt of large wealth transfers rather than the act of giving (e.g., Alstott forthcoming; Murphy and Nagel 156 2002; Duff 1993; Rudick 181).

The proposed inheritance tax does just that: it taxes the receipt of large wealth transfers. Moreover, the tax rate rises with the size of the inheritance. As a result, it more effectively advances equal economic and political opportunity than does the estate tax because it directly targets extraordinarily large inheritances which, both symbolically and practically, pose the greatest threat to these democratic ideals.

What's more, unlike the current system, the inheritance tax creates a direct incentive to break up large concentrations of wealth. The estate tax burden on a taxable estate of $50 million is the same regardless of the number and affluence of the recipients. By contrast, under the inheritance tax proposed, if a wealthy donor gives $50 million to five hundred regular Americans so that each receives $100,000, there probably would be no tax. It is unlikely that each beneficiary would be in the top income tax bracket or have inherited anywhere close to $2.3 million. Meanwhile if the same donor gives all $50 million to one heir, under the inheritance tax the heir would be taxed, and at a higher rate than under 2009 law, because the exemption is smaller and the top marginal tax rate somewhat higher under the inheritance tax. Thus, while our current system does not check the natural inclination of extraordinarily wealthy donors to give narrowly to an inner circle of heirs who typically are already affluent, the inheritance tax would.

An estate tax cannot directly strengthen the fairness of the tax system in these ways. Unlike the inheritance tax, the estate tax pays no attention to how much each heir inherits and how much other income the heir has. As a result, it cannot directly treat inherited income as relevant for measuring one's ability to pay income taxes, and it cannot directly impose larger tax burdens on larger inheritances in order to promote equal opportunity and the breakup of dynastic wealth. The proposal furthers both of these objectives by combining inclusion tax and accessions tax features.

The estate tax succeeds to a fair extent in indirectly promoting these objectives because, as discussed in §5.1, all wealth transfer taxes are probably borne largely by heirs. Currently, fewer than 2 percent of estates owe wealth transfer taxes; that figure has never exceeded 7 percent (IRS tbl. 16 2006). The heirs of these large estates typically inherit large sums of money and are relatively well-off prior to receiving their inheritance. Indeed, the distributional analysis provided below (see §5.1.2, this paper) suggests that the burden of the estate tax in aggregate rises sharply by inheritance size and by a broad definition of heir income that includes a portion of inheritances received.

Nevertheless, at an individual level the inheritance tax promotes these equity objectives much more precisely and effectively than does the estate tax. For example, the model used to produce the distributional estimates in this paper suggests that no heir inheriting less than \$2.3 million pays any tax under the inheritance tax, but 37 percent of the heirs burdened by the estate tax inherit less than \$1 million. Ultimately, only an inheritance tax is able to achieve this tight link between the tax and the heir's economic status because of the fundamental differences between the two systems.

In addition to being substantively more equitable, an inheritance tax is more likely to be *understood* as being equitable by the public. In 2001, advocates of the repeal of the estate tax successfully built public opposition around a stylized image of the typical taxpayer as a hard-working, frugal, generous entrepreneur who is subject to a double tax at the moment of her death (Graetz and Shapiro 82 2005). While there were many factual distortions in the assertions of repeal advocates, there was a kernel of truth to this image: it is the decedent who is nominally taxed, and she is subject to a separate tax based on the size of her gifts.

An inheritance tax instead focuses the spotlight—both substantively and symbolically—on the potentially profligate heirs of the world: the heir who receives a windfall she has done nothing to earn and who may or may not be contributing to society in other ways. It asks her simply to contribute a portion of her economic income to the fisc, just as everyone else does. Moreover, it asks her to do so not through a separate tax system, but through the income tax. Anecdotal evidence suggests that many people (incorrectly) believe that the income tax already is levied on gifts and bequests received. Thus, to the extent that the estate tax is indirectly effective at promoting the fairness concerns described above, an inheritance tax is still preferable, because political support for it is likely to be more enduring.

2.2. Efficiency

A second set of reasons for switching from an estate tax to an inheritance tax is based on the general principle that tax policy should be designed, where possible, to minimize any negative incentives on work, saving, or giving. Some allege that an estate tax discourages all three, because the potential donor knows that gifts and bequests to the next generation will face an additional tax. Nevertheless, it is unclear both theoretically and empirically whether the estate tax creates meaningful net distortions to work, saving, and giving. In fact, it may reduce the distortions created by the tax system overall, given the alternatives for raising revenue.

From the perspective of potential heirs, the estate tax should reduce the distortions to work and saving that the tax system as a whole generates. Heirs are inclined to respond to receiving large inheritances by reducing their efforts to work and save (see §5.2, this paper). As a result, taxing gifts and bequests should induce more work and saving among heirs, making possible lower direct tax rates on income from these activities for everyone else. These lower direct tax rates imply smaller disincentives to engage in work and saving overall.

By contrast, from the perspective of potential donors, the efficiency effects of the estate tax are far more ambiguous. In particular, theoretical analysis of the estate tax suggests that the distortions it creates to the work, saving, and giving decisions of potential donors depend critically on the donor's motivation for the work and saving that generated the funds for the bequest.

To date, there is not firm evidence that potential donors actually decide to reduce their level of work, saving, and giving because of the potential bite of the estate tax (see Kopczuk and Slemrod 2001; Joulfaian 2006a; Kopczuk and Lupton 2007; and §5.2, this paper). The estate tax may therefore be a relatively efficient tax. But let's assume that taxing wealth transfers does generate some efficiency losses by creating incentives for potential donors to alter their behavior, even if the efficiency losses are small relative to other taxes. Even then, any such losses should be reduced if the tax is based on the amount inherited and the recipient's other income—and not based on the amount given. In other words, any efficiency losses associated with a wealth transfer tax should be minimized if it has the essential features of the proposed inheritance tax.

The reason that this type of inheritance tax should minimize any potential efficiency losses relates to the reasons that donors may have for making a gift or bequest. While there is considerable dispute regarding the relative prevalence of different donor motives (e.g., Bernheim 900 1991; Hurd 1987; Altonji, Hayashi, and Kotlikoff 1992; Laitner and Juster 907 1996; Page 2003; Kopczuk and Lupton 2007), there is consensus that the existing pattern of gifts and bequests is due to some mix of four motives, each of which has different efficiency implications (Gale and Perozek 221 2001; Holtz-Eakin 511 1996).

One possible motive is that a gift or bequest may be altruistic, meaning that the donor made the gift because she is concerned about the heir's welfare.[1] In this case, purely from an efficiency perspective, the transfer should potentially be subsidized in order to account for the fact that the heir, donor, and possibly society all benefit from the transfer (e.g., Gale and Slemrod 35 2001). However, any such subsidy should decline as the heir's income rises, to reflect the fact that society presumably benefits from voluntary redistribution only to the extent that the beneficiary is less well off, or would rely on government programs (e.g., Kaplow 474 1995). In addition, heirs should have to include a portion of the inheritance in taxable income, above and beyond any income tax inclusion justified on fairness grounds. Doing so accounts for the fact that the heir will likely respond to the inheritance by working and saving less, thereby producing less tax revenue from her earned income and income from savings (Kaplow 174–175 2001). This partial income inclusion produces higher tax rates on gifts and bequests for heirs who have more noninherited income. But this result is efficient because the associated revenue loss is greater when heirs in higher income tax brackets work and save less.

Another possible motive is what economists refer to as an unintentional or accidental bequest. This can occur if there are limits on a donor's ability to purchase annuities or full health insurance. The donor may respond by saving funds for the possibility that she will live to a very old age or that she will

1. The following analysis also applies to "warm glow" transfers if the donor cares about the size of the after-tax transfer (Kaplow 178–179 2001).

incur unusually large health expenses, and not for her heirs. If she dies sooner than planned or does not have to spend large amounts on health care, these unused funds would be considered an accidental or unintentional bequest. A third but related potential motive is that all or a portion of the transfer arose because the donor is egoistic, meaning that she worked and saved the funds transferred simply because she enjoyed the work, the competition for the most money, or the prestige of being wealthy, and not because she was concerned about her heirs' welfare.

Unintentional and egoistic transfers are not limited to bequests where there was no will. Rather, the portion of a transfer that is considered unintentional or egoistic is the portion that the donor would have earned and saved even if the tax rate on wealth transfers was 100 percent. Under this definition, unintentional and egoistic transfers have no particular impact on the donor's motivation to work and save, and an extremely high tax rate on them is most efficient (e.g., Gale and Slemrod 35 2001).

The final possible motive for a gift or bequest is that all or part of it is in exchange for something and not a gratuitous transfer. For example, a parent might give her child funds with an understanding that the child will take care of her in old age. In this case, the transfer is economically a payment for services from the heir, and distortions to the transferor's work, saving, and giving decisions are minimized if the payment is included in the heir's taxable income.[2]

These possibilities suggest that as long as the existing pattern of wealth transfers is explained by some mix of these motives, it is most efficient for any tax on wealth transfers to take the form of the inheritance tax proposed. This is the case because the efficient tax for altruistic and exchange-motivated inheritances should apply to the amount inherited, and the tax rate should rise with the heir's income from other sources. Meanwhile, unintentional and egoistic transfers should be virtually expropriated with the tax rate unrelated to the heir's other income. Put differently, the level of wealth transfer taxation that minimizes efficiency losses resulting from the tax system as a whole turns on the relative prevalence of donor motives. But, given the consensus that current gifts and bequests evidence some mix of all four motives, the efficient form for the tax is the type of inheritance tax proposed. It is neither a pure inclusion tax, a pure accessions tax, nor an estate tax.

Inheritance taxes also have a further potential efficiency benefit relative to the estate tax because they are nominally paid by the heir. If all taxpayers were rational and farsighted, this wouldn't matter. A rational donor should respond to a given wealth transfer tax liability in the same manner, regardless of whether she, her estate, or her heirs pay the tax. But there is some evidence that people are not rational and tend to be influenced by framing effects, and that they tend to focus on salient features of a tax, such as the nominal tax rate or nominal payor, not on the actual tax rate or who bears the ultimate economic burden (c.f., Davis, Millner, and Reilly 2005; Duflo, Gale, Liebman, Orszag, and Saez 2006; Eckel and Grossman 2003; Liebman and Zeckhauser 2004). Because any efficiency losses from gifts and bequests arise from their impact on the behavior of potential donors, and not their impact on the behavior of potential heirs, this also argues that, all else equal, any economic distortions created by taxing wealth transfers will be smaller under an inheritance tax than under an estate tax.

Thus, because of differences in who substantively and nominally bears the tax, the proposal should, if anything, result in a slight increase in work, saving, and giving by potential donors, and more work and saving by the most productive heirs. These effects would make it possible, in turn, to lower direct tax rates on work and saving. Accord-

2. The issue is substantially more complicated if donors or heirs act strategically with respect to exchange-motivated gifts and bequests.

ingly, this type of wealth transfer tax should be more efficient by reducing the distortions the tax system generates.

2.3. Treatment of Accrued Gains

The efficiency and fairness benefits of the inheritance tax proposed relative to our current system are magnified by an additional feature: the repeal of stepped-up basis. As an illustration, imagine someone who originally bought an asset worth $1 million, which had risen in value to $3 million at the time of that person's death. Under the income tax, if the asset is bequeathed, it is transferred to the heir with a stepped-up basis, which effectively means that no income tax is ever due on the $2 million capital gain even though the donor would have been taxed on the gain if she had sold the asset right before she died. If the asset is instead given as a gift while the donor is still alive, the asset is transferred with a carryover basis, which means that the recipient must eventually pay tax on the gain, but only when (if) she sells the asset.

The proposal would replace stepped-up basis with carryover basis so that all bequests are treated like gifts made during life. This reform could be adopted within our current system as well. The potential amount of revenue at issue could be significant. 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 (Poterba and Weisbenner 439–40 2001).

An efficient tax system should distort the choice between different investments as little as possible, so that financial investments are made because of their actual risk and return characteristics, and not because they offer a tax break. Replacing stepped-up basis with carryover basis should further this goal. While doing so increases incentives for heirs to hold on to appreciated assets, it substantially reduces incentives for donors who are near death to hold on to unproductive assets purely for tax reasons. Moreover, carryover basis is more equitable. Stepped-up basis results in higher tax burdens on donors who are not savvy about the tax law and who sell appreciated assets before they die. Thus, this final element of the proposal further strengthens the fairness and efficiency benefits of the inheritance tax by ensuring that the income tax counts the gains on all assets the same: in other words, once.

2.4. Simplification

The final set of reasons to shift to the inheritance tax proposed stems from the fact that the proposed tax may substantially simplify our approach to taxing wealth transfers. Presently, the estate and gift taxes create large incentives to structure gifts and bequests in legally different but economically identical forms. For instance, gifts made during life tend to be taxed at lower effective rates than are bequests (see §5.4.2, this paper). The tax rate on wealth transfers from a married couple to their children is generally lower if each parent transfers a sizable portion of their collective estate (see §5.3.1, this paper). In addition, transfers of appreciated property are taxed at lower effective rates than are transfers of nonappreciated property, in part as a result of stepped-up basis. The proposal would reduce or eliminate incentives to structure transfers in these ways, and not in other ways that are economically equivalent. While our current system could be reformed to address these problems, to date it has not been.

In addition, an inheritance tax could simplify the taxation of wealth transfers in ways that can never be accomplished in the context of an estate and gift tax. An enormous amount of complexity in the current system results from efforts to close loopholes that would otherwise allow taxpayers to convert taxable transfers to lower-taxed or tax-exempt transfers through valuation games when the amount that potential beneficiaries will ultimately receive is unclear. To a large extent, these rules—and the tax-planning costs they create—would no longer be necessary under an inheritance tax. By waiting to see who gets what, the inheritance tax would not need to value such split and contingent transfers up front, but instead would tax heirs based on what they actually receive. An estate tax can't adopt this wait-and-see approach. Because its tax rate is based on the amount transferred, and not on the amount received, it has to be levied at the time of transfer. That an inheritance tax could substantially simplify the taxation of wealth transfers is not a new discovery. Historically, several prominent studies by estate tax practitioners and scholars have reached the same conclusion (Andrews 1967, 1969; Halbach 1988).

The simplification benefits of inheritance taxation for taxpayers should be mirrored at a governmental level. At first blush, one might think that it would increase administrative burdens if more information returns were filed, and if taxes on inheritances were not always levied immediately at the time of transfer. But the government's administrative burdens should ultimately be lower as the number of rules and gaming opportunities that it has to police declines. Moreover, experience in other jurisdictions suggests that an inheritance tax is administratively feasible. Each component of the proposal has been implemented in various U.S. states or other countries. In fact, inheritance taxes are much more common than estate taxes are cross-nationally, and seven U.S. states have some type of inheritance tax in place (see §5.5, this paper).

In short, an inheritance tax, implemented on a revenue-neutral basis, would be fairer, simpler, and more efficient than our current system.

Ultimately, the reason that opponents of the estate tax achieved their oddly temporary political success in 2001 may lie in these shortcomings of the current system. For example, it is hard to build political support for the estate tax on the grounds that it advances equal opportunity if it fails to encourage broad giving or to base tax burdens on the advantages the heir has received. Similarly, it is hard to make a case that the current system is simple and makes tax burdens better attuned to taxpayers' ability to pay when it takes no account of how advantaged and affluent the heirs of large estates are, and when it imposes vastly different tax burdens depending on how sophisticated taxpayers are in structuring their affairs.

The inheritance tax proposed here responds to these objections. It creates incentives to give more broadly and to those who are less privileged. It strengthens the targeting and fairness of the income tax by simply treating the inheritances of lucky heirs as relevant in determining their ability to pay. And it should substantially reduce the returns to tax planning that exist under our current system by equalizing the treatment of many transfers that are different in form but economically identical.

We should seize this political moment to improve the taxation of wealth transfers by replacing the estate tax with an inheritance tax. Before turning to the specifics of the proposal, however, some basic background on our current system is necessary.

3. Overview of Current Law

Our current method for taxing gifts and bequests has five elements: the estate tax, the gift tax, the generation-skipping transfer tax, the basic income tax treatment, and the income tax treatment of accrued gains. This section discusses each in turn.

3.1. Estate Tax

The first element, the estate tax, was enacted in 1916. At that time, Congress considered the possibility of adopting an inheritance tax and thought it would be more equitable (Ratner 367 1967). Indeed, our second income tax, which was enacted in 1894 and struck down as unconstitutional in 1895, included inheritances in taxable income (McDaniel, Repetti, and Caron 3 2003; *Pollack v. Farmers' Loan and Trust Co.* 1895). We also had an inheritance tax in place during the period 1862–70, and during the period 1898–1902 (when the United States had no income tax) (McDaniel, Repetti, and Caron 3–4). Nevertheless, the drafters of the estate tax selected that model instead of the inheritance tax model for several reasons: They thought it would raise more revenue and balance out the state-level inheritance taxes in place at the time. They found it convenient to model the U.S. wealth transfer tax on the British system, which was an estate tax (U.S. Congress 1916; Ratner 367 1967; Seligman 1916). Finally, they thought an estate tax would be more administrable, in part because it would place filing burdens on wealthy decedents rather than on their less wealthy heirs (U.S. Congress; Hull 80 1948; Ratner 367 1967).

As of 2007, the estate tax imposes a tax of 45 percent on lifetime gifts and bequests transferred that exceed $2 million (Internal Revenue Code [IRC] §2010(c) 2007). Effectively, this means that over their lifetimes, a married couple can transfer $4 million to their children or other beneficiaries tax free. As illustrated in Table 2, the $2 million per donor exemption is scheduled to rise to $3.5 million in 2009 before the estate tax disappears in 2010. The estate tax then reappears in 2011 with a $1 million exemption and a top marginal tax rate of 55 percent.

TABLE 2

Schedule Changes to Tax Treatment of Gifts and Bequests

	Tax rate		Exclusions			Basis provisions
	Estate and GST	Gift	Annual gift*	Lifetime estate and GST	Lifetime gift	
2007	45%	41–45%	$12,000	$2,000,000	$1,000,000	Gifts: Carryover Bequests: Stepped-up
2008	45%	41–45%	$12,000	$2,000,000	$1,000,000	Same
2009	45%	41–45%	$12,000	$3,500,000	$1,000,000	Same
2010	0%	35%	$12,000	N/A	$1,000,000	Gifts and bequests: Carryover Up to $4.3M capital gains tax-exempt
2011 and on	41–55%◇		$12,000	$1,000,000	$1,000,000	Gifts: Carryover Bequests: Stepped-up

* The exclusion is inflation-adjusted so it may rise above $12,000 after 2007.

◇ For estates between $1 million and $3 million, the marginal tax rate rises from 41% to 55%. For estates above $3 million, the marginal tax rate generally is 55%. However, a surtax that eliminates the lower brackets technically results in an effective marginal tax rate of 60% on taxable estates between $10 million and $17.184 million.

3.2. Gift Tax

The second component of our current system is the gift tax, which has been a stable fixture of our tax system since its enactment in 1932. It prevents donors from avoiding the estate tax by making transfers to their heirs during life. (These transfers are called *inter vivos* gifts). While the lifetime exemptions for the estate and gift taxes used to be the same, they no longer are. As of 2007, gifts exceeding $1 million over the donor's lifetime are subject to a tax rate of 41 percent, with the tax rate rising to 45 percent for gifts of more than $1.5 million (IRC §2012 2007). In addition, each year a donor can disregard $12,000 of gifts to a given heir (effectively, a married couple can disregard $24,000), meaning that these gifts do not count toward the lifetime exemption (IRC §2503(b) 2007). Unlike the estate tax, the gift tax is scheduled to stay fairly constant in the coming years, although the top marginal rate is scheduled to rise to 55 percent in 2011.

3.3. Generation-Skipping Transfer Tax

In 1976, Congress enacted a third tax in response to concern that transfers directly to a donor's grandchildren were taxed under the estate and gift taxes only once, while transfers to a donor's grandchildren through her children were taxed twice. The generation-skipping transfer (GST) tax imposes a second (but only a second) layer of tax on transfers to recipients who are two or more generations younger than the donor (IRC §2611 2007). Its exemptions and rates mirror those of the estate tax. Collectively, the estate, gift, and GST taxes are commonly referred to as wealth transfer taxes.

Under all three wealth transfer taxes, a large portion of gifts and bequests are tax exempt. For example, transfers to spouses and charities are not taxed (IRC §§2055, 2056 2007). Similarly, amounts paid during life for education, medical, or basic support expenses of heirs are tax exempt (IRC §2503(e) 2007). There are also special provisions for transfers of certain closely held businesses to address concerns that the tax might otherwise force the sale of the business (see §4.2.4, this paper). For example, any tax due on the transfer of a closely held business can be paid in installments over a period as long as fifteen years (IRC §6166 2007).

3.4. Basic Income Tax Treatment

The fourth piece of our system for taxing gifts and bequests is their basic income tax treatment. As discussed above in §2.1, donors do not receive an income tax deduction for gifts and bequests (other than those to charitable organizations), and recipients of gifts and bequests do not have to include the amount received in taxable income (IRC §102(b) 2007). While a great deal of attention is typically paid to wealth transfer taxes and the estate tax specifically, public debate generally focuses much less on how gifts and bequests are treated under the income tax, even though the effects are often equally or more important. Indeed, anecdotal evidence suggests that many people are not even aware that inheritances are excluded from taxable income.

3.5. Income Tax Treatment of Accrued Gains

The final important element of our current system is carryover basis for gifts and stepped-up basis for bequests. Like the estate tax, stepped-up basis is scheduled to disappear in 2010 and then return in 2011 (IRC §1014 2007). In the meantime, during the bizarre year of 2010, recipients of bequests are scheduled to receive a carryover basis but will be able to exclude up to $4.3 million in capital gains on property received. As with the general income tax treatment of inheritances, the public is generally not aware of how important and costly stepped-up basis is. Under some estimates and exemption levels, replacing stepped-up basis with carryover basis for bequests would over time raise about 12 percent of wealth transfer tax revenue, and taxing estates on the capital gains of all the assets in the estate at the time of transfer would raise about 25 percent.[3]

3. See Office of Management and Budget tbl. 2.5 2000; CBO 311, 312 2000 (citing JCT revenue estimate). Percentages based on revenue estimate for each option after it is in effect for three years.

4. The Proposal

4.1. Overview

The inheritance tax system proposed here represents a fundamental shift in our approach to taxing wealth transfers. There would no longer be any separate wealth transfer tax system, and the focal point of taxation would no longer be the amount transferred. Instead, taxation of inheritances would be integrated into the income tax, and the amount taxed would be the amount received. The proposal is designed to raise approximately the same amount of revenue as our current system would under 2009 law by varying the exemption level. It has four main components:

1. First, if a taxpayer inherits more than $2.3 million over the course of her lifetime, she would be required to include amounts inherited above this threshold in her taxable income under the income tax. The amount above this $2.3 million threshold would also be subject to a 15 percent surtax. Bequests that were included in income 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 $5,000 in gifts and $25,000 in bequests could be disregarded entirely, meaning that they would not count toward the $2.3 million exemption. All of these thresholds and the amount of prior inheritances would be adjusted for inflation. The income tax treatment of donors would not change. Donors would not receive an income tax deduction for gifts and bequests made unless the transfer was to a charitable organization.

To understand how the proposal works, imagine a person receives a bequest of $3 million above the annual exemption and has not received inheritances exceeding the annual exemptions in any prior year. This person would have to include only $700,000 of the bequest in her taxable income. The $700,000 would be taxed under the same rate structure as her other ordinary income plus 15 percentage points. 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 also elect to file as if she received only $140,000 of taxable inheritance in the current year and the previous four years.[4]

Similar to current law, the proposal would not tax a large portion of wealth transfers. All inherited income below the annual exemptions of $5,000 and $25,000, and the lifetime exemption of $2.3 million, would be tax exempt. In addition, if a taxpayer received gifts from a given donor over the course of the year that totaled less than $2,000, that donor's gifts would not count toward the annual exclusion even if the annual sum of such gifts from multiple donors exceeded $5,000. Transfers from spouses would be disregarded entirely. To the extent that the current wealth transfer tax exemptions for charitable contributions and gifts made during life for education, medical expenses, and basic support expenses are considered desirable, these exemptions also could be maintained.

2. If it is deemed politically necessary, the second element of the proposal would address the politically

4. This averaging feature would be an election, so taxpayers would not be required to retain prior year returns. In order to avoid the need to file amended returns, the tax could be calculated as follows: First, the taxpayer would calculate her income tax liability without the inheritance. Next, she would calculate her average income over the current year and up to four prior years, excluding the inheritance. Third, she would recalculate her current year income tax liability based on this average of (noninherited) income instead. She would then perform the same recalculation on her current year income tax liability but add 20% of the inheritance (if she is averaging over five years). Her inheritance tax liability would be the difference between her recalculated income tax liability including the inheritance and not including the inheritance, multiplied by the number of years over which she had averaged. Her total income tax liability would be this amount plus her income tax liability without the inheritance and without averaging her income.

TABLE 3

Comparison of Current Law and Proposal

	Current law	Proposal
Tax on bequests	45% to extent lifetime gifts and bequests made exceed $2 million	Income tax rate plus 15 percentage points to extent lifetime gifts and bequests received exceed $2.3 million
Tax on gifts	45% to extent lifetime gifts made exceed $1 million	Same as above after exclusions
Annual exclusion	$12,000 of gifts made per donee	$5,000 of gifts received, $25,000 of bequests received
Capital gains treatment for gifts	Carryover basis, taxed at time of sale	Carryover basis, taxed at time of sale
Capital gains treatment for bequests	Stepped-up basis, accrued gains never taxed.	Carryover basis, taxed at time of sale
Liquidity provisions	Tax on certain closely held businesses can be paid in installments over 15 years with below-market interest rate. Also special valuation provisions	Tax on illiquid assets can be deferred at market interest rate until sale, regardless of how far in future, to extent that tax exceeds liquid assets.
Generation-skipping provisions	GST tax	Generally none

explosive issue of family-owned businesses through a special provision for illiquid assets, such as family farms. Specifically, to the extent that the tax due on such assets exceeds the liquid assets that an heir inherits, she could elect to defer the tax due with interest at a market rate until she sold the illiquid assets. This would eliminate the possibility that an heir would need to sell an inherited family business immediately in order to pay the associated tax liability. It would also eliminate the possibility that she would ever need to sell the asset if, over time, she and the other owners earn on average at least a market rate of return. At the same time, this approach would minimize incentives or disincentives to hold wealth in illiquid forms.

3. Third, moving to an inheritance tax would permit a different and simpler method for taxing split or contingent transfers made, for instance, through trusts. As discussed in more detail below, this can be a complicated issue if there are multiple potential beneficiaries, and transfers to some would be taxed at higher rates than transfers to others. The proposal would wait to see who gets what before taxing transfers for which the beneficiary is unclear. In the meantime, it would impose a withholding tax. Once an heir received her inheritance, she would receive a refund if the amount withheld on her share of the funds was more in present-value terms than the tax she actually owed. As a result, the proposal would avoid many of the complicated valuation issues that arise under current law.

4. Finally, the proposal would repeal stepped-up basis for bequests so that both gifts and bequests would receive a carryover basis. This means that if the donor has not paid the capital gains tax due on a transferred asset, the heir will eventually have to pay tax on the gain when she sells the asset.

Table 3 summarizes the main differences between the proposal and current law.

A few additional features of the proposal bear noting: The heir would be responsible for filing a return reporting aggregate bequests of more than $25,000 and aggregate gifts of more than $5,000 (disregarding annual gifts from a specific donor that were less than $2,000). Once the heir began using up her lifetime exemption, she would have to report the cumulative amount used annually on her income tax return. Donors or their estates would also have to report information on transfers above these annual exemption levels to the IRS (e.g., similar to Schedule K-1) and would be subject to a penalty for underreporting. The heir would be responsible for paying any tax due if her lifetime reportable inheritances exceeded $2.3 million. If a minor child inherited such a large amount, a separate return would be filed on the child's behalf following the current law default for her earned income. In addition, there would generally be no equivalent to the GST tax, although unborn heirs would be treated differently in certain circumstances, as discussed in §4.2.6.

Finally, the transition to the inheritance tax would occur all at once and would be effective on a date prior to enactment, such as the date the bill was introduced. Prior inheritances and prior estate and gift taxes paid would not be taken into account. The only exception would be for inheritances on which estate or gift taxes had been paid and that were received after the effective date. Such inheritances would be tax exempt.

4.2. Rationale for the Proposal's Structure

The proposal is designed to realize the fairness, efficiency, and simplification benefits of an inheritance tax relative to an estate tax. To some extent, this entails radical reform. The proposal's approach to taxing wealth transfers is fundamentally different from current law. At the same time, however, a valuable infrastructure of legal rules and administrative practices has arisen under the estate tax, all of which help to prevent evasion and to promote compliance. Rather than "throw the baby out with the bath water," the proposal seeks to capitalize on and, in some instances, improve on this infrastructure.

This section (§4.2) explains the ways in which the proposal is designed to promote fairness, efficiency, and simplicity while maintaining a large degree of stability relative to current law. It also describes some features of the proposal in more detail and explains the ways in which the proposal strikes a balance between its goals when the goals conflict. Those uninterested in the rationale for each provision and its technical details should skip to §5.

4.2.1. Rate Structure

The most essential difference between the proposal and current law is that the proposal is an inheritance tax that combines inclusion tax and accessions tax features. The lifetime exemption and the 15 percent surtax together form an accessions tax. The requirement that heirs include lifetime inheritances above the exemption in taxable income is an inclusion tax. Like all inheritance taxes, the proposal's tax rate turns solely on characteristics of the heir, not on characteristics of the donor.

As explained in §2.1 and §2.2, this type of inheritance tax is more equitable and more efficient than other types of inheritance taxes and than our current system. It minimizes any adverse incentives on heirs' and donors' work, saving, and giving decisions. It helps to strengthen the fairness of the income tax by more closely linking income tax burdens to a taxpayer's ability to pay. It creates incentives to give to more people and to those who are less affluent. Finally, it adjusts the income tax rate based on the large advantage in life that heirs of extraordinarily large inheritances receive.

Some other features of the rate structure bear further explanation. Heirs could spread out taxable bequests over the current year and several prior years in order to ensure that the heir's income tax rate is based on a longer-term measure of her economic income. This spreading also increases the incentive for donors to give to heirs who are less affluent. Taxable bequests could only be spread backward in order to limit reductions in work and saving when a person inherits an extraordinarily large bequest. If bequests could be spread forward, the heir would not only have less need to work because she had become wealthier, but she would also face a higher marginal tax rate on work going forward because doing so would increase the taxes she owed on her inheritance.

As discussed in more detail in §5.4 and §5.5, the rate structure also reduces several tax-planning incentives that exist under present law. For example, taxing amounts inherited rather than amounts transferred eliminates the incentive for spouses to carefully plan transfers to each other. It also removes many differences in the tax treatment of gifts and bequests by applying the same exemption and tax rate to both, and by lowering the annual gift exemption. While the lower annual exemption will generate additional administrative and compliance costs because more heirs have to file information returns on inheritances, it is likely that the tax-planning incentives created by the current higher exemption generate far more onerous burdens on taxpayers in the long run.

Finally, the lifetime exemption of $2.3 million was selected in order to render the proposal revenue neutral relative to a politically plausible estate tax compromise that would make the 2009 law permanent, and is not meant to suggest anything about the amount of revenue that wealth transfer taxes should ideally raise. It is worth stating the obvious, however: $2.3 million is a lot of money. An individual who inherits $2.3 million at age eighteen can live off her inheritance for the rest of her life without her or her spouse ever working, and her annual household income will still be higher than that of nine out of ten American families.[5] Such vast inheritances undermine the American ideals of a level playing field and a meritocratic society. Indeed, they risk creating precisely the kind of economic aristocracy that de Tocqueville and Roosevelt feared—one in which a politically powerful segment of society does not need to work due solely to the fortunate circumstances of their birth.

Thus, an argument could certainly be made that this exemption is too high, and that any inheritance tax should raise more revenue by reaching more heirs. If revenue neutrality is politically necessary, however, a high exemption is a better approach than a low exemption and a lower surtax. The 15 percent surtax ensures that extraordinarily large inheritances bear roughly the same average tax rate as 2009 law, given that the income inclusion aspect of the proposal frequently generates lower initial marginal tax rates above the exemption. The surtax also addresses the unique harm that extraordinarily large inheritances pose to our democratic values of equal economic and political opportunity. Moreover, the high exemption minimizes administrative and compliance costs. The distributional estimates provided below suggest that only 0.2 percent of people who receive a bequest in a given year will owe any tax on the bequest under the proposal.

4.2.2. The Tax Base

While the proposal's rate structure is quite different from our current system, many of the rules underlying it can and should remain unchanged in order to benefit from the knowledge that practitioners and government officials have developed over time about how to prevent evasion and promote compliance. This is most evident in defining the tax base. There is an extensive legal infrastructure governing questions of when a transfer has occurred, how it should be valued, and what transfers should be taxable. The proposal generally adopts this infrastructure wholesale.

For instance, the proposal would generally consider a taxable transfer to have occurred at the same point in time as is the case under current law. If a parent transfers a 401(k) to her child, the child would be treated as if she inherited the assets in the year of the transfer, not the year when she withdraws funds from the account (Treas. Reg. §1.402 (a)-1 2007). Likewise, if a parent buys life insurance and irrevocably transfers it to her child as the beneficiary, the premiums paid would be considered an inheritance in the year they are paid, instead of treating

5. Author's calculations based on U.S. Census Bureau tbl. IE-4 (2004) and 5 percent interest rate.

the amount paid on the contract as the inheritance when the parent dies. An important exception is transfers for which the beneficiary is unclear. As discussed in §4.2.5, these would not be taxed at the same point in time as current law but would be treated as an inheritance when the beneficiary becomes clear.

In addition, the current exclusions for spousal transfers, charitable transfers, and transfers made during life for education, medical expenses, and basic support expenses for minors could continue in their current form (IRC §§2055, 2056, 2503(e) 2007). The exclusion for basic support expenses is clearly politically and administratively necessary; the public would undoubtedly be outraged, and the IRS and parents overwhelmed, if parents were required to maintain records over the course of the year of how much they paid for items like their minor children's food and clothing. Similarly, the exclusion for spousal transfers would undoubtedly be maintained in order to ensure that couples are treated the same regardless of whether they live in a community property state, and as part of the more general tax policy to treat married couples as one taxable unit. The exclusions for charitable contributions and education and medical expenses are more debatable, but these ancillary aspects of wealth transfer taxation are not the focus of this paper. Accordingly, with the exception of a brief discussion in §6.3.2, they are set aside.

4.2.3. Appreciated Property

While the proposal generally follows our current approach to defining the tax base, one area where it does not do so is appreciated property. The proposal's replacement of stepped-up basis with carryover basis is intended to reduce the inefficiency and inequity that arises from treating bequests of appreciated assets more favorably than bequests of other assets.

The income tax generally creates incentives to hold on to appreciated assets because accrued gains are not taxed until the asset is sold or exchanged. However, this lock-in incentive is particularly acute in the case of assets that a taxpayer might bequeath because stepped-up basis results in the tax on accrued gains being entirely forgiven if the taxpayer holds on to the asset until death. Such lock-in is a drag on the economy. Stepped-up basis also unfairly privileges sophisticated taxpayers; less well-advised taxpayers may realize accrued gains prior to death to the detriment of their heirs from a tax perspective. Moreover, stepped-up basis arbitrarily results in lower tax burdens on taxpayers who happen to invest in assets that appreciate in value and do not produce a steady stream of taxable income.

Replacing stepped-up basis with carryover basis addresses many of these inequities and distortions to investment choices. It ensures that all capital income is taxed once, regardless of how sophisticated the donor. It also reduces incentives for investors to hold on to underperforming assets purely for tax reasons as they near the end of life.

As discussed in §6.3.1, it would be even better if the donor or heir were taxed on accrued gains at the time of the transfer. While carryover basis reduces lock-in incentives for donors, it increases them for heirs. The heir can avoid paying tax on the accrued gain for as long as she holds on to the asset. Donors and heirs who invest in appreciating assets also continue to bear lower tax burdens under carryover basis than those who invest in assets generating income that is immediately taxable. These remaining inefficiencies and inequities would be reduced if making a wealth transfer triggered taxation of any accrued gains.

Nevertheless, the proposed inheritance tax does not adopt this more comprehensive approach because doing so might undercut political support for taxing inherited income. Indeed, shortly after Canada began taxing all gains on wealth transfers at the time of the transfer, its estate tax was repealed. Observers believe this occurred because the public began to view the estate tax as a double tax once it was levied at the same time as the tax on capital gains (e.g., Bird 133 1978, citing Benson 1971).

An alternative would be to follow the Canadian model instead and only tax accrued gains on inherited assets at the time of transfer, without ever taxing the inheritance itself. The proposal does not adopt this approach either because it would likely raise less revenue, make it far more difficult for Congress to subsequently apply a positive tax rate to inherited income, and—if tax rates on capital income continue to decline—could eventually raise virtually no revenue. This alternative also would not target as effectively heirs who receive the largest inheritances or have the most other income. Many heirs receiving very small inheritances would pay higher taxes than they would under current law because estates and inheritances of all sizes frequently include appreciated assets (Poterba and Weisbenner tbl.10 2001). Conversely, the highest tax rate that could apply to heirs receiving extraordinarily large inheritances would only be the top capital gains rate, which is currently 15 percent. An heir who inherits $100 million in assets with no accrued gains would owe no tax on her inheritance whatsoever.

To avoid actual double taxation, one technical adjustment to the proposal is necessary. If an heir inherits an appreciated asset exceeding the lifetime exemption and counts the fair market value as the amount inherited, she is essentially paying inheritance tax on the capital gains tax that she must subsequently pay on the asset. Conceptually, she should be able to reduce the subsequent capital gains tax due by this excess inheritance tax paid. To address this issue, the proposal would follow current law for ordinary income that has not been taxed to the donor. The heir would have to treat the fair market value of the appreciated asset as an inheritance at the time of receipt. She would also be taxed on the accrued gain when she subsequently sells the asset, but she could take a deduction against her income from capital gains in an amount equal to the share of her inheritance that the accrued gain represented at the time of receipt, multiplied by her inheritance tax rate at that time. This is identical to the current treatment of 401(k)s and other deductible retirement savings (IRC §691 2007), and has been a reasonably successful "rough justice" solution to the problem.

In addition, in order to minimize compliance costs and make carryover basis politically palatable, some further adjustments are necessary. Donors or their estates should be required to supply the heir with information on the basis of assets when it is commonly available (e.g., stocks). However, there should be exceptions to this requirement—and to carryover basis in general—for assets for which the basis is likely to be difficult to obtain. One possibility is to permit stepped-up basis for appreciated assets—such as a baseball card collection or a piece of furniture—that were not held for the production of income and are worth less than, for example, $10,000.[6]

4.2.4. Family Businesses and Other Illiquid Assets

Perhaps the most politically volatile issue facing any wealth transfer tax proposal is the question of what exceptions should be made for family farms, family-owned businesses, and other illiquid assets. In their book on the 2001 bill, Michael Graetz and Ian Shapiro (32–40 2005) argue that the failure of estate tax supporters to address this issue adequately was a prime reason for the success of estate tax repeal advocates.

This problem has been greatly exaggerated in the public debate. For example, neither the American Farm Bureau nor the *New York Times* has been able to identify a single instance of a family farm being sold to pay estate taxes (Graetz and Shapiro 126 2005). More generally, business assets can create liquidity problems only if they constitute a large portion of a wealth transfer, which is the case for only a small portion of transfers. According to estimates by the Tax Policy Center (TPC), under 2006 law,

6. The test for whether an asset was held for the production of income could be whether the donor took any deductions on the asset, such as depreciation or brokerage fees.

41 percent of taxable returns contain some farm or business assets (Urban-Brookings TPC tbl. T06–0020 2006; Urban-Brookings TPC tbl. T06–0023 2006), but such assets compose more than half of estate value for only 2.8 percent of taxable returns (Urban-Brookings TPC tbl. T06–0020 2006; Urban-Brookings TPC tbl. T06–0022 2006).[7]

Rhetoric, however, may be more important than reality on this issue. Accordingly, the political viability of the inheritance tax may depend on the ability to demonstrate that it will not force the sale of a family business. Aside from politics, this is a desirable objective to the extent that the business or asset is most productively held in the heir's hands. However, the task is complicated by the fact that there are also costs of giving closely held businesses special treatment. The portion of estates composed of business assets tends to rise with the estate size (Urban-Brookings TPC tbl. T06–0020 2006; Urban-Brookings TPC tbl. T06–0022 2006; Urban-Brookings TPC tbl. T06–0023 2006), which means that preferences for closely held businesses will tend to benefit the fortunate heirs of the largest inheritances the most. Such preferences will also tend to distort investment decisions and favor heirs of business assets over heirs of other types of assets. In addition, there is no hard evidence that inherited businesses are more beneficial to the economy than other businesses; in fact, there is a fair amount of evidence that businesses owned or managed by heirs tend to perform relatively worse (e.g., Pérez-González 2006; Bennedsen, Nielsen, Pérez-González, and Wolfenzon 2006; Villalonga and Amit 2004; Morck, Strangeland, and Yeung 2000; Smith and Amoako-Adu 1999; but see McConaughy, Walker, Henderson, and Mishra 1998). Thus, efficiency, fairness, and simplification concerns all suggest that, to the extent possible, the tax treatment of inheritances should create neither incentives nor disincentives to conduct business in this form.

Current law generally does a poor job of achieving these objectives. It does provide special treatment for closely held businesses.[8] For example, certain business assets can be valued at less than their normal market value (IRC §2032A 2007). There is a special deduction for certain qualified family-owned business interests that sunsets in 2004 but is scheduled to return in 2011 (IRC §2057 2007). Payment of any estate taxes attributable to a closely held business can also be deferred for five years and then spread out over ten more years at a below-market interest rate (IRC §6166 2007).[9] However, these provisions tend to subsidize closely held businesses, thereby creating incentives to invest in such assets purely for tax reasons. They also fail to set a clear policy that no closely held business that is reasonably well-run will have to be sold in order to pay wealth transfer taxes. While this may be true empirically, it depends in practice on a number of factors, such as whether the family continues to manage the business and how soon they plan to sell the business after the donor's death.

Assuming that addressing liquidity problems is politically necessary, the proposal would respond to these problems by allowing heirs to choose to defer taxes due on illiquid assets at a market rate of interest until disposition, no matter how far in the future. This deferral election would only be available to the extent that the tax could not be paid with other inherited liquid assets, after leaving a reasonable cushion. The deferred tax would accumulate interest at a market rate, but neither the interest nor the principal would be due until disposition.[10]

7. Taxable returns with some farm or business assets constitute 59 percent of the value of all taxable returns, and taxable returns for which farm and business assets make up more the 50 percent of the value of the return represent 7 percent of the value of all taxable returns (Urban-Brookings TPC tbl. T06–0020 2006; Urban-Brookings TPC tbl. T06–0022 2006; Urban-Brookings TPC tbl. T06–0023 2006).
8. The IRS Commissioner may permit deferral of wealth transfer tax liabilities at her discretion (IRC §6161 2007).
9. The interest rate is 2 percent on the tax attributable to roughly the first $1 million transferred and 45 percent of the federal tax underpayment rate thereafter (IRC §§6601(j), 6166 2007).
10. Technically, disposition could be defined as a sale or exchange that constitutes a realization and recognition event for tax purposes.

In addition, if the heir held on to an illiquid asset for life and ultimately bequeathed it to someone else, the associated tax would carry over to the new heir. Heirs would, however, have to provide the IRS with periodic valuations of the illiquid asset(s), and the IRS would have a secured interest in the asset.

Because the tax deferred would bear a market rate of interest, illiquid assets could be defined fairly broadly. For example, the category could include closely held businesses, real property held for investment purposes, and collectibles. Illiquid assets should not, however, be defined to include property used in part for personal consumption, because its value will tend to decline as it is consumed (Dodge 1199 1978).

To illustrate how this provision would work, suppose an heir who is in the highest-income tax bracket receives a bequest of $10 million, all of which is above the lifetime exemption. Three-quarters of the bequest is a closely held business and one-quarter is liquid assets, such as publicly traded stock. Neither is an appreciated asset. In this case, the heir's total tax liability would be $5 million. She could choose to defer $2.5 million of the taxes due until the business was sold.

This provision responds to the politically charged objection that our current system may force heirs to sell family-owned businesses. As long as the heir earns a market rate of return on the asset over time, she will never have to sell the asset. Unlike prior proposals to defer estate taxes due on illiquid assets at a market rate of interest (Gutman 1271 1983; Force on Federal Wealth Transfer Taxes 139 2004), it differs by imposing no time limit on deferral. Such time limits create the possibility of hypothetical scenarios where an heir would ultimately need to sell the asset in order to pay the associated tax liability, even though she is managing it fairly well.

At the same time, the provision avoids creating incentives to hold assets that qualify for the election by requiring that any deferred taxes accrue interest at a market rate. On a present-value basis, this interest accrual should eliminate any potential revenue loss.

Finally, the deferral election is limited to the portion of the heir's inheritance tax liability that exceeds her inherited assets that are readily marketable for several reasons. First, this feature may be necessary to minimize behavioral distortions and maintain the proposal's revenue neutrality within the budget window if heirs irrationally perceive the deferral election as advantageous. The limit also avoids creating a cliff effect and the associated planning costs. Under the current-law deferral provision, if closely held business interests exceed 35 percent of the value of the estate, taxes on all such assets can be deferred at a below-market interest rate; if they constitute 34 percent, no deferral is available (IRC §6166 2007). In response to this all-or-nothing approach, taxpayers frequently spend significant time and funds on tax planning in order to ensure that a trivial valuation difference does not result in loss of the lucrative below-market loan that current law offers (Task Force on Federal Wealth Transfer Taxes 138–39 2004). The limit is also fair. Any heir who has inherited enough liquid assets to pay any inheritance tax due can freely choose whether to continue investing in the family business. If she chooses to do so, she should either pay the tax due upfront or pay interest on it as she does for any other outstanding debt.

In short, unlike current law, this deferral provision should address the concern that taxing inheritances may force the sale of family businesses, while minimizing incentives or disincentives to hold assets in this form.

4.2.5. Transfers of Split, Contingent, and Future Interests

Another challenge that any wealth transfer tax faces is how to deal with trusts with multiple potential beneficiaries and other types of transfers where a single beneficiary does not have immediate control over the property. This is a tremendously important issue because trusts are a pervasive estate-planning tool for both tax-related and nontax reasons, especially for the wealthiest donors. Moving from our current system to an inheritance tax creates opportunities for extensive simplification in this area.

The proposal would approach the issue of trusts in three ways that depend on the certainty and identity of the beneficiaries: First, if a trust or interest has only one beneficiary, any inheritance tax would apply at the time the trust was created. For example, suppose a parent deposits $100,000 in a trust for her minor child that the child could access only when she became an adult. Five thousand dollars of the assets would be disregarded under the annual exclusion and the remaining $95,000 would count toward the child's lifetime exclusion. (If the child died before reaching adulthood, any tax paid would be refunded with interest.) This would eliminate the need for some of the special rules governing future interests under current law, such as Crummey trusts.

Second, if the trust or property transferred has multiple potential beneficiaries, all of whom are tax exempt, no inheritance tax would apply. For example, as under current law, if a donor creates a trust that is supposed to distribute its income to her surviving spouse for the rest of her life and then go to charity, no tax would be imposed (see, e.g., IRC §2056(b)(8) 2007).

The most complicated issues arise in a third scenario: there are multiple potential beneficiaries who may be subject to different tax rates. In this scenario, the inheritance tax would only be imposed when there was a distribution to a beneficiary, meaning that the beneficiary was deemed to fully own all or part of the property. In the interim, it would impose a withholding tax, and the rules governing the taxation of income earned by a trust would remain unchanged. The donor or her estate would be responsible for remitting the withholding tax, and she could apply one lifetime exemption of $2.3 million to all such interests that she creates. Thereafter, the withholding tax rate would be the highest tax rate applicable to inheritances. When assets are ultimately distributed to a beneficiary, the beneficiary could claim a refund in the form of a refundable credit to the extent that the withholding tax rate was higher than her actual tax rate on the inheritance. The credit would be calculated so that it accrues interest at the same rate of return as that earned on the transferred assets. While not immediately obvious, this approach could substantially simplify the taxation of such transfers relative to current law. The ways it would do so relate to the development of wealth transfer tax law more generally.

Currently, the lion's share of transfers with multiple potential beneficiaries are discretionary trusts where all potential beneficiaries are taxable. However, historically there were substantial incentives to transfer property through split or contingent interests where a potential beneficiary was nontaxable. By doing so, the donor could maximize the portion of the transfer that was deemed to go to the nontaxable person, who was usually a spouse or charity. For example, if an income interest in the trust was given to the donor's children with the remainder to charity, the donor could deduct the present value of the remainder interest. She could then have the trustee follow investment policies that favored the income beneficiaries and resulted in the charity ultimately getting much less.

In response, a host of estate tax rules were created to grapple with these incentives. Under current law, donors can claim a charitable deduction for partial interests transferred in trust or nontrust form only if the interest fits within certain prescribed categories that ensure a more accurate valuation of the interest (e.g., IRC §§642, 664, 2055, 2522 2007 on charitable remainder trusts, charitable lead trusts, pooled income funds; McDaniel, Repetti, and Caron 569–83 2003). Similarly, donors can only claim a spousal exclusion for transfers of partial interests if the transfer meets certain statutory tests designed to ensure that the portion of the transfer that is not consumed by the surviving spouse is ultimately included in her taxable estate (e.g., IRC §§2044, 2056, 2056A, 2519 2007). The net result is less evasion and fewer valuation games. The downside is that a donor now has to fit her wealth transfers into these prescribed and very complicated categories if she wants to transfer part of her estate to her spouse or a charity and part to taxable beneficiaries but does not know in advance what allocation would be best. She cannot simply set up a discretionary trust for her entire estate, or she won't be eligible for a spousal exclusion or charitable deduction at all.

The basic problem giving rise to these rules and categories is that estate and gift taxes are imposed at the time of transfer. If the beneficiaries are uncertain, the law has to make some judgment about how much each potential beneficiary is ultimately likely to receive, a judgment that can never be perfect.

By contrast, an inheritance tax can avoid these valuation issues—and the need for constraining safe harbors to address with them—because it is imposed at the time of receipt. In particular, under the proposal's wait-and-see approach, the present value of the tax ultimately paid by the beneficiary will generally be the same as the tax she would have paid at the time of the initial transfer if we knew exactly what portion of the transfer she would receive at that time and if she left that portion in the trust until distribution. Essentially, this approach is economically equivalent to the tax system having perfect foresight regarding which potential

Box 1. Withholding Tax and Refund Calculation when Beneficiaries Are Uncertain

If the ultimate beneficiaries of a wealth transfer are unclear, a withholding tax would be imposed at the highest possible marginal rate on all such wealth transfers by the donor to the extent that they collectively exceed one lifetime exemption. The credit upon distribution would be calculated as the amount distributed times a credit ratio. The credit ratio would in turn equal the tax withheld, divided by the property left in trust after payment of the withholding tax. The credit itself would be treated as part of the heir's inheritance.

For instance, suppose a donor transferred $10 million to a trust, and the trustee had discretion to determine the ultimate beneficiary. The withholding tax would be imposed on the amount above a single beneficiary's lifetime exclusion, or $7.4 million, and at the highest possible rate of 50 percent. Thus, the amount withheld would be $3.7 million, the effective withholding tax rate would be 37 percent, and the trust assets after the withholding tax would be $6.3 million.

Suppose further that ten years pass, the trust assets double to $12.6 million, and the trustee distributes all the trust assets to one beneficiary whose effective tax rate on the inheritance is 30 percent, not 37 percent. The heir's credit ratio would be the amount of tax withheld ($3.7 million) divided by the trust value after the withholding tax ($6.3 million), or 59 percent. Her refundable credit would be the amount distributed ($12.6 million) times the credit ratio (59 percent), or $7.4 million.

The refundable credit would be considered part of her inheritance, bringing her taxable inheritance on distribution to $20 million. Because her effective tax rate on inheritances is 30 percent, she would initially owe $6 million in taxes. However, after claiming the credit, she would receive a net refund of $1.4 million (the $7.4 million refundable credit minus the $6 million initially owed in taxes). Her after-tax inheritance would be the amount distributed ($12.6 million) plus the refund ($1.4 million), or $14 million.

In present value terms, this is the same amount she would have received if the donor had transferred the original $10 million to her directly, instead of through a discretionary trust. In this alternative scenario, her taxable inheritance would have been $10 million, and she would have owed $3 million in taxes on receipt because her effective tax rate on inheritances is 30 percent. Assuming she earned the same rate of return on her $7 million after-tax inheritance, it would have also doubled in ten years. As a result, she would end up with the same after-tax inheritance of $14 million that she receives under the wait-and-see approach applied to the discretionary trust.

beneficiaries will get what. For those interested in the technical details, Box 1 explains precisely how the wait-and-see approach achieves this result.

The simplification potential of this wait-and-see approach shouldn't be oversold. The equivalence between the tax due under this approach and the tax due if a beneficiary is taxed at the time of transfer on her ultimate share of a bequest is not perfect. It depends, for example, on whether and in what direction the heir's tax rate changes in the interim. It also depends on whether the trust could invest in assets with a higher rate of return if it had more funds, or if the income earned by the trust is taxed at a different rate than it would be if received by the heir. In addition, there are no new benefits (or drawbacks) of this approach in the more common situation where all of the potential beneficiaries are taxable; then, current law does not need to value each beneficiary's interest. Furthermore, despite this general equivalence, the proposal creates some countervailing incentives to transfer property through contingent interests due to generation-skipping issues, which are discussed next in §4.2.6. Moreover, if donors are irrational and don't understand the equivalence, it could induce fewer such transfers among donors who erroneously view the withholding tax as a penalty. Conversely, it could induce more such transfers among donors who erroneously view the additional donor exemption for such transfers as an opportunity to reduce the tax burden on her heirs. These twin possibilities are the reason why the proposal permits donors to claim one additional exemption but not more for transfers where the beneficiaries are unclear.

Nonetheless, the advantages of this approach also shouldn't be understated. Relative to current law, the proposal's wait-and-see approach should eliminate tax incentives to transfer assets through the existing pre-approved categories of partial and contingent interests. It should also sharply reduce disincentives to transfer property in forms that do not fit neatly into these boxes. As a result, it should simultaneously reduce gaming, reduce the number of rules the IRS has to police, and allow many more donors to make economically equivalent wealth transfers in whatever form they prefer without triggering adverse tax consequences.

4.2.6. Generation-Skipping Transfers

A further feature of the proposal that merits explanation is its approach to GSTs. Under current law, the GST tax helps ensure that donors cannot lower their wealth transfer tax burden through GSTs. In practice, at times it taxes a direct transfer to one's grandchild slightly more heavily, and at other times, slightly less heavily, than a transfer directly to one's child that is subsequently transferred by the child to the grandchild. The GST tax is inconsistent with the goal of taxing people on only their inherited income and not on income over which they have never had control. As a result, the proposal generally declines to tax GSTs any differently from other taxable transfers.

For example, suppose a person decides not to bequeath all her assets to her child, but instead to bequeath part to her child and part directly to her grandchild. The proposal would essentially reward this broader giving through a lower net tax rate because both the child and the grandchild could exclude $2.3 million of the amount they inherit from taxable income. To be sure, the donor has only given more broadly in this scenario if the child has no legal claim to the grandchild's inheritance and does not receive any transfers back from the grandchild. Indeed, if the child does have a claim to the property or receives transfers from the grandchild, the property or those transfers would be treated as part of the child's inheritance. But otherwise the child should not be taxed on the grandchild's inheritance because she never has had any right to the property.

There are some drawbacks to this approach. In certain circumstances, it creates tax-planning opportunities. For instance, if a donor believes that her child will end up giving a portion of her bequest to her grandchild, she can ensure a lower tax burden on both by transferring the bequeathed funds through a trust over which the child does not have full control and not directly to the child. Then the child will be taxed only on the amount she actually receives, not the entire bequest, and more will be left after-tax for the grandchild. Such tax-planning opportunities are undesirable but the price of basing tax burdens on the amount of funds that a donee actually owns outright. They are also the price of creating incentives to give more broadly. Moreover, the resulting tax planning costs should be smaller than one might expect because most large wealth transfers already are made through trusts. Finally, while fairness concerns and not simplification concerns motivate this aspect of the proposal, creating a GST tax equivalent within the inheritance tax is also enormously complicated because, unlike the estate tax, the tax rate on transferred funds depends on the heir's other inherited and noninherited income.

Notwithstanding the general reasoning against adopting a GST tax equivalent, one particularly troubling type of GST—the perpetual trust—does merit special treatment. Under a perpetual trust, an extraordinarily wealthy individual can establish a trust that pays a portion of its income to her descendents but never invades the principal. As a result, her descendents can live off the trust for multiple generations and hundreds of years. Perpetual trusts have been on the rise ever since states began to repeal the rule against perpetuities after realizing that they could attract large estates by doing so (Sitkoff and Schanzenbach 2005).

The increasing prevalence of perpetual trusts is disquieting because it directly embodies the concerns about inherited economic power that Roosevelt and others articulated. Moreover, transfers to hypothetical, unborn people through perpetual trusts may be less likely to be motivated by pure altruism, implying that a higher rate of tax may be efficient.

In order to address these concerns, the proposal would disallow the refund for withholding taxes described above if the beneficiary claiming it was not born at the time the trust was created and was not of the same generation as someone who was alive and also a potential beneficiary. The refund would be available to beneficiaries of the same generation as those alive at the trust's creation in order to avoid incentives for a donor to disinherit, for example, grandchildren who were born after her death. The net effect of this provision would be to impose one additional layer of tax (but not more than one), just as the GST tax does, although in a much narrower set of circumstances.

4.2.7. Transition Rules

The final element of the inheritance tax is its transition rules. The approach proposed is to apply the inheritance tax to all inheritances received after some date prior to enactment, such as the date the bill was introduced. Prior inheritances and prior estate and gift taxes paid would not be taken into account. The only exception would be for split or contingent trusts (or similar interests) that were subject to the estate tax. Distributions from such trusts after the inheritance tax goes into force would be tax exempt.

This approach is the most administrable and would also limit gaming. Once it becomes apparent that an inheritance tax is likely to be enacted, wealthy donors will face strong incentives to make *inter vivos* gifts up to the lifetime gift tax exemption. If the tax is effective as of the date of enactment, those who were savvy would likely take advantage of this opportunity to lower the tax burden on their heirs, while heirs of less savvy donors would not be so lucky. A transition that is effective prior to enactment minimizes these transition costs and inequities between heirs.

The transition rule proposed is also reasonably precise. The Survey of Consumer Finance data on which the prior inheritance estimates for this paper were based suggest that, among children receiving bequests of more than $1.7 million, bequests represent, on average, 94 percent of their lifetime inheritance to date. The comparable figure for nonchild beneficiaries is 99 percent. This pattern probably occurs because about 60 percent of married decedents give their entire estate to their spouse or charities and leave nothing for their children (IRS 1992 Collation Study data used for estimates in

Box 2. Ireland's Inheritance Tax

Ireland's inheritance tax, the Capital Acquisitions Tax ("CAT"), was enacted in 1976 after publication of the 1974 White Paper on Capital Taxation (Sandford and Morrisey 6-7 1985). The White Paper proposed abolishing the unpopular estate tax and replacing it with various taxes on capital, including the CAT (Carroll 374 1994). Critics of the estate tax at the time objected to it on a number of grounds, many of which mirror the debate in the United States. They argued that it was a double tax on income; it was psychologically cruel to levy a tax at death; it potentially forced the sale of small businesses and family farms; it was unfair because it did not hit all estates at the same interval of time; and it was inefficient and ineffective at redistributing wealth because it was applied regardless of the economic circumstances of the recipient (Carroll 374; Irish Parliamentary Debates 1012, 1034 1976a).

The CAT currently taxes gifts and bequests received above a lifetime exemption amount at a flat rate of 20 percent (Irish Tax and Customs 2007). The lifetime exemption varies by relationship of the heir to the donor, and inheritances are aggregated within each relationship group over time. The lifetime exemption for inheritances from parents is about $685,000 (Id).

The transition from the estate tax to an inheritance tax in Ireland appears to have occurred relatively smoothly. All bequests received prior to April 1, 1975 were subject to the estate tax, and all bequests received on or after this date were subject to an inheritance tax (Carroll 374). The one year lag after publication of the White Paper was considered to be a sufficient amount of time for taxpayers to adjust their wills or other estate plans (Ireland Department of Finance 60). With respect to gifts, Ireland did not have a gift tax prior to the CAT (Carroll 374). To limit tax planning, all gifts made on or after the date of the White Paper publication date were liable for the new gift tax, although taxes were not collected until after its 1976 enactment (Capital Acquisitions Tax Act Second Schedule, Part I 1976). Gifts received between 1969 and the White Paper publication date were not themselves subject to tax, but were aggregated with gifts after that date for the purpose of determining gift tax liability (Id). This final feature was attacked as inequitable because it was a retrospective tax (e.g., Irish Parliamentary Debates 1407-14 1975b). The proposed transition rule does not incorporate it.

§5.1, this paper). Many children therefore receive only one substantial inheritance during their lifetime. Failing to count prior inheritances received toward the lifetime exemption therefore would not create widespread inequities.

Ireland applied a fairly similar transition rule when it transitioned from an estate tax to an inheritance tax in 1976, as discussed in Box 2. It is the only country I have identified that has transitioned directly from an estate tax to an inheritance tax and, interestingly, its inheritance tax is the closest analogue cross-nationally to the one proposed here.

One alternative transition rule that could be more precise is to attempt to determine the actual amount of prior inheritances that an heir has received through previously filed gift tax and estate tax returns. In practice, however, this would be difficult to administer and probably completely so. Heirs have the best access to such information and have no incentive to disclose it. There is also no current requirement to keep such records, so some heirs couldn't comply even if they were willing to do so.

Another alternative would be to phase in the exemption thresholds by age. At a theoretical level, some sort of phase-in is a reasonable approach because any prior inheritances that were partially or fully exempt from the estate tax should count toward the heir's lifetime inheritance tax exemption. Absent information on prior inheritances, age is a rough proxy. However, providing lower exemptions to the elderly might be less exact than the recommended approach and would certainly be more difficult to maintain politically.

A complete transition that is effective on a date prior to enactment is thus the simplest, most administrable, and fairest of the alternatives.

5. The Proposal's Likely Effects

Shifting from our current system to the proposed inheritance tax would have a number of important effects: It would change the economic burden of taxes on gifts and bequests. It would affect the incentives faced by donors and heirs, and would change the nature and level of tax complexity. Finally, it could affect the states' wealth transfer tax systems. This section discusses the proposal's likely effects. The conclusions are summarized here and explained in more detail in §§5.1–5.6.

Section 5 begins by providing estimates of the revenue and distributional effects of the proposal (§5.1). These suggest that the proposal is revenue neutral relative to 2009 law, and that it is somewhat more progressive by inheritance size and a broad measure of heirs' income, and somewhat less progressive by estate size and decedent income. While both the proposal and our current system are highly progressive along all four dimensions, and their incidence is fairly similar in aggregate, at the individual level the distributional effects of the inheritance tax are decidedly different. The most reasonable assumption appears to be that both taxes are largely borne by heirs, but which heirs owe tax and how much varies widely, with the inheritance tax allocating tax burdens based on the amount an heir inherits and the heir's other income much more precisely.

The section then discusses the proposal's likely effects on donors' and heirs' level of work, saving, and giving (§5.2), and on the pattern of giving (§5.3). Based on previous work, it concludes that the proposal should have no clear net effect on heir labor supply but possibly induce relatively more work by high-income heirs. It should also have either no effect or a slight positive effect on donor work, saving and giving. The proposal should induce donors to give somewhat more broadly (especially to grandchildren) and to those more in need. It should also induce more outright transfers to surviving spouses. The likely effects of the proposal on the level of charitable giving are unclear, both theoretically and empirically. However, it should result in a change in the form and objects of charitable bequests, with more charitable bequests going to tax-exempt nonprofits that are not 501(c)(3)s, and with more charitable bequests taking the form of appreciated property. The inheritance tax will also likely result in donors using fewer trusts or split or contingent interests that fit into the current law safe harbors, and more for generation-skipping purposes or simply to meet their nontax needs.

The section next provides a summary of the proposal's advantages with respect to simplification and reducing tax-planning costs (§5.4). It also concludes that the proposal should be administrable in light of the experience of U.S. states and other countries (§5.5).

It concludes by considering the potential impact on state wealth transfer taxes (§5.6). States would probably conform their wealth transfer taxes to the federal structure. If desired, any of the forms of revenue sharing with the states that have been implemented under our current wealth transfer taxes could be replicated under the proposal.

5.1. Revenue and Distributional Effects

The TPC estimated the revenue and distributional effects of the proposal relative to current law. To our knowledge, this is the first time these effects of a U.S. inheritance tax have been estimated.

The following estimates are based on the TPC estate tax microsimulation model, which was adapted to estimate the amount that individual heirs inherit and each heir's other income. The estimates are very rough because of data limitations that require multiple levels of imputation, and because they rely in part on data from 1992. The estimates are also restricted to the core proposal to change the rate structure applying to gifts and bequests. No attempt is made to model the provisions regarding trusts and illiquid assets, or the proposal to replace stepped-up basis with carryover basis. Details on the methodology are provided in the appendix.

The distributional estimates assume that donors do not respond to the different incentives created by the proposal by changing the proportion of their estate that they transfer to taxable heirs or the proportion allocated to each heir, and that heirs do not respond to the different incentives created by the proposal, for instance by working more. Both assumptions are definitely very strong, but they are probably the least misleading in light of the very limited information available to study the issue. The potential implications of relaxing these assumptions are discussed in §5.1.2.

The distributional estimates also generally assume that the incidence of both the estate tax and the inheritance tax is on the heirs, not decedents. This assumption rests on two suppositions: (1) the proportion of the estate tax and the proposal that is borne by heirs, donors, and other groups, respectively, is identical under both taxes, and (2) as a first approximation, it makes the most sense to assign the burden of both taxes to the beneficiaries of wealth transfers.

The first supposition follows initially from the general economic principle that the statutory payor of a tax has no bearing on who bears the economic burden of a tax. As discussed in §2.2, one exception would be if people irrationally respond differently to two taxes that are economically identical but nominally paid by different parties. Assuming taxpayers are rational, though, it shouldn't make any difference that the estate tax is technically paid by donors and the inheritance tax by heirs. Another exception would be if changes in the burdens of the tax among heirs in turn changes the relative burden borne by donors versus heirs. As discussed next, this is possible if donor motives vary systematically by characteristics of the heir or donor. However, there is little firm evidence to date of such variance. Thus, a reasonable assumption based on existing evidence is that the proportion of the burden borne by each of the relevant groups is identical under both taxes.

The research to date also suggests that the second supposition holds and that heirs bear most of the economic burden of wealth transfer taxes, although there has been surprisingly little consideration of the question. Like the efficiency effects of wealth transfer taxes, their incidence depends in part on the donor's motivation in making the transfer.

To the extent that a transfer is altruistic or exchange-motivated, the relative burden on donors versus heirs depends on the magnitude of income and substitution effects, but should generally fall on heirs. Heirs necessarily bear a portion of the tax burden if the donor does not compensate for the tax by transferring more on a pre-tax basis so that her heirs' after-tax inheritances are the same. A donor (and others benefiting from donor saving) only bears part of the direct incidence if she responds to an increase in wealth transfer taxes by reducing her lifetime consumption in order to transfer more on a pre-tax basis to her heirs. In other words, a donor only bears a portion of the direct burden to the extent that, relative to the value she places on personal market consumption, the value she places on wealth transfers rises as her income declines. This seems unlikely, although it is possible. Instead, as discussed in §5.2, previous studies have found, if anything, that donors tend to transfer less on a pre-tax basis when the estate tax rate is increased. This substitution effect implies an indirect burden on donors. But heirs are likely to bear much more of the direct burden of revenue raised from taxes on transfers that are altruistically- or exchange-motivated than donors do.

Furthermore, to the extent that a transfer is accidental or egoistic, heirs should bear the entire burden of a wealth transfer tax (see §2.2, this paper). In such circumstances the donor, by definition, will not adjust her pre-tax transfers at all in response to a change in the tax rate. Recent evidence suggests that the majority of wealth transfers may be unintentional or egoistic (Kopczuk and Lupton 2007; Kopczuk 2006), implying that quite a large share of wealth transfer taxes are borne entirely by beneficiaries.

Based in part on the above considerations, there appears to be an emerging consensus that the most reasonable assumption is that wealth transfer taxes are largely borne by heirs (e.g., Entin 2004; Mankiw 2003). To date, however, the distributional estimates of the estate tax have all assumed that it is borne by decedents. This was driven to some extent by the fact that there was no readily-available data on who heirs are, so decedents were selected by default (Entin 2004; Burman, Gale and Rohaly 6-7 2003). Now that estimates of the effect on heirs are possible, however rough, it makes more sense to assume that the incidence of wealth transfer taxes falls predominantly on heirs, not their benefactors.

5.1.1. Revenue Estimates

Turning to the estimates, according to the TPC model, the proposal raises roughly the same amount of revenue as 2009 law if the lifetime exemption for the inheritance tax is $2.3 million. The total amount both taxes raise in 2009 is approximately $17.5 billion. Under 2009 law, the estate and GST tax exemptions are $3.5 million, the gift tax exemption is $1 million, and the tax rate for all three is 45 percent.

One variant to the proposal that was considered is applying a 10 percent surtax rate instead of the proposed 15 percent surtax. In this scenario, the lifetime exemption that raises the same amount of revenue as 2009 law is $2.0 million instead.

5.1.2. Distributional Analysis

Given the assumption that the incidence of wealth transfer taxes is on heirs, the distributional effects of the proposal turn on whether it alters which heirs are burdened by wealth transfer taxes, and the tax rate that applies to their inheritances. Theoretically, the distributional incidence of an estate tax and an inheritance tax would be identical if both systems applied a flat rate to all inherited income, including the first dollar received, or if the inheritance tax rate was unrelated to the heir's other income and all estates had only one heir.

In practice, however, the two have quite different distributional effects. Donors typically give to multiple heirs, neither system exhibits flat tax rates due

FIGURE 2

Average Tax Rate on All Inheritances: By Inheritance Size

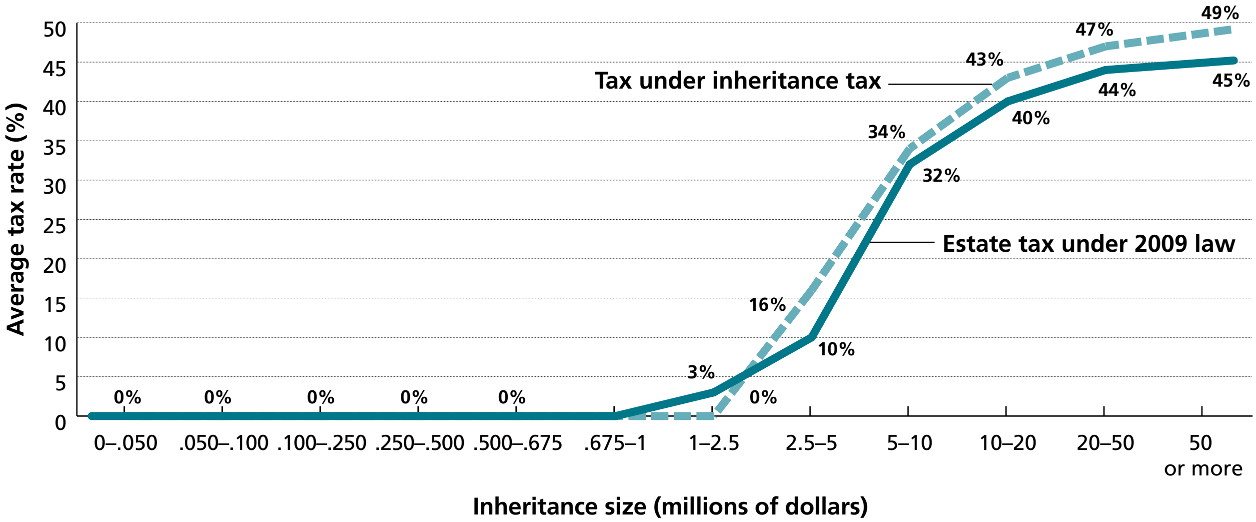
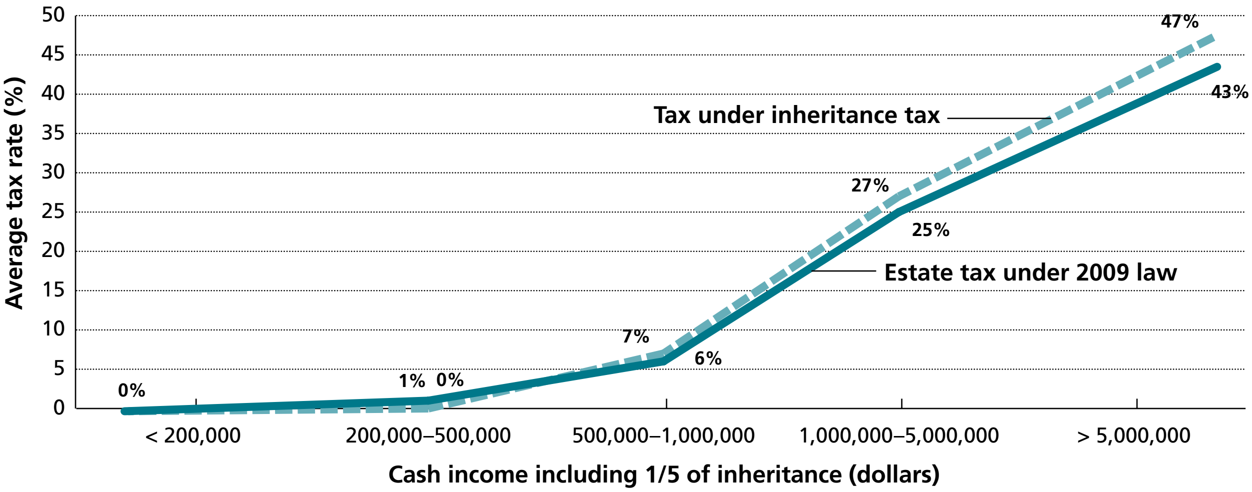


FIGURE 3

Average Tax Rate on All Inheritances: By Heir Economic Income



to lifetime exemptions and, in the case of the proposal, the link between the tax rate on inherited income and the income tax schedule. While both are highly progressive in aggregate, they are progressive in different ways. Moreover, at an individual level, their distributional effects are different to a much greater extent.

The aggregate progressivity of the proposal relative to the estate tax depends on what measure of ability to pay is applied. As illustrated by Figure 2, the proposal is more progressive by inheritance size. For inheritances below $2.5 million, the average tax rate on all inheritances received is higher under the estate tax, while for inheritances above $2.5 million it is higher under the inheritance tax. (Lower tax rates on some inheritances must be counterbalanced by higher taxes on others because the proposal is revenue neutral.)

The proposal is also more progressive by a comprehensive measure of heir income, which is referred to as *heir economic income* and includes the heir's cash income[11] plus one-fifth of her inheritance. We used this measure because focusing solely on an heir's cash income (analogous to adjusted gross income (AGI)) would not include any of her inherited income. As argued above, inheritances are economic income and should be considered relevant when measuring one's ability to pay income taxes. However, including all inheritances received in the current year in an heir's income measure for the current year does not provide an accurate picture of an heir's long-term economic status either, because presumably people who are heirs in a specific year do not receive gifts or bequests of the same size in every year.

Figure 3 shows that the proposal is more progressive by this measure of heir economic income, although both taxes are highly progressive. Heirs with economic income of less than $500,000 pay higher average tax rates on their inherited income under the estate tax. Heirs with $500,000 or more of economic income pay more tax under the inheritance tax. This pattern is a result of the fact that the inheritance tax rate directly rises in part with the heir's other income and in part with her lifetime receipts of gifts and bequests. The estate tax is also highly progressive by heir economic income because estate size tends to be positively correlated with heirs' other income and heir inheritance size,

11. Cash income is defined at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=574.

FIGURE 4

Average Tax Rate on All Inheritances: By Gross Estate Size

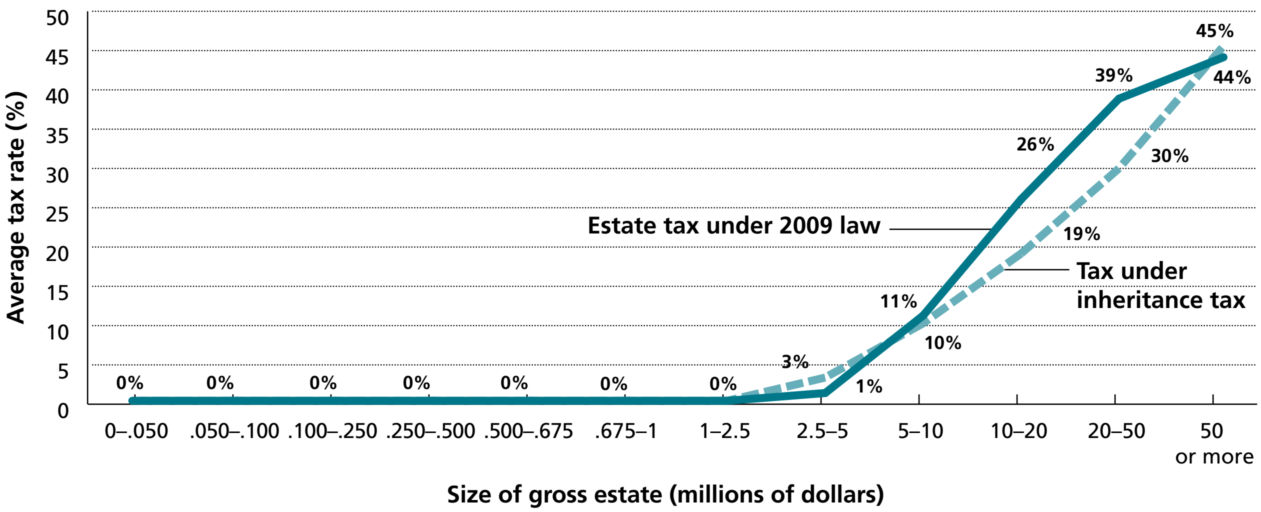
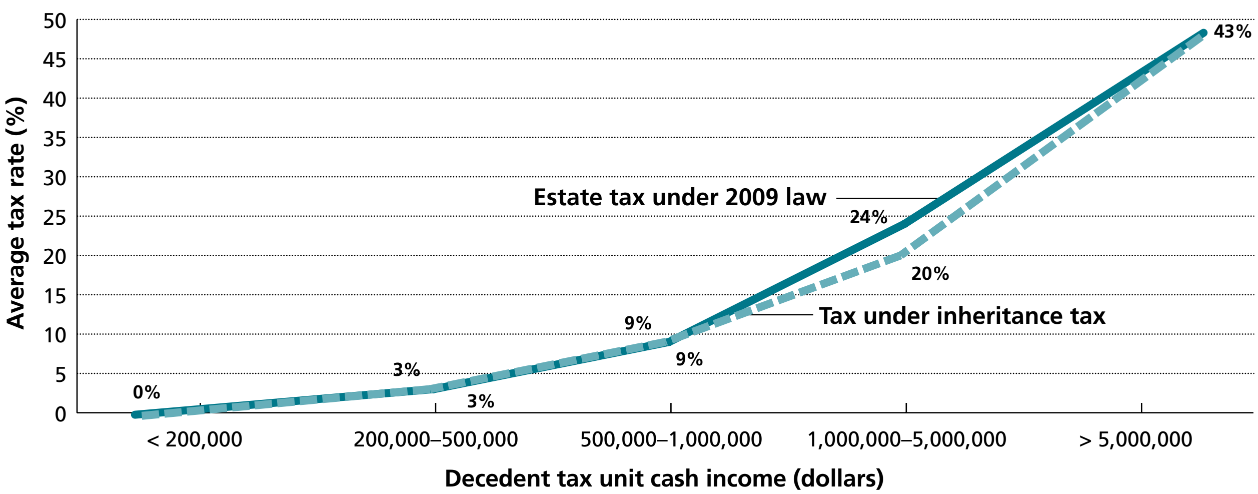


FIGURE 5

Average Tax Rate on All Inheritances: By Decedent Tax Unit Income



but it is slightly less so because its progressivity is an indirect, not direct, result of its rate structure.

By contrast, the proposal is generally less progressive if the average tax rates on inheritances are compared by the estate size, as seen in Figure 4. Estates of less than $5 million face a higher average tax rate under the inheritance tax, and estates of more than $5 million generally face a higher tax rate under the estate tax. An exception is the largest estates (more than $50 million) for which the inheritance tax rate is higher. It is not clear, though, why one should care about this type of progressivity. Greater progressivity along this dimension implies that heirs inheriting from larger estates generally pay more tax under the proposal, and heirs inheriting from smaller estates pay less, even if the latter have inherited more and are more affluent prior to the inheritance.

Finally, Figure 5 shows the distributional burden by the decedent tax unit's income. The two systems have quite similar effects. However, again, it not clear why this matters to the extent that the tax is borne by heirs and not by the decedent.

In practice, the proposal would likely be even more progressive than our current system along all four of these dimensions. The simulations do not include replacing stepped-up basis with carryover basis. Since the percentage that accrued capital gains represent of the value of gifts and bequests rises with the size of the transfer, which is positively correlated with heir economic income, heir inheritance size, and the donor tax unit's income, this feature of the proposal might magnify its progressivity. More importantly, to the extent that donors respond to the incentives to give more widely and to those with less pre-inheritance income, pre-tax gifts and bequests might be more progressive by inheritance size and heir economic income. This potential behavioral response is not included in the TPC estimates either.

The distributional estimates confirm that the proposal is more equitable than our current system. What matters in measuring the ability to pay of an heir is the amount inherited and the heir's other income, not the size of the estate from which she inherited it. On this view, some massive estates should bear relatively low tax burdens if they are distributed widely and to those who are less affluent. Conversely, some smaller but still vast estates should bear relatively higher tax burdens if they are distributed narrowly to heirs who are already affluent. What is important in determining the fairness of a wealth transfer tax system is thus the distribution of its economic burdens by inheritance size and a comprehensive measure of heir income, not estate size or decedent income. While the estate tax is quite progressive along both of these dimensions in aggregate, the inheritance tax is even more so.

Despite these improvements in the aggregate allocation of wealth transfer tax burdens, a reader might question whether the differences between these two systems are really worth the effort of reform. For instance, in Figure 3 the two lines certainly follow each other quite closely. One might interpret this as suggesting that there is not a big difference between the estate tax and the proposal in how much each enhances the precision of the income tax in measuring ability to pay. This is an understandable reaction, but Figures 2 to 5 paint an incomplete picture. By focusing on aggregate statistics, they mask crucial differences between the two systems at an individual level. When one instead focuses on individual heirs, it becomes apparent that the two systems affect very different people, often in radically different ways.

One way to understand the individual-level differences between the two systems is by considering the correlation between the two tax rates represented in the lines in Figures 2 to 5. The correlation is only 0.23. Correlation is a measure of the tendency of two variables to increase or decrease together, and 0.23 is quite low. Its square (the r-squared) suggests that only 5 percent of the inheritance tax rate of individual heirs is directly accounted for by the heir's estate tax rate, and vice versa. In other words, it suggests that at an individual level, heirs often face quite different tax rates under the estate tax and the proposal, but when heirs are grouped together by income class, the differences offset each other to a great extent.

The substantial difference between the two systems at an individual level can be seen most clearly in Figure 6, which shows the average estate tax rate and the average tax rate under the proposal on inheritances for individual heirs who pay some tax under at least one of the systems. Each point represents an heir, and each circle represents multiple heirs. While on average the estate tax rate rises with the inheritance tax rate, many inheritances are subject to a much larger estate tax rate than inheritance tax rate, or vice versa. A full 37 percent of heirs burdened by the estate tax inherit less than $1 million, while no heir burdened by the inheritance tax has inherited less than $2.3 million.

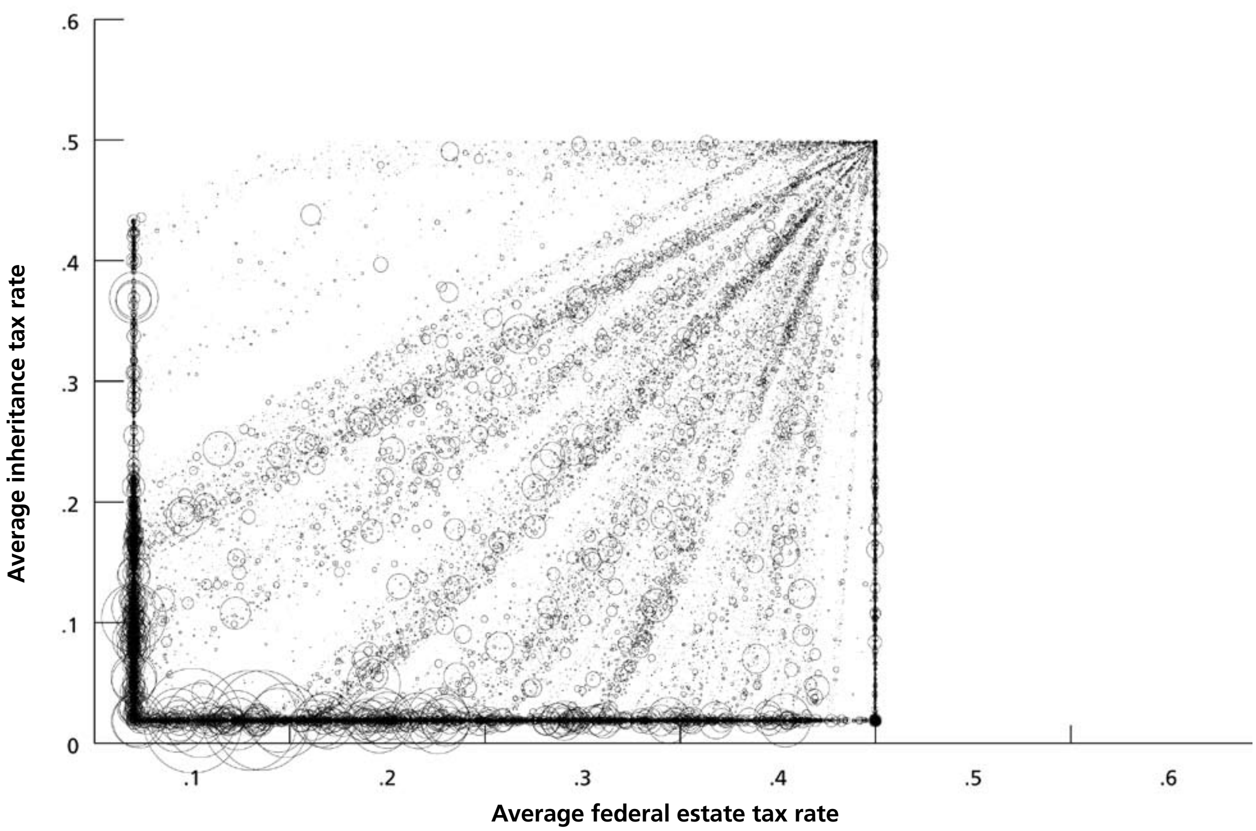
Two examples may help explain why the incidence of the proposal differs from that of the estate tax so much more at a micro level than at an aggregate level. For example, consider two taxable estates of $10 million each where the donors have not made any *inter vivos* gifts. Both would be subject to an average estate tax rate of 29 percent regardless of how many beneficiaries there were. However, if one was bequeathed entirely to one heir who was in the top income tax bracket and had received $1 million in prior inheritances, the bequest would be taxed at a much higher average rate of 44 percent under the proposal. If the other were bequeathed pro rata to five heirs who had no prior inheritances, the average inheritance tax rate would be 0 percent.

As another example, suppose there are two heirs with economic income of $1.2 million. Heir A might have inherited $5 million on top of an AGI of $200,000 from an estate worth $5 million. Her inheritance would bear a much higher tax rate under the inheritance tax (27 percent) than under the 2009 law estate tax (14 percent). Heir B might have the same inheritance and AGI but have received her bequest from an estate worth $30 million. Her tax burden under the inheritance tax would be the same (27 percent), but it would be much higher under the estate tax (40 percent). In aggregate, if there were only slightly more As than Bs, the inheritance tax rate would be only slightly higher for heirs in this income class. But at the individual level, the inheritance tax rate is quite different, and the proposal measures much more precisely the ability of heirs to pay the tax.

The above analysis assumes that donors allocate a fixed percentage of their estate to their different heirs. As mentioned, if they respond to the proposal by giving more broadly, the incidence of the tax on heirs who receive small bequests will be smaller or even negative because the heir will then inherit assets that she otherwise would never have received. Conversely, it is possible that donors tend

FIGURE 6

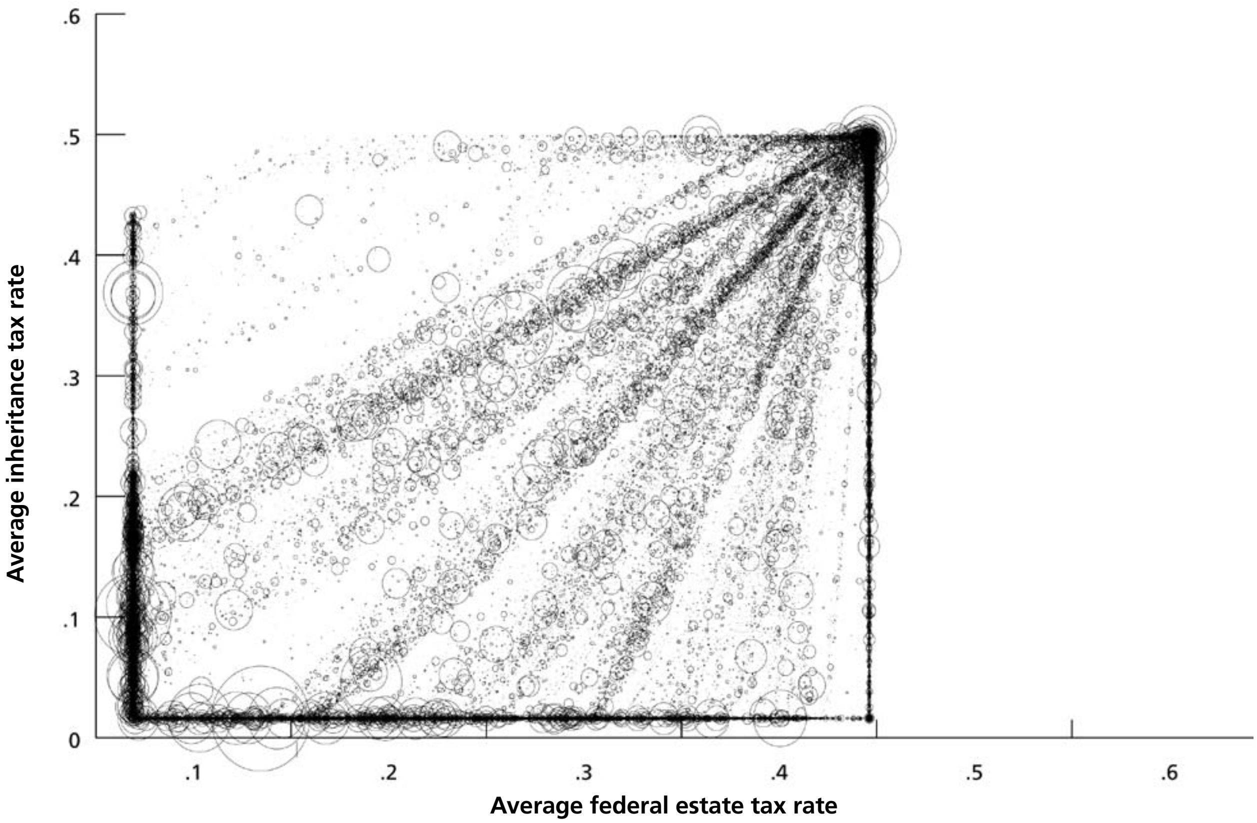
Relationship between Average Tax Rate on Inheritances under Proposal and under Estate Tax for Individual Heirs



Source: Tax Policy Center.

FIGURE 7

Relationship between Average Tax Rate on Inheritances under Proposal and under Estate Tax for Individual Heirs (Weighted by Inheritance Size)



Source: Tax Policy Center.

to allocate a fixed dollar amount to heirs receiving a small share of their estate, with the remainder going to their children or most important heirs. In this case, heirs of small bequests would not be better off (or worse off, for that matter). Under both the estate tax and the inheritance tax, such heirs bear no tax burden.

If either of these alternative assumptions hold true, the low correlation between the average tax rate under the estate and inheritance tax might be biased by weighting heirs of small bequests as heavily as heirs of large bequests. To address this possibility, we recalculated the correlation statistic where each observation is weighted by the size of the inheritance. In other words, a $100 million inheritance is weighted one thousand times more heavily than a $100,000 inheritance. The correlation statistic rises substantially to 0.68 but remains surprisingly low, still implying that only 46 percent of the inheritance tax rate of individual heirs is directly accounted for by the heir's estate tax rate, and vice versa.

Figure 7 illustrates the relationship between the average estate tax rate and the average tax rate under the proposal when each observation is weighted in this manner. Once again, inheritances frequently are subject to drastically different estate and inheritance tax rates. In fact, 14 percent of the revenue raised from each tax is raised from heirs facing zero tax burden under the other tax.

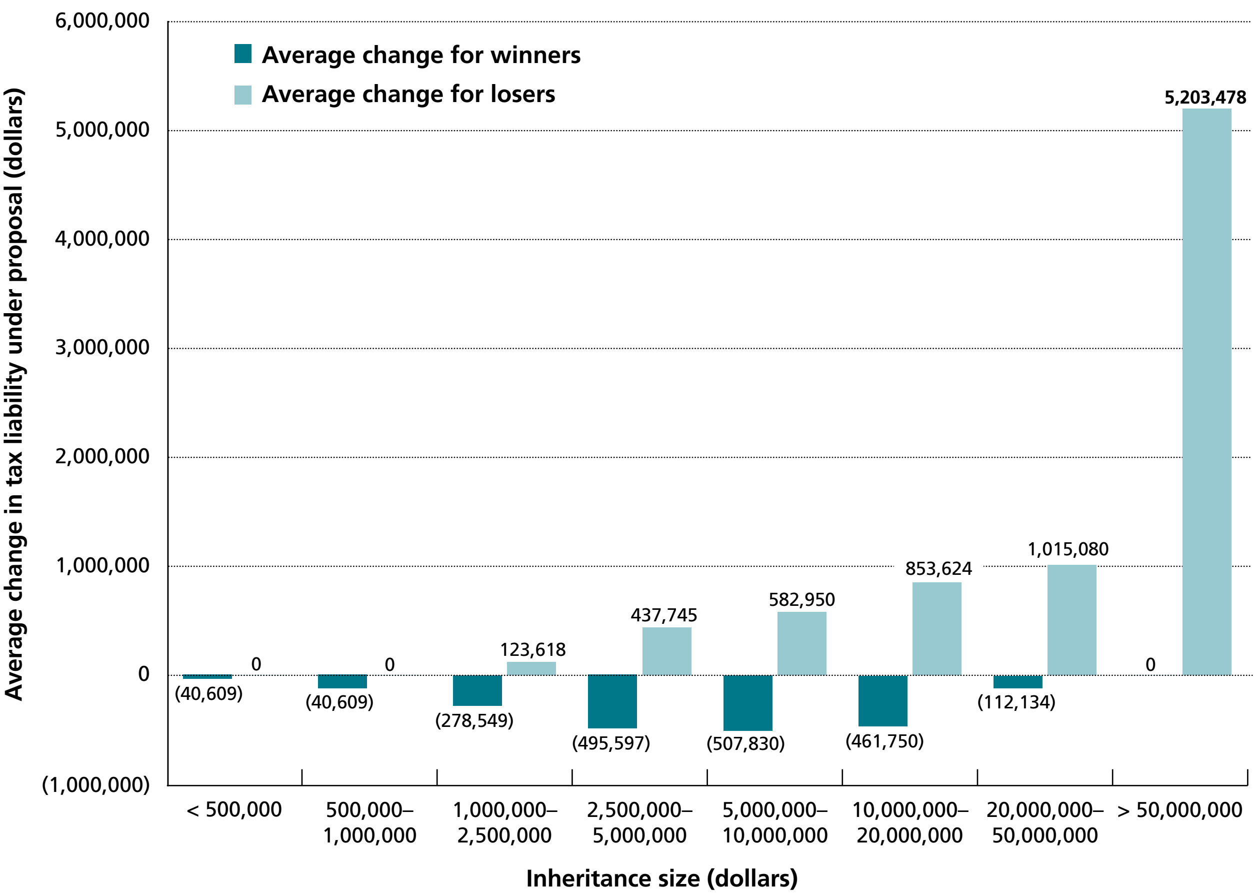
Figures 6 and 7 also illustrate to some degree the relative importance of the proposal's lifetime exemption and income inclusion approach in determining the tax rate on inheritances. The slight clustering of the points in diagonal lines results from the fact that the model imputes the amount inherited based on the estate size and various numbers and combinations of children and other beneficiaries. Each clustered line represents one possible inheritance size as a proportion of the estate. The lines are fuzzy because the inheritance tax rate on a given amount of inherited income depends also on the heir's prior inheritances and current noninherited income. Thus, the figure implies that the individual-level variance between the two tax rates stems to a large extent from the fact that the lifetime exemption applies to the amount transferred under the estate tax and to the amount received under the inheritance tax. However, the income inclusion approach of the proposal also contributes to the individual-level differences between the two systems. Under our estimates, about 14 percent of the value of inheritances subject to the inheritance tax are subject to tax rates below the top marginal rate.

5.1.3. Winners and Losers

The individual-level differences between the two systems can be understood still further by considering the winners and losers from the proposal. Our estimates suggest that, overall, each year there are more heirs who are winners (19,208) than losers (10,071) under the proposal. The vast majority of these winners are people inheriting less than $2.5 million. Moreover, as illustrated by Figures 8 and 9, the amounts won and lost are substantial. Heirs who are extraordinarily privileged and inherit more than

FIGURE 8

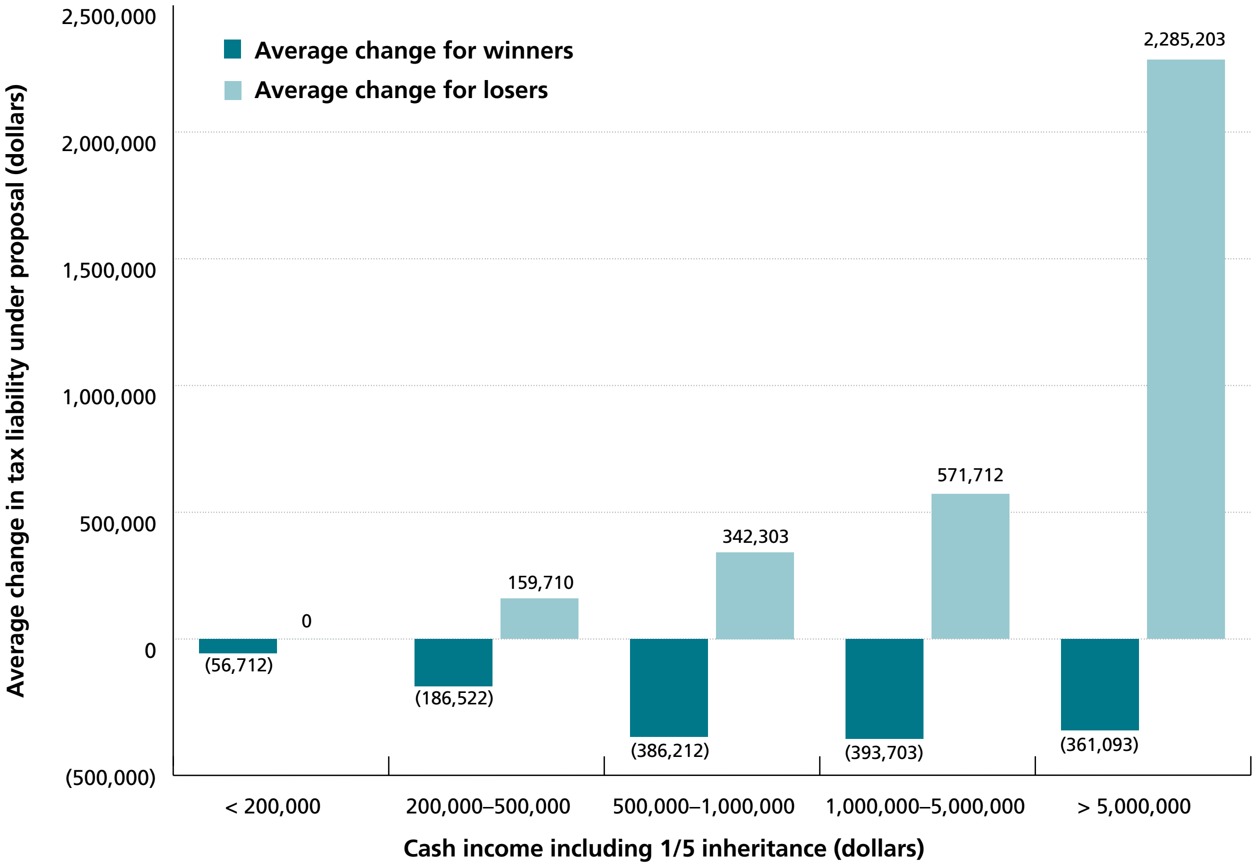
Average Change in Tax Liability for Winners and Losers Among Those Receiving Inheritances: By Inheritance Size



Source: Tax Policy Center

FIGURE 9

Average Change in Tax Liability for Winners and Losers Among Those Receiving Inheritances: By Heir Economic Income



Source: Tax Policy Center.

$50 million owe about $5 million more in taxes, on average. Similarly, those with economic income of more than $5 million who lose under the proposal pay about $1.7 million more, on average. Conversely, roughly 90 percent of heirs have economic income in the current year of less than $200,000. While fewer than one in a thousand of this group pays tax under either system, those who pay tax under the proposal win, owing about $57,000 less in taxes, on average.

5.1.4. Number of Taxpayers Affected

The final issue we modeled was the number of taxpayers affected. These estimates suggest that almost 60 percent more heirs inherit money from an estate paying some estate tax (22,000) than heirs who pay some inheritance tax (14,000). Thus, more heirs are burdened by the estate tax. The reverse is true from the perspective of estates. Under 2009 law, about seven thousand estates are projected to owe some estate tax. By contrast, heirs who were subject to the proposed inheritance tax inherit from about eleven thousand estates. This implies that the number of taxable returns should roughly double under the proposal because more estates are responsible for paying the estate tax (7,000), while heirs are responsible for paying the inheritance tax (14,000).

Despite these differences, the percentage of all heirs and estates burdened by either tax is tiny. Only an estimated 0.3 percent of heirs bear some estate tax burden annually, and only 0.2 percent bear any inheritance tax burden. Thus, while the proposal would often substantially change the tax burden on heirs, it would not dramatically change the number of taxpayers affected.

5.2. Level of Work, Saving, and Giving

The previous revenue and distributional estimates assume that there is no behavioral response to the proposal in the form of changes in the level of work, saving, and giving. This section considers this assumption. The behavioral response could go either way, but it is limited by the fact that the proposal is revenue neutral.

Previous empirical work suggests that wealth transfer taxes induce a fairly substantial increase in work by heirs (e.g., Brown, Coile, and Weisbenner 2006; Joulfaian tbl. 1 2006b; Gale and Slemrod 2001; Mikow and Berkowitz 2000; Holtz-Eakin, Joulfaian, and Rosen 1993). For example, Joulfaian finds that when people inherit more than $150,000 (in 1989 dollars), their labor force participation falls on average by 9 percentage points and their labor earnings by 12 percent. The decline in heirs' work tends to occur more through reductions in heirs' employment rate than through reductions in hours worked (Holtz-Eakin, Joulfaian, and Rosen 1993). It is unclear whether the proposal would increase or decrease heir labor supply. Tax burdens under the proposal are more calibrated to inheritance size and heir income, but there is little evidence regarding how heirs' labor response varies by inheritance size or income. Given that the proposal is revenue-neutral, there may be little effect either way. The proposal may, however, generate somewhat more income tax revenues than the estate tax to the extent that it induces relatively more work by heirs with higher earning potential due to its link to the heir's other income.

The effect of the proposal on heirs' saving is also unclear because there is little evidence of what effect receiving an inheritance has on an heir's savings rate (e.g., Gale and Slemrod 2001; Weil 1994; Holtz-Eakin, Joulfaian, and Rosen 1994).

Turning to potential donors, there is also limited evidence that the work and savings decisions of potential donors are responsive to the estate tax rate. Studies have found some evidence that the size of estates is negatively correlated with the level of wealth transfer taxation at the time of saving, which implies that potential donors may save and give somewhat less if the level of wealth transfer taxation is higher (e.g., Kopczuk and Slemrod 2001; Joulfaian 2006a; McGarry 2000). Because the level of wealth transfer taxation remains the same under the proposal, it may have no effect on the level of donor work, saving, and giving. If anything, it could induce a slight increase in such behavior to the extent that potential donors irrationally tend to respond more to a tax that they nominally pay, rather than a tax that is nominally paid by their heirs.

Another possible explanation for the negative relationship between estate size and the level of wealth transfer taxation is tax avoidance. As discussed in §5.4, the proposal creates some new opportunities to reduce wealth transfer taxation by giving to more heirs, but it also eliminates a number of avoidance opportunities under current law.

5.3. Recipients of Gifts and Bequests

While the proposal shouldn't have a large effect on the magnitude of giving, it could nevertheless affect giving patterns in a number of ways that would also alter the estimated revenue and distributional effects. In particular, it could change the identity of individuals receiving inheritances and the amount of charitable contributions. These possibilities are considered in turn.

5.3.1. Individuals

The effect of the proposal on giving patterns to individuals is unclear, but it is likely to induce donors to give slightly more broadly, especially to grandchildren, and to those who are lower-income. It is also likely to result in more wealth being transferred to surviving spouses than is the case under current law.

The proposal creates incentives to give to more heirs because a gift or bequest is tax exempt if it does not result in the heir exceeding the $2.3 million lifetime exemption. It also creates incentives to give to lower-income heirs because the tax rate on transfers above that threshold turns in part on the heir's income tax rate. Neither of these incentives exists under current law. A wealthy donor can give to one hundred heirs or one, to Paris Hilton or a foster child, and the tax rate is the same.

How much donors will actually respond to these changed incentives is unclear. On the one hand, donors do seem to be willing to give beyond their children; presently about one-third of taxable transfers go to nonchildren (Joulfaian 1994; Hendricks 2001). They will likely be even more willing to do so once grandchildren are more of an option. In addition, wealthier decedents tend give a larger portion of their estates to charity (Joulfaian; Hendricks), and this may indicate that they are responsive to tax incentives for charitable contributions. Furthermore, controlling for wealth, donors tend to give more to charity if their children are relatively high-income, implying that they already do take into account the heir's noninherited income to some extent, at least when making charitable gifts (Auten and Joulfaian 85 1996).[12] On the other hand, anecdotal discussions with estate tax practitioners suggest that donors tend to come in with set ideas about who their taxable beneficiaries will be. For example, about 70 percent of bequests to children are split evenly among the children, regardless of the child's income (Joulfaian 1994; Hurd and Smith 16 2002; Wilhelm 880 1996).[13] This suggests that, at least between their children and in the absence of tax incentives, donors generally do not take into account differences in their children's income when making bequests. Whether this preference would change in response to the proposal's newly created incentives for such giving remains to be seen.

On balance, a reasonable hypothesis is that donors will respond to the proposal by giving slightly more to nonchild beneficiaries, especially grandchildren, and slightly more to heirs who are low-income and who have inherited less over their lifetime.

Donors also may alter their individual giving by giving more outright to surviving spouses. Current law discourages a decedent from transferring her entire estate to her surviving spouse because doing so results in wasting her lifetime exemption. For example, under 2007 estate tax law, if a married couple has $4 million in assets, they can avoid paying any estate tax if she leaves $2 million to him and $2 million to their children, and he then transfers the remaining $2 million to their children. By contrast, half of their wealth transfers will be taxed if she bequeaths all of the assets to him and he bequeaths all $4 million to their children. Although many married decedents do not follow this basic tax minimization strategy (see §4.2.7, this paper), many also do. The inheritance tax treats both of the above possibilities the same; married decedents will likely leave more outright to their surviving spouse because such transfers would no longer face a potential tax penalty.

5.3.2. Charities

Presently, about 11 percent of the value of estates filing estate tax returns is distributed to charitable organizations (IRS 2005). The effect of the estate tax on charitable giving has been an important part of the debate about estate tax repeal. The likely effects of the proposal in this area are unclear for two reasons: (1) it creates conflicting incentives, and (2) the evidence on how much donors respond to wealth transfer tax incentives for charitable giving is mixed.

12. The authors found a similar effect for charitable bequests, but it was not statistically significant.
13. Joulfaian (1994; 63 percent); Hurd and Smith (16 2002; 81 percent), Wilhelm (880 1996; 67 percent divided exactly evenly, 88 percent divided approximately evenly).

In some respects, the proposal strengthens incentives for charitable giving. In particular, it expands the incentive to give appreciated property to charities because of the repeal of stepped-up basis. Under current law, neither the donor nor the heir ever has to pay the capital gains tax due on appreciated property that is bequeathed. Under the proposal, this is no longer the case. The heir would eventually have to pay that tax, but nobody would pay it if the donor instead bequeathed the property to a charity. Thus, there is a new incentive to bequeath appreciated property to charity. There is also a new incentive to give to tax-exempt nonprofits, such as 501(c)(4)s, that are not clearly eligible for the charitable deduction under the income and estate taxes. Because they are tax-exempt entities, by definition they are not subject to the inheritance tax. In addition, the fact that the top marginal tax rate under the proposal is higher than under current law creates further incentives for charitable transfers.

In other ways, however, the proposal weakens incentives to make charitable contributions. For instance, if a prospective heir would be subject to a lower inheritance tax rate than estate tax rate, the donor faces a weaker incentive. Moreover, the proposal creates the possibility of electing such lower tax rates on transfers to individuals. Currently, once a donor has exceeded the lifetime exemption for wealth transfers, the only way she can avoid the gift and estate taxes is by transferring funds to her spouse or charity. Under the proposal, there is a third option: she can transfer funds to an individual, such as a grandchild, sibling, or good friend, who is under the lifetime exemption.

Overall, therefore, the proposal simultaneously creates larger and smaller incentives to give to charity relative to current law. Which effect dominates for a particular donor depends on how much appreciated property she has, what tax bracket her current heirs would be in, and how much she values transferring funds to new heirs versus charity.

Let us presume for a moment, though, that on balance the proposal creates modest disincentives for charitable giving. Even then, it is unclear what effect it would have in practice because the empirical evidence is mixed regarding how responsive charitable giving is to wealth transfer tax incentives (Auten, Clotfelter, and Schmalbeck 414–17 2000). Most studies estimate that eliminating the estate tax would reduce charitable contributions, but the estimates vary from 0 percent to 37 percent (McClelland 2004; Bakija and Gale 2003; Greene and McClelland 2001; Joulfaian 2000; Auten and Joulfaian 64 1996; Fleischer forthcoming (b)). On the other hand, some studies estimate that charitable contributions would increase (Schervish and Havens 2003). Moreover, the wealthy tend to give a substantial proportion of their charitable giving at death, in direct contradiction to the income tax's strong incentives to give during life (Auten, Clotfelter, and Schmalbeck 414 2000).

In the face of such conflicting incentives and empirical evidence, it is hard to draw meaningful conclusions. A reasonable guess is that the proposal would result in no change or a small decline in charitable giving overall. However, it would likely induce some change in the form and object of charitable giving, with more transfers of appreciated property and more transfers to tax-exempt entities that are currently ineligible for the charitable deduction.

5.4. Tax Planning and Compliance Burdens

One of the most subtle but important advantages of the proposal is its potential for simplification. In this area, it may be helpful to distinguish two types of costs that taxpayers bear. A tax system can impose direct compliance costs on taxpayers, for example by requiring them to spend multiple hours reading instructions and filing returns. It also may impose indirect compliance costs by creating tax-planning incentives. When the tax system taxes differently transactions that are economically identical, taxpayers will often spend substantial time and resources trying to structure their affairs in ways that result in them owing less tax.

It may be hard to imagine anything worse than time spent filing tax returns, but often the indirect compliance costs of a tax system are worse than the direct ones. This is certainly the case with the estate tax. Extraordinarily wealthy individuals typically spend many hours and vast sums on estate planning, while their executor spends a relatively insignificant amount of time filing their postdeath return. Moreover, unlike direct compliance costs, tax-planning incentives tend to be unfair and especially inefficient because they privilege well-advised taxpayers and result in them changing the form of their transactions in ways they would otherwise not prefer, purely for tax purposes. The proposal could result in a slight increase in direct compliance costs, but it is likely to result in a net reduction in tax-planning burdens.

5.4.1. Areas where Net Effects Are Unclear

- *Direct Compliance Costs.* Starting with the downsides, the proposal may increase direct compliance costs because more tax units will have to file returns. As summarized above, the TPC model suggests that about seven thousand estates will owe some estate tax under 2009 law, while about fourteen thousand heirs would owe some inheritance tax. This is a substantial increase in percentage terms, but both numbers represent a tiny fraction of the population. The more important source of new filing obligations will be information reporting as heirs and donors will have to report (but not pay tax on) gifts and bequests that fall below the lifetime exemption but above the annual exclusions. Despite these new filing and reporting burdens, direct compliance costs could nonetheless decline on net if they are more than offset by the reduction in the rules and tax forms necessary to address the existing tax-planning incentives as described in this section.

- *Appreciated Property.* Another area where the net effect of the proposal is unclear is appreciated property. The repeal of stepped-up basis would get rid of one of the largest incentives to hold on to appreciated property. In particular, it would eliminate the incentive for donors to bequeath appreciated property while consuming nonappreciated property during their retirement. At the same time, though, it would increase "lock-in" incentives for heirs. Individuals inheriting property with large accrued gains would benefit from delaying realization of those gains as long as possible. On balance, these two incentives should result in less lock-in (see §§2.3, 3.5, this paper). The incentive to transfer appreciated property would remain, however, with respect to charitable transfers. Thus, the proposal could increase or decrease tax-planning associated with accrued gains.

- *Trusts and Contingent Transfers.* A final area in which the proposal may or may not increase indirect compliance costs is the creation of discretionary trusts or other interests whose beneficiaries are unclear. If donors are irrational, they may view the withholding and credit system for such transfers as a tax penalty because the withholding tax is paid earlier in time. Conversely, they erroneously may view the lack of withholding on the first $2.3 million of such transfers as an opportunity for tax savings. In either case, the proposal might result in donors creating fewer or more such trusts than they would otherwise prefer.

  The proposal also could induce donors to transfer more funds via generation-skipping trusts due to the absence of a GST tax. If the donor wants to provide for her child and is not sure how long her child will live, the best strategy would be to create some kind of restricted trust. Then the amount that goes to the child can vary depending on the child's needs, and the child will be taxed only on distributions she actually receives. Any remaining funds will go to any grandchildren and will be taxed only as an inheritance of the grandchildren, not as an inheritance of the child. Whether this shift would be a positive or negative development is unclear because, given the GST tax, it could move donors closer to or farther from their non-tax preferences.

With the above exceptions, however, the proposal should reduce tax-motivated contingent transfers, as explained next.

5.4.2. Areas where Burdens Are Reduced

The potential drawbacks of the proposal described in §5.4.1 are significant. But in practice they are likely to be swamped by the many ways that the proposal clearly curtails or eliminates tax-planning incentives by treating economically identical transfers more alike. The benefits are largest in the context of spousal transfers, *inter vivos* gifts, and valuation games.

- *Spousal Transfers.* First, the proposal would eliminate the need for spouses to carefully plan transfers in order to minimize their joint tax liability. As discussed above, spouses currently can reduce their joint tax liability by making sure that they each transfer an amount equal to the lifetime exemption to their heirs. If the surviving spouse needs access to some of the transferred assets, however, this can be quite a complicated task. The couple then should generally use what is called a credit shelter trust, which permits the first-to-die to treat assets as going to their heirs even though the surviving spouse still has some access to the assets (McDaniel, Repetti, and Caron 617–77 2003; McNulty and McCouch 415–21 2003). The proposal creates no incentive for such complicated planning and eliminates the need for rules to address it. Instead, any tax is based on the amount each heir receives, regardless of whether the inheritance was from her mother or her father.

- *Gifts vs. Bequests.* A second way in which the proposal would decrease tax-planning burdens is by dramatically narrowing differences in the tax treatment of gifts and bequests. Presently, gifts are generally taxed much more lightly than are bequests. Donors appear to respond to this incentive by transferring far more wealth through *inter vivos* gifts than they would absent taxes (McGarry 93 2001). This occurs because gifts below the annual exclusion are tax free, and the estate tax applies to the pre-tax transfer, while the gift tax does not. As a result, gifts are subject to a lower effective tax rate. More specifically, the current gift tax rate is effectively 31 percent if it is calculated by reference to the pre-tax transfer, while the current estate tax rate (which is calculated by reference to the pre-tax transfer) is 45 percent.[14] Gifts are also tax preferred because only the nominal value of gifts counts toward the lifetime exemption. This means that if a donor is considering whether to transfer an asset by gift or bequest, she can avoid paying wealth transfer tax on the asset's appreciation between the time of the gift and her death if she transfers it by gift.

  To further confuse matters, however, bequests are taxed more lightly in other ways. Only bequests are eligible for stepped-up basis. And currently the lifetime exemption under the estate tax is larger than under the gift tax.

  The proposal would eliminate many of these differences. Regardless of whether the amount inherited was a gift or a bequest, the same lifetime exemption would apply, and the tax rate would apply to the pre-tax inheritance. In addition, the proposal would treat all capital gains on appreciated property the same under the income tax. Furthermore, by indexing prior gifts and the lifetime exemption to inflation, it would reduce the extent to which donors and heirs can avoid paying wealth transfer tax on the appreciation of a

14. For instance, under the gift tax, the tax due on a $100 after-tax gift is $45. The pre-tax gift is $145, and thus the tax inclusive rate is $45 over $145, or 31 percent.

transferred asset. Presently, donors and heirs can accomplish this result through gifts. They can also do so through other types of estate freezes, where the donor retains control of the asset but is deemed to have transferred it (or sold it at a token price) many years before her death.

Donors would still face some incentive to transfer property prior to death under the proposal. For example, by spreading out transfers over time, a donor could take advantage of her heirs' lower income tax brackets and remaining annual exclusions. In addition, the only way to fully avoid the benefits of estate freezes is to index prior gifts and the lifetime exemption rate to the market rate of return. This alternative is not proposed because it would increase the likelihood of indexing rate brackets and exemptions to the market rate of return in other contexts where such indexation might not be desirable. Despite these remaining differences in the tax treatment of gifts and bequests, however, the proposal is a vast improvement.

- *Valuation Games and Associated Rules.* Many of the reductions in tax-planning incentives described thus far, such as the harmonized treatment of gifts and bequests, could be accomplished in the context of our current system. Yet there are other ways in which the proposal would reduce indirect compliance costs that inherently can be achieved only through an inheritance tax. These simplification benefits unique to an inheritance tax all involve limiting the ability of donors to use valuation games in order to minimize taxes.

In a couple of areas, the proposal would create new opportunities for valuation games. For instance, the proposal creates more valuation points when funds are transferred through trust or contingent interests to multiple beneficiaries. Donors could also reduce the total value of a bequeathed business by dividing it between heirs so that each receives a minority discount. In practice, these new avoidance opportunities could be curtailed by, for example, valuing an heir's inherited interest in a business in proportion to the total value of the business in the donor's hands.

Instead, overall, the proposal should significantly cut back on opportunities to engage in valuation games. As discussed in §4.2.5, a large portion of the complexity of our current system arises from potential donors taking advantage of the fact that our wealth transfer taxes are imposed at the time of transfer. This feature does not, in and of itself, create opportunities to undervalue the total amount transferred. But it does create sizable opportunities to allocate an unreasonably large proportion of the wealth transferred to tax-exempt beneficiaries or beneficiaries taxed at low rates. In response to such misallocations historically, an enormously complicated body of rules has developed over time. For example, the rules governing grantor trusts, charitable trusts, spousal trusts, GSTs, and Crummey trusts (e.g., IRC §§676, 664, 666, 678 2007) are all designed, to some extent, to prevent donors from using split, contingent, revocable, or future interests in order to maximize the portion of their transfers that are deemed to be subject to lower tax rates.

The proposal generally eliminates or sharply curtails tax incentives to use these vehicles by waiting to see who gets what before imposing any tax. Moreover, because it is intended to be a tax only on receipts, it makes no attempt to tax people on gifts or bequests that they never actually own.

By reducing these tax-planning incentives, the proposal should, in turn, reduce the need for rules to address the incentives. In practice, the simplification effects in this area could be the most extensive of all the effects discussed. Prior studies have reached similar conclusions (see Andrews 1967, 1969; Halbach 1988). The current rules governing marital trusts, charitable trusts, grantor trusts, Crummey trusts, and the GST tax compose one-fourth of a leading casebook (McDaniel, Repetti, and Caron 2003). Thus, the wait-and-see approach of the proposal on its own should ensure that the proposal results in substantial reductions both of indirect and direct compliance costs because, quite simply, there will be less law.

5.5. Administrative Burdens

This likelihood that the proposal will reduce taxpayer compliance burdens on net should be mirrored at the governmental level. Because the proposed system would have fewer rules to enforce and fewer tax-planning strategies to address, administrative burdens should decline.

Nevertheless, the proposal does represent a fundamental shift in our approach to taxing wealth transfers. A reasonable question, therefore, is whether it might prove administratively infeasible in practice in ways that cannot be anticipated in advance. This is unlikely to be the case. Each component of the proposal has been successfully implemented at the state or federal level in the United States or in other countries. Indeed, seven U.S. states and twenty-three countries currently impose some kind of inheritance tax.[15] As mentioned in §3.1, the United States had an inheritance tax during and after the Civil War from 1862 to 1870 and then from 1894 to 1895 and from 1898 to 1902. The United States also required taxpayers to include gifts and bequests in income beginning in 1894 until the income tax was struck down as unconstitutional in 1895 (see McDaniel, Repetti, and Caron 3–4 2003).

Turning to specific features of the inheritance tax proposed, its use of lifetime measures should not prove problematic. While most jurisdictions imposing inheritance taxes do not aggregate inheritances across time and donors, some—like Ireland—do. More importantly, lifetime measures are a long-standing element of our own federal wealth transfer taxes. Income inclusion should also be administrable. Four countries require taxpayers to include gifts in income;[16] our own system did so in the nineteenth century.

Similarly, experience suggests that carryover basis for bequests would be workable. While the United States enacted carryover basis in 1976 and then repealed it before it went into effect due to concerns about implementation, those concerns appear to have stemmed from peculiar features of the bill and not any fundamental implementation barriers (Lustgarten 1978).[17] Indeed, at least five countries currently provide for carryover basis for bequests, including such large economies as Germany, Australia, and Japan (Ault and Arnold 184 2004). Our own system is scheduled to apply carryover basis to bequests for the strange year of 2010 (IRC §1022 2007).

Finally, the provisions in the proposal for using a withholding and credit system for transfers where the beneficiary is unclear should be administrable. These provisions are modeled on a proposal developed by Bill Andrews for a 1969 American Law Institute panel composed of prominent estate tax practitioners and academics, who also thought such an inheritance tax would not only be administrable,

15. For this purpose, an inheritance tax is defined on as a tax on gifts or bequests that is lower in certain circumstances if the donor gives to more donees. The U.S. states with an inheritance tax are Indiana, Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania (Indiana Department of Revenue 2001; Iowa Department of Revenue 2005; Kentucky Revenue Cabinet 2003; Comptroller of Maryland 2006; CCH, Inc. [CCH] 2006; New Jersey Division of Taxation 2006; Pennsylvania Department of Revenue 2006). In all seven states, the tax only applies to bequests and a representative of the estate files the return. The twenty-five countries with some type of inheritance tax are Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Japan, Korea, Lithuania, Luxembourg, Netherlands, Norway, Poland, Russia, Serbia, Slovenia, Spain, Switzerland, and Turkey. In the case of Russia, the inheritance tax only takes the form of including certain *inter vivos* gifts in income; there is no separate tax in gifts or bequests received (International Bureau of Fiscal Documentation 2006a; International Bureau of Fiscal Documentation 2006b; Beom-Gyo 2002).

16. The countries are Denmark, Iceland, Lithuania, and Russia (International Bureau of Fiscal Documentation 2006b).

17. For example, the legislation included an amnesty provision that required taxpayers to value all of their assets on one day in history in order to claim its benefits. The proposal includes no such amnesty provision and a taxpayer would only need to value appreciated inherited assets if they were subject to tax so that she could claim the deduction for inheritance taxes paid. Such valuation would already have occurred because they would necessarily have exceeded the annual exclusion.

but that it would also be much simpler than the law at the time (Andrews 1967; Andrews 446 1969). Moreover, several state inheritance taxes impose a withholding tax coupled with a refund to the extent that the withheld taxes exceed the tax due, demonstrating that it can work (e.g., Iowa Code §450.96; Kentucky Revised Statutes §140.110; New Jersey Statutes §54:36–6).

Thus, there is ample precedent for implementing the various elements of the proposal in practice.

5.6. State Wealth Transfer Taxes

The existence of state inheritance taxes raises the final question about the likely effects of the proposal: that is, how it would affect the states. Historically, the federal estate tax offered a dollar-for-dollar credit for state wealth transfer taxes up to a limit, which allowed states to receive part of the revenue from federal wealth transfer taxes without actually imposing any new economic burden on their residents. Although this credit was part of the law for more than eighty years, it disappeared at the beginning of 2005 and was replaced with a deduction for state wealth transfer taxes (IRC §2058 2006; Cooper 840 2006). (This credit is scheduled to reappear in 2011.) Because the credit was worth more than the deduction, and all fifty states had some type of wealth transfer tax in place in 2001, the economic effect was to cut back on federal revenue sharing with the states. This was a blow to state finances, which were already in a precarious position.

Perhaps as a result of states' shaky finances, state wealth transfer taxes have proven more resilient than some observers expected (Yablon 243 2006). By late 2005, twenty-eight states still had wealth transfer taxes. In the twenty-two states that no longer had wealth transfer taxes in that year, repeal largely occurred because their prior taxes by statute were tied to and contingent on the federal estate tax credit (Yablon 278).

Regardless of how much federal estate tax revenue one thinks should be shared with the states, an inheritance tax could achieve the same division. For example, a credit or deduction could be offered under the proposal for state inheritance taxes and an heir's share of state estate taxes. States would likely act to conform their wealth transfer tax systems to the inheritance tax model in order to piggyback on the new federal reporting requirements, as they did under the federal estate tax credit (even states that had an inheritance tax).

The proposal therefore should not require any change in our level of revenue sharing with the states. Instead it has the benefit of making it easier for states to retain or enact wealth transfer taxes that do more than soak up federal revenue sharing if they so choose. Observers expected that the repeal of the state wealth transfer tax credit would result in the states competing to attract wealthy, elderly residents by eliminating their wealth transfer taxes. This expectation was borne out in as many as twenty-two states. By contrast, under an inheritance tax, states might also compete in this way, but their incentive to do so would be reduced; each heir would have a smaller tax incentive to move, and heirs may find it more difficult to move than retirees for employment reasons. In addition, shifting to a federal inheritance tax would facilitate state adoption of inheritance taxes, with their attendant political advantages, which might provide states with further latitude to expand wealth transfer taxes if they so wish.

6. Questions and Concerns

Because an inheritance tax represents a fundamental change to our current system, it is likely to generate a number of questions and concerns. This section considers three. Doesn't the proposal unfairly advantage bigger families? Why not tax inheritances from relatives at lower rates? Finally, shouldn't the proposal go farther by taking on some related and much-needed reforms?

6.1. Doesn't the Proposal Give an Unfair Advantage to Bigger Families?

One common first reaction to the idea of shifting to an inheritance tax is to point out that it will impose lower tax burdens on donors with larger families. Whether this is unfair depends on the incidence of a tax on wealth transfers and one's views of why we should tax gifts and bequests.

As discussed in §5.1, heirs probably bear most of the burden of wealth transfer taxes, not donors. Moreover, the view taken in this paper is that we should at least tax large amounts of inherited income like all other income, and if people have inherited extraordinary sums, we should tax the special advantage that inheritance represents through somewhat higher rates. In this view, it is privilege and ability to pay that matters, and it is eminently fair for gifts and bequests by donors with larger families and the same net worth to bear lower tax burdens. If one child and her nine siblings each inherits $1 million from their parents, that child is less privileged than a child with no siblings who inherits $10 million from her parents.

6.2. Why Not Tax Inheritances from Relatives at a Lower Rate?

Another common question is to point out that most jurisdictions with inheritance taxes impose lower tax rates on inheritances from relatives and to ask why the proposal doesn't follow this practice. This is factually correct. Every U.S. state and nineteen of the twenty-three countries with an inheritance tax impose higher taxes on gifts and bequests received by nonrelatives.[18] Often, the tax rates rise as the relationship to the donor becomes more attenuated. Inheritances from parents bear the lowest tax rates. Inheritances from aunts and uncles bear higher rates, and inheritances from nonrelatives bear the highest rates of all.

The rationale for this practice is unclear. Most likely it results from a natural sympathy toward the idea of giving to one's children and relatives.[19] While understandable, it misses the point. An inheritance tax doesn't seek to encourage giving more to nonrelatives than to one's children: it simply seeks to tax all people on all of their income and not let the most privileged off the hook at the expense of regular people who don't receive large inheritances. Children of the

18. All seven U.S. states with inheritance taxes tax bequests to nonrelatives more heavily (Indiana Department of Revenue 2001; Iowa Department of Revenue 2005; Kentucky Revenue Cabinet 2003; Comptroller of Maryland 2006; CCH 2006; New Jersey Division of Taxation 2006; Pennsylvania Department of Revenue 2006). In addition, at least nineteen countries follow this approach: Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Japan, Lithuania, Luxembourg, the Netherlands, Serbia, Slovenia, Spain, and Switzerland. Iceland, Norway, Poland and Turkey are the only countries that do not tax transfers to nonrelatives more heavily. However, Poland and Turkey both tax gifts and bequests received by some relatives more lightly than nonrelatives but do not distinguish between, for example, grandchildren and nonrelatives (International Bureau of Fiscal Documentation 2006a; International Bureau of Fiscal Documentation 2006b).

19. The lower exemptions for inheritances from more distant relatives or nonrelatives may also stem from a presumption that the heir has or will inherit much more from her parents. Since most jurisdictions use annual and not lifetime exemptions, bequests from one person generally do not affect the tax rate on bequests from others. Another potential explanation is that inheritances from distant relatives may be more likely to be utterly unintentional and unforeseen if there was no will and the estate passed to the distant relative by the laws of intestacy (Waldron 1468–71 1997, citing Bentham 1952). However, this does not explain the lowest exemptions for transfers to nonrelatives.

wealthy already gain vast intangible advantages from being raised in an affluent household that go untaxed.

Because the tax rates on inherited income are progressive under the proposed inheritance tax, the practical effect is to encourage broader and more equal giving, including to nonrelatives who have inherited little or nothing from their own families. But this is not a drawback; it is desirable from a fairness perspective. Such broader and more equal giving breaks up family wealth dynasties, softens inequalities of opportunity, and can help narrow economic disparities. This is one area in which the ordinary practice in other jurisdictions with inheritance taxes should not be followed.

6.3. Shouldn't the Proposal Go Further?

The final question one might ask is if the proposal doesn't go far enough. If it is already proposing a fundamental change to wealth transfer taxation, why not take on a variety of related issues? Two sets of related reforms worth consideration in a less politically constrained world are summarized in §§6.3.1 and 6.3.2. Section 7 discusses whether the overall level of wealth transfer taxation should be higher.

6.3.1. Appreciated Assets

The first reform worth consideration is to tax gains on inherited assets at the time of transfer and not when the heir sells the asset. This could be accomplished by taxing donors or their estates on all such accrued gains. Alternatively, the receipt of gifts and bequests above the $2.3 million lifetime exemption could be treated as a realization event for the heir, which would mean that the heir would pay the capital gains tax due on the appreciated assets when she inherits them. If part of an inheritance fell below the threshold and part above, the accrued gains on the inheritance could be allocated pro rata, or the donor could be allowed to allocate basis however she pleases.

Either reform would have several advantages. Both would reduce lock-in incentives further than this paper's proposal to replace stepped-up basis with carryover basis. The second approach would probably enhance the progressivity of the tax treatment of gifts and bequests because the portion of an estate representing appreciated assets tends to rise with the estate size, implying that the share of inheritances does as well. (The first would not if implemented on a revenue-neutral basis, because even small inheritances tend to include some accrued gains.) The primary substantive objection is likely to be that both reforms would be inadministrable. However, five countries treat gifts or bequests as realization events.[20] The most notable example is Canada, which has treated gifts and bequests as realization events since 1972 without encountering major administrative difficulties (Zelenak 2004).

Both approaches could also be coupled with further desirable reforms to the treatment of appreciated assets. For example, our current-law tax preferences for life insurance are hard to justify. All gains on life insurance policies—including the pure savings element—are tax exempt if paid as a result of the death of the person insured, which violates the principle of taxing all capital income at least once. In addition, under current law, people donating appreciated property to charity can often take an income tax deduction for the full value of the property even though they haven't paid tax on its capital gains.

This set of reforms is not included in the proposal largely as a matter of priorities and political pragmatism. As discussed, the Canadian experience suggests the inheritance tax might not survive if coupled with taxing accrued gains on gifts and be-

20. Canada and Estonia treat both gifts and bequests as realization events, while Australia, Ireland, and the United Kingdom treat *inter vivos* gifts as realization events (Ault and Arnold 184 2004; International Bureau of Fiscal Documentation 2006a; International Bureau of Fiscal Documentation 2006b).

quests at the time of the transfer. The judgment here is that taxing inherited income is more important than taxing accrued gains on gifts and bequests earlier in time. In addition, as explained next, reform of tax incentives for charitable contributions is such a broad issue that it merits separate consideration elsewhere.

6.3.2. Tax Incentives

Turning to tax incentives, the proposal would present no barriers to replicating our current wealth transfer tax treatment of charitable contributions, our current gift tax exclusions for amounts paid for education and medical expenses, and our current income tax exclusion for life insurance payments paid upon death. Whether we should do so is another question. For example, the exclusion for education expenses undercuts the ability of the proposal to promote equal opportunity in light of the vast sums that wealthy parents spend on private schools, colleges, and graduate schools, and the significant share of wealth embedded in human capital (Kaplow 191 2001 citing Davies and Whaley 1991; Jorgenson and Fraumeni 1989). Meanwhile, the question of how to tax charitable contributions in some respects is identical to the question of how to tax gifts and bequests. If we could know the ultimate beneficiaries, the ideal subsidy would look much different. Donors shouldn't be able to deduct such contributions, and the additional tax on the transfer should turn on the income of the beneficiaries, potentially rising from a negative tax to a relatively high tax rate.

More generally, there are a variety of ways in which the current set of tax incentives in the tax code as a whole is far from ideal (e.g., Batchelder, Goldberg, and Orszag 2006; Simon, Dale, and Chisolm 273–79 2006; Edlin 2005; Furman 493 2006; Fleischer forthcoming (a); Halperin 2002; Bittker and Rahdert 1976). Most tax incentives operate through deductions, exclusions, and, more rarely, nonrefundable credits. As Fred Goldberg, Peter Orszag, and I have argued elsewhere, a fairer and more efficient way to deliver tax incentives, if they are desirable at all, is through uniform refundable credits, which do not arbitrarily exclude a large portion of tax units from eligibility for the incentive.

While this is too broad a subject to discuss here, it is worth noting that, to the extent that incentives for certain kinds of wealth transfers are desirable, an inheritance tax has a unique advantage. Currently, the exclusions for amounts paid for support for minors and education and medical expenses apply only to gifts, and not to bequests. Under an estate tax, extending such tax incentives to bequests would create the same valuation issues that arise for other tax-exempt transfers. By contrast, an inheritance tax, with its wait-and-see approach, could eliminate these valuation issues. As a result, it could further narrow the differential treatment of gifts and bequests, and extend tax incentives to the 83 percent of reported wealth transfers that are made through bequests (IRS 2006b; IRS 2007).

7. Conclusion: Why Tax Wealth Transfers at All?

Ultimately, the most fundamental question that might be asked of the proposal is why we should continue to tax wealth transfers at all. Estate tax repeal advocates were fairly successful in their efforts to create some doubts about whether the estate tax should exist. Polling data suggests that 47 percent of the public believes the estate tax should be repealed even after it is explained to them who actually pays the tax (Graetz and Shapiro 124 2005 citing Greenberg Research). Those who are convinced of the merits of estate tax repeal may believe that this paper has focused on a straw man by comparing an inheritance tax to our current system because neither is desirable. This conclusion argues there are a number of compelling reasons why we should continue to tax wealth transfers regardless of the method. An inheritance tax is simply the better way.

To begin, economic disparities in the United States are extensive and rising. While median household income has stagnated over the past decade (U.S. Census Bureau 2006), the top 1 percent of Americans received about 20 percent of all pre-tax income in 2004, which was their highest share since 1929 with the exception of the stock market bubble in 1999 and 2000 (Piketty and Saez 2006). Wealth disparities are even more extensive: the wealthiest 1 percent of individuals own more than one-third of total wealth (Hendricks 2001). While estimates vary widely, all the evidence suggests that inheritance is a significant driver of these gaps. Inherited wealth represents 15 to 30 percent of all wealth (Kopczuk and Lupton 2007).

Many view reducing economic disparities as an important goal of the tax system. This is an important reason why we have rising marginal rates. If one views economic income as the best measure of ability to pay and economic well-being, this implies taxing gifts and bequests. Gifts and bequests should come out of the after-tax income of the donor because she, and not the public, is choosing how to spend the money and could just as easily choose to spend it on goods that would be taxed. Inheritances should also be included in the heir's income—or subject to a separate wealth transfer tax such as the estate tax as a proxy—because they are just as much income for the heir as are wages or lottery winnings.[21]

Moreover, many believe that the tax system should seek to promote more broad-based economic and political opportunity and the breakup of dynastic wealth. In this view, we have a social obligation not only to mitigate economic disparities between the rich and poor, but also to help ensure that all children have very roughly the same opportunities in life. This is a hard goal to accomplish. However, one of the most obvious ways to begin is by taxing gifts and bequests slightly more heavily than other income because of the advantages they provide, and using the revenue to fully fund programs promoting greater opportunity for the least advantaged.

Taxing wealth transfers is thus essential for advancing several core American values. It makes our tax system better attuned to the various receipts and circumstances that affect an individual's ability to bear the burdens of government finance. In doing so, it strengthens the ability of our tax system to help mitigate widening economic disparities and unequal starting points.

At the same time that fairness considerations push in favor of maintaining or expanding wealth transfer taxes, there is no consensus about whether doing

21. If one's primary concern is inequality of all consumption, the analysis is quite similar. The ideal approach is then to have an inheritance tax by taxing gifts and bequests as consumption by the donor and taxing heirs on consumption from inherited income (c.f., McCaffery 1994). But if one's concern is inequality of private market consumption, that may imply a different approach (Stiglitz 1978).

so results in efficiency losses, and if so, how large. The most efficient level of tax on gifts and bequests depends to a large extent on the donor's motivation for making the transfer and how much heirs increase their work and saving in response to the tax. It could be higher or lower than current law. But it is plausibly higher, especially if most transfers are not motivated by pure altruism.

Taxing wealth transfers potentially has further fairness and efficiency benefits because it can help ensure that all capital income is taxed at least once (Graetz 273 1983). The increasing mobility of capital income, the deferral of capital gains taxes until an asset is sold, and stepped-up basis often combine to result in capital income being subject to little or no tax under our current system. Wealth transfer taxes, including taxing accrued gains, can offset this tendency. Taxing bequests also provides an opportunity to uncover income tax fraud and evasion because new information can be revealed through the probate process.

Furthermore, there is no consensus that our current wealth transfer taxes are more complicated than a correspondingly progressive tax on noninherited income (Gale and Slemrod 37–39 2001). Moreover, an inheritance tax could substantially simplify our current approach to taxing wealth transfers.

Finally, the estate tax is a small but important source of revenue. According to estimates by the Joint Committee on Taxation, the cost of making estate tax repeal permanent after 2010 over the 2007–2016 period is $386 billion (Friedman and Aron-Dine 2006). It would be significantly higher if the estate tax were repealed for the entire period. For all of these reasons, wealth transfer taxes should be retained.

If anything, the above considerations and others suggest that we may want to expand wealth transfer taxes in the future. Taxing wealth transfers more heavily could well increase economic growth. There is emerging evidence that countries grow faster if large inheritances and firms managed by heirs are a smaller share of GDP (e.g., Bloom and Van Reenan 2006; Morck, Strangeland, and Yeung 2000). In addition, according to the revenue estimates prepared for this paper, the average tax rate on inheritances under the proposal (and 2009 estate tax law) is only 2.5 percent. Relative to the average income tax rate on noninherited income of 8.7 percent, this seems unduly low (Congressional Budget Office [CBO] 2006). More revenue could be raised if the exemption levels were lowered, the surtax were increased, or capital gains on inherited assets were taxed immediately. The revenue increase could be substantial: if inheritances were simply subject to the same average income tax rate as wages and other income, the inheritance tax would raise roughly $60 billion in 2009 alone.

The arguments in favor of wealth transfer taxes also illustrate why the proposal is a better way to tax gifts and bequests than are its principal alternatives. Unlike a pure income inclusion approach, where there is no exemption or surtax, it takes into account how much an heir has inherited, and therefore how much of an advantage she has—or has not—received in life. Unlike a pure accessions tax, which disregards the other income of the heir, the proposal also takes into account how well-off the heir is.

Finally, the proposal is a better way to tax wealth transfers than the estate tax. It focuses directly on allocating tax burdens fairly between those who have received inheritances and those who have not, rather than between those who do and those who don't make large wealth transfers as under the estate tax. Given that both appear to be borne largely by heirs, heirs are the most reasonable focus. Furthermore, this paper has shown that the incidence of the two taxes among heirs would be quite different to the extent that heirs do bear the tax, with each often burdening an heir who is not burdened at all by the other, and vice versa. Under the estate tax, the extent to which an heir is taxed on her inheritance turns on the success and generosity of her donors. Under the inheritance tax, it turns on her privilege and affluence.

The proposed inheritance tax would thus strengthen the ability of our current system to achieve its underlying goals. It would be more effective at reducing economic disparities and inequality of opportunity. It would make the income tax more equitable by basing tax burdens on a more accurate measure of the taxpayer's economic status. It could enhance efficiency and result in significant simplification benefits. And ultimately, by better aligning our wealth transfer taxes with our ideals, the proposed inheritance tax could reinvigorate public support for taxing inheritances in the first place.

Appendix: Methodology for Revenue and Distributional Estimates

The revenue and distributional estimates in this paper are based initially on the Urban-Brookings Tax Policy Center Estate Tax Microsimulation Model (ETMM).[22] That model was built by imputing wealth onto micro data of individual income tax returns. The model then assigns a probability of death and imputes how much would be given to charities and a surviving spouse in order to create a data set of taxable estates in the current year that matches published IRS data on taxable estates.

The ETMM was modified to estimate the revenue and distributional effects of an inheritance tax in the following ways. First, the number of beneficiaries in each relationship group (children and other beneficiaries) was imputed based on the decedent's marital status and estate size.[23] The share of the estate allocated to beneficiaries in each relationship group was then imputed based on decedent's marital status, the estate size, and the number of beneficiaries.[24] Next, each individual beneficiary was assigned a marital status based on the decedent's marital status, the estate size, and the beneficiary's relationship to the decedent.[25] Then each beneficiary was assigned an income group based on the decedent's marital status, the estate size, the beneficiary's relationship to the decedent, and the beneficiary's marital status.[26] These imputations were based on restricted IRS (1992) Collation Study data.

Once these variables were imputed, the inheritance size for each beneficiary in a given relationship group was calculated by assuming that the portion of the estate going to that relationship group was bequeathed pro rata. Specifically, the inheritance size for each beneficiary was calculated as the product of the taxable estate (the estate after expenses and transfers to spouses and charities) and the portion assigned to the beneficiary's relationship group, divided by the number of beneficiaries in that relationship group. Based on each beneficiary's inheritance size and relationship group, a ratio

22. For further details on ETMM, see Rohaly, Carasso, and Saleem 2005.

23. The marital status of decedents is their marital status if they had not passed away. Estates were grouped in the following categories: (1) less than $600,00; (2) at least $600,000 but less than $1,000,000; (3) at least $1,000,000 but less than $2,500,000; (4) at least $2,500,000 but less than $5,000,000; (5) at least $5,000,000 but less than $10,000,000; and (6) at least $10,000,000. The number of beneficiaries allowed in the imputation is none, one, two, three, four, and more than four (in which case an average value is imputed). For estates of single decedents, the restricted IRS data suggest that the average number of child beneficiaries is between 1.08 and 1.20, and the average number of other beneficiaries is between 2.01 and 4.01, depending on the estate size. For estates of married decedents, the average number of child beneficiaries is between 0.68 and 1.17, and the average number of other beneficiaries is between 0.19 and 1.44, depending on the estate size.

24. For example, the share of an estate allocated to children is 100 percent if it has two child beneficiaries and no other beneficiaries. If a similar estate has two children beneficiaries and one other beneficiary, some positive share was imputed as going to children and the remainder as going to other beneficiaries.

25. Each beneficiary is assigned a marital status as either single or married, but not both. The fraction of beneficiaries who are married was derived from IRS (1992) data.

26. Beneficiary income was grouped in the following categories: (1) not more than $10,000; (2) more than $10,000 but not more than $25,000; (3) more than $25,000 but not more than $50,000; (4) more than $50,000 but not more than $100,000; (5) more than $100,000 but not more than $200,000; and (6) more than $200,000, in 1992 dollars. Income growth rates were based on CBO (2005). The measure of income in the IRS 1992 Collation Study includes wages, tax exempt interest, taxable dividends, alimony received, pension, taxable IRA distribution, unemployment compensation, social security, rents received, royalties received, partnership and S-corp income, estate income, and trust income. It also includes the following when positive: Schedule C gross profit (from first three schedules); Schedule F profit (from first two schedules); supplemental gains, other income, farm/rent income, taxable interest income, net short-term gain, and net long-term gain.

27. Current inheritances were classified into the following groups: (1) not more than $10,000; (2) more than $10,000 but not more than $50,000; (3) more than $50,000 but not more than $100,000; (4) more than $100,000 but not more than $500,000; (5) more than $500,000 but not more than $1,000,000; and (6) more than $1,000,000. In order to impute the prior inheritance to current inheritance ratio, heirs were classified into 12 sub-groups based on their relationship group and inheritance size group. For each subgroup, a probability distribution of the ratio was calculated and each heir was randomly assigned a ratio equal to the midpoint of one of the following four sections of that distribution: zero to fortieth percentile, fortieth to sixtieth percentile, sixtieth to ninetieth percentile, and ninetieth to one hundredth percentile. For example, among heirs classified as children inheriting more than $1,000,000, 10 percent were assigned a ratio equal to the ninety-fifth percentile of the ratio for that subgroup.

between the beneficiary's prior and current inheritance size was imputed.[27] Prior inheritances were then calculated as the product of the imputed ratio and the beneficiary's current inheritance. These imputed ratios were derived from combined 2001 and 2004 Survey of Consumer Finance data.

At this point, the heir's AGI, income, taxable income, capital gains, and other tax information were imputed by randomly assigning a micro record from the TPC data on individual income tax returns that matched the heir's income group.[28] The heir's inheritance tax liability was then calculated based on her taxable income, current inheritance, and prior inheritance.

Estate tax burdens were calculated as under the ETMM, which includes an imputed value for *inter vivos* gifts previously transferred by the donor. For purposes of comparing heirs, the tax liability of estates was assigned to individual heirs in the same manner as described above. Any estate tax due was assumed to be borne by an heir in the same proportion as her inheritance bore to the inheritances of all other nonspousal heirs of the estate.

Two further assumptions underlying the model should be noted. First, the estimates of both estate tax and inheritance tax liability assume no state wealth transfer tax liability. This assumption was made because the proposal is intended to mimic the preferred level of revenue sharing with the states under the estate tax, not to alter our approach in this area. Second, as discussed, the estimates assume no behavioral response, e.g., no change in the magnitude of wealth transfers or their allocation on a pre-tax basis. If donors do respond to the proposal's incentives to give to more heirs or to those who are lower income and the change in inheritances is included in the distributional estimates, the proposal should be even more progressive by heir economic income and inheritance size.

One question that may arise is why the inheritance tax lifetime exemption is so large relative to the revenue-neutral estate tax lifetime exemption. This is the result of three factors. First, a large portion of inheritances go to children, and the wealthiest decedents have between 0.68 to 1.20 children who are alive and receive some inheritance, on average. Nonchild beneficiaries typically receive amounts below the exemption threshold. As a result, the inheritance tax often taxes fewer than two child beneficiaries per estate, if it taxes any heirs at all. Second, the top marginal tax rate on gifts and bequests under the inheritance tax is five percentage points higher than under the estate tax, and a large portion of inheritances above the lifetime exemption (86 percent) is subject to that top marginal rate. Finally, prior inheritances received are typically larger than prior *inter vivos* gifts transferred, because most transfers occur at death, but heirs often receive two substantial inheritances, one from each parent. As a result, a larger share of the lifetime exemption has been used up by prior inheritances under the inheritance tax than has been used up by prior gifts under the estate tax. This is a relatively small factor, however. Eliminating prior inheritances and gifts from the model only reduces the revenue-neutral inheritance tax lifetime exemption by about $300,000.

The estimates should be treated with a high degree of caution. As should be clear from the discussion above, the model is based in part on data from 1992 and involves multiple layers of imputation due to the fact that there is no publicly available micro data linking estate tax returns to the amount heirs receive and the heir's tax return.

28. For this purpose, income refers to cash income as defined at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=574.

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