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WHAT SHOULD SOCIETY EXPECT FROM HEIRS? A PROPOSAL FOR A COMPREHENSIVE INHERITANCE TAX

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WHAT SHOULD SOCIETY EXPECT FROM HEIRS? A PROPOSAL FOR A COMPREHENSIVE INHERITANCE TAX

Lily L. Batchelder*

Abstract

The upcoming one-year repeal of the federal estate tax in the U.S. creates an opportunity to reconsider the taxation of wealth transfers. This article argues that if inheritances are included in an optimal tax framework, existing evidence suggests that the ideal wealth transfer tax would be much higher than current law, and take the form of a comprehensive inheritance tax, which includes amounts inherited above an exemption in the tax base and subjects them to higher rates. Doing so accounts for the net efficiency benefits of taxing inheritances, and the direct and indirect information they provide about the heir's economic status.

The article then proposes seizing the political moment to replace the federal estate tax with a comprehensive inheritance tax that takes into account administrative and political constraints. This new tax would exempt from taxation roughly \$2 million in lifetime gifts and bequests received. Inheritances received beyond this amount would be taxed at the heir's income tax rate plus 15 percentage points. The proposal would improve incentives and reduce complexity

* Associate Professor of Law & Public Policy, NYU School of Law. I owe special thanks to Surachai Khitatrakun for his work on modeling the revenue and distributional effects of the proposal. For helpful comments and discussion, I am grateful to Anne Alstott, Aviva Aron-Dine, Noel Cunningham, Mitchell Kane, Fred Goldberg, Michael Graetz, Daniel Halperin, Deborah Schenk, David Schizer, Dan Shaviro, Michael Udell, David Walker, and Ethan Yale, and participants in the 2008 Harvard Law School Seminar on Current Research in Taxation and 2008 Tax Law Review Symposium. I am particularly indebted to Jim Hines, Wojciech Kopczuk, Ann Mumford, and Tom Nagel for their extensive reactions to an earlier version of this article. Rachel Jones and Annmarie Zell provided outstanding research assistance. This paper draws on several earlier pieces, including Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (manuscript, 2007); Lily L. Batchelder, *How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?* (manuscript, 2007); Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*, BROOKINGS INST. HAMILTON PROJECT DISCUSSION PAPER 2007-07 (June, 2007); and Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*, in *THE PATH TO PROSPERITY: HAMILTON PROJECT IDEAS ON INCOME SECURITY, EDUCATION AND TAXES* (Jason Furman and Jason Bordoff, eds.) (Brookings Institution Press, forthcoming, 2008).

relative to the estate tax. More importantly, it would enhance the equity and transparency of the tax system. The paper's estimates suggest that the estate tax does a good job in aggregate of correcting for the undertaxation of heirs relative to those whose wealth is self-made, but that it does a poor job at an individual level. The proposal would allocate tax burdens more fairly amongst heirs. Ultimately, because its form more transparently embodies its effects, it could also reinvigorate public support for taxing inheritances at more socially-optimal levels in the first place.

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I. INTRODUCTION

One of the fundamental questions that every society faces is how to shape the intergenerational transmission of wealth. It is a question that cannot be avoided. Each year many individuals die without a will.¹ Claims on property inherited by hypothetical descendants yet to be born may become administratively unenforceable.² Moreover, nations that apply a broad-based income or consumption tax must decide to what extent they will include inherited wealth in the tax base. The issue therefore is not whether the law should influence the pattern of intergenerational wealth transfers, but how.

Presently, the U.S. is facing this question once again in the context of its tax system. With a looming fiscal gap of about \$30 trillion,³ wealth transfers are expected to explode as the baby boom generation passes away, totaling between \$40 and \$135 trillion over the next 55 years.⁴ Inherited wealth is currently taxed at one-fourth the rate of earned income⁵ due to high estate tax exemptions and the exclusion of inheritances from the income and payroll tax bases. Moreover, under the tax cuts passed in 2001, the estate tax is scheduled to be repealed for one year in 2010. This temporary repeal creates untenable and gruesome incentives, requiring a legislative response. But it also creates a window of opportunity to revisit the tax treatment of wealth transfers.

This article considers how the tax system should affect the pattern of wealth transfers going forward. Taking into account existing empirical evidence, it argues that the ideal welfarist approach is to include gifts and bequests received above a basic lifetime exemption in the tax base and to

¹ Among Americans aged 50 or older, 40 percent report not having a will. AARP Research Group, *Where there is a will... Legal Documents Among the 50+ Population: Findings of a AARP Survey 1* (Apr., 2000), available at <http://assets.aarp.org/rgcenter/econ/will.pdf>.

² JENS BECKERT, *INHERITED WEALTH* 11 (2007).

³ Alan J. Auerbach, Jason Furman, and William G. Gale, *Facing the Music: The Fiscal Outlook at the End of the Bush Administration* 7 (May 8, 2008), available at http://www.econ.berkeley.edu/~auerbach/facing_the_music.pdf (estimating the fiscal gap at \$20 to \$40 trillion over a 75 year period, depending on the assumed revenue and spending baseline).

⁴ John J. Havens and Paul G. Schervish, *Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy* 1-2 (Boston College Social Welfare Research Institute, Oct. 19, 1999). These estimates assume a 2 percent and 4 percent secular growth rate, respectively.

⁵ See *infra* Figure 7 and accompanying text.

tax them at somewhat higher rates—an approach that is referred to as a *comprehensive inheritance tax*. In the U.S. political context specifically, it proposes seizing the political moment to replace the estate tax system on a revenue-neutral basis with a comprehensive inheritance tax. This new tax would exempt from taxation a much higher amount—roughly \$2 million in lifetime gifts and bequests received. Inheritances received beyond this amount would be taxed at the heir’s income tax rate plus 15 percentage points.

The advantages of a comprehensive inheritance tax are threefold. First, such a tax would enhance social welfare by more accurately measuring ability to pay. The U.S. and most jurisdictions currently exclude financial inheritances from the income tax base of heirs. But substantial financial inheritances clearly affect the well-being of the recipient. In addition, they provide valuable indirect information about the heir’s welfare because they are correlated with non-financial inherited assets and traits that powerfully affect earning ability—such as educational level, race, social networks, intelligence, and personality. A comprehensive inheritance tax captures this information, thereby ensuring that fiscal burdens and benefits are allocated more fairly.

A tax system that ignores wealth transfers necessarily ignores this information. Instead it taxes heirs, as a group, at substantially lower rates relative to those with a comparable ability to pay who are self-made. An estate tax partially mitigates this inequity because it directly taxes inherited wealth, and its economic burdens fall predominantly on heirs.⁶ But it is intrinsically much less effective because it applies to the amount transferred rather than the amount received. As a result, an estate tax provides only a “rough justice” accounting of inheritances when measuring economic status—and systematically misallocates fiscal burdens in individual cases. For example, we estimate that about 22 percent of heirs burdened by the U.S. estate tax have inherited less than \$500,000, while 21 percent of heirs inheriting more than \$2,500,000 bear no estate tax burden. A comprehensive inheritance tax eliminates these inequities, measuring ability to pay much more precisely.

In addition, a comprehensive inheritance tax creates a more equitable, efficient and simple pattern of incentives for donors and heirs than the estate tax. On the one hand, its exemption protects a basic level of

⁶ See *infra* notes 28-27 and accompanying text.

familial economic support that one hopes all parents will provide so that each child has a reasonable opportunity to grow and flourish. On the other hand, by gradually taxing inherited wealth in excess of this amount, a comprehensive inheritance tax encourages extremely wealthy donors to share further wealth transfers with individuals who otherwise would have much fewer opportunities than their children. It also encourages their children to use their talents to earn additional wealth instead of relying on further familial largess. Neither an estate tax, nor a tax system that ignores wealth transfers, can create this pattern of incentives. Moreover, neither is clearly more efficient or administrable and, for a variety of technical reasons, a comprehensive inheritance tax may be simpler.

Finally, a comprehensive inheritance tax should improve public understanding of the taxation of wealth transfers. The fact that an estate tax focuses by design on the donor tends to lead the public to believe that its economic burdens fall on donors in practice. Meanwhile, public awareness of the income tax exclusion for inherited wealth is limited. These misperceptions have been exploited by opponents of the estate tax, who have framed the estate tax as a double tax on frugal, hard-working donors who are ruthlessly taxed right at the moment of death.⁷ But the estate tax is, in fact, generally the only tax ensuring that those whose wealth is inherited share at least somewhat equally in financing the cost of government with those whose wealth is self-made. A comprehensive inheritance tax should help resolve this confusion because its form more transparently embodies its function. Moreover, by expressly taxing the heir, it should enable the public to make a more informed decision about how much society should expect from heirs.

While the key normative claim of this paper is that a comprehensive inheritance tax is the best approach to taxing wealth transfers in general, much of the article is devoted to describing the structure and advantages of a specific proposal for a comprehensive inheritance tax that is designed in light of the unique administrative and political constraints of the U.S. In particular, the paper assumes that any reform of the U.S. wealth transfer tax system must raise the same amount of revenue as the 2009 estate tax. This appears to be the most likely political compromise if the estate tax is not replaced.⁸ It also assumes that there must be very large annual and lifetime exemptions and that the top marginal rate applied to inherited wealth cannot

⁷ See, e.g., MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 82 (2005).

⁸ See *infra* note 185.

exceed 50 percent, which is, roughly speaking, the top rate applied to earned income.⁹ It further presumes that accrued gains on inherited wealth generally cannot be taxed at the same point in time as the inheritance. Finally, given the politically explosive debate about family businesses and farms, it assumes that any proposal must eliminate the possibility that an heir would ever need to sell an inherited family business to pay the associated tax liability. Notably, this paper does not adopt the assumption embodied in some important prior work that constitutional, administrative, or political constraints prevent the U.S. from taxing capital income at socially-desirable rates through the individual and corporate income taxes, or a periodic wealth tax, thereby leaving wealth transfer taxes as the third best option.¹⁰

The primary contribution of this paper is the structure of and justification for its proposal. To my knowledge, no other commentator has proposed a comprehensive inheritance tax¹¹ or provided estimates of the distributional effects of a wealth transfer tax reform option at an heir level. While the proposal is similar to one that I have advanced previously,¹² this paper elaborates on its various components and estimated effects in more detail. It also more clearly delineates when the proposal deviates from the ideal welfarist approach on administrative and political grounds.

The paper proceeds as follows. Part II explains in more detail why a comprehensive inheritance tax is the best approach to taxing wealth transfers given existing evidence on wealth transfers. Part III outlines the benefits and drawbacks of the current U.S. estate tax. Part IV presents the

⁹ See *infra* note 187.

¹⁰ See, e.g., Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L. J. 259 (1983); William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967).

¹¹ But see Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income Inclusion system and Abandoning the GST*, 56 SMU L. REV. 551 (2003) and Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L. J. 283 (1994), both of which allude to the possibility that a comprehensive inheritance tax (in an income or consumption tax context respectively) may be the best approach.

¹² See Lily L. Batchelder, *Reform Options for the Estate Tax System: Targeting Unearned Income*, Testimony before the United States Committee on Finance (March 12, 2008), available at <http://finance.senate.gov/hearings/testimony/2008test/0312081bttest.pdf>; Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*, in THE PATH TO PROSPERITY: HAMILTON PROJECT IDEAS ON INCOME SECURITY, EDUCATION AND TAXES (Jason Furman and Jason Bordoff, eds.) (Brookings Institution Press, forthcoming, 2008); Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*, BROOKINGS INST. HAMILTON PROJECT DISCUSSION PAPER 2007-07 (June, 2007).

core proposal to replace the estate tax with a comprehensive inheritance tax. Part V provides suggestions for how to address a variety of related issues if the proposal were enacted, including the tax treatment of appreciated assets, illiquid assets and family businesses, charitable contributions, retirement savings, and life insurance. Section VI concludes.

II. WHY TAX WEALTH TRANSFERS?

Over time, scholars and politicians have offered a number of rationales for and against taxing wealth transfers. Some have argued that taxing wealth transfers is essential for democracy in that it reduces concentrations of power in family dynasties.¹³ Others have for and against wealth transfer taxation as a method for equalizing opportunity.¹⁴ This

¹³ See, e.g., ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA [DE LA DÉMOCRATIE EN AMÉRIQUE] (Henry Reeve, trans.) ([1835] 1945) (described laws regulating inheritance as part of the “moving and palpable cloud of dust, which signals the coming of Democracy”). Cf., Michael J. Boskin, *An Economist’s Perspective on Estate Taxation, in DEATH, TAXES AND FAMILY PROPERTY* 56, 65 (Edward C. Halbach, ed.) (1977); Harry J. Rudick, *What Alternative to the Estate and Gift Taxes?*, 38 CAL. L. REV. 150, 158-59 (1950).

¹⁴ For example, John Stuart Mill advocated sharply limiting inheritances because “accidents of birth” have no normative place in the liberal social order. JENS BECKERT, *INHERITED WEALTH* 167 (2007), citing John Stuart Mill 889 ([1976] 1846). Similarly, Franklin D. Roosevelt 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.” Franklin D. Roosevelt, *Message to the Congress on Tax Revision (June 19, 1935)*, in PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT VOL. 4 (1916). Other scholars advocating for wealth transfer taxes on equal opportunity grounds include Richard Ely, Harry Rudick, Mark Ascher, David Haslett, and Anne Alstott. See JENS BECKERT, *INHERITED WEALTH* 167 (2007), citing Richard T. Ely 318-19 (1888); Harry J. Rudick, *What Alternative to the Estate and Gift Taxes?*, 38 CAL. L. REV. 150, 158-59 (1950); Mark L Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990); D. W. Haslett, *Is Inheritance Justified?*, 15 PHIL. & PUB. AFFAIRS 122, 130 (Spring, 1996); Anne L. Alstott, *The Uneasy Liberal Case against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363, 369 (1996).

Still other theorists, including Milton and Rose Friedman, have objected that it is unfair to attempt to equalize material inheritances because doing so discriminates against advantages of wealth and in favor of genetic advantages, like intelligence and good looks. See, e.g., JENS BECKERT, *INHERITED WEALTH* 167 (2007), citing MILTON FRIEDMAN AND ROSE FRIEDMAN, *FREE TO CHOOSE* (1980). Advocates of wealth transfer taxation on equal opportunity grounds have countered that this objection implies that if society cannot affect one kind of unearned advantage, it must, in all fairness, commit to allowing all other kinds of unearned advantages to continue to exist. See, e.g., D. W. Haslett, *Is Inheritance Justified?*, 15 PHIL. & PUB. AFFAIRS 122, 141 (Spring, 1996).

article, by contrast, adopts a welfarist approach.¹⁵ Before considering what welfarism implies about the ideal taxation of wealth transfers, however, it is first necessary to understand who would bear the burden of any tax imposed.

A. Who Bears the Burden of Wealth Transfer Taxes?

Wealth transfers, or *inheritances*, may be defined as gratuitous financial gifts and bequests that are not transferred to one's spouse, to charity, or for certain other purposes that generally are not taxable, including education, health care, or support of a minor child. This definition accords with current law and the academic literature. Given that no existing income tax provides a deduction to donors for wealth transfers made (unless to a charitable organization),¹⁶ a *wealth transfer tax* may be defined as any direct, additional tax or subsidy on wealth transfers beyond inclusion in the donor's income tax base.¹⁷

¹⁵ This may be a false dichotomy to some degree. Theoretically, a social welfare function can purge utility functions of complicating factors such as expensive tastes, and can value principles such as equal opportunity by assigning a positive weight to them or imposing a hard constraint that rejects outcomes predicated on unequal starting points. At the same time, resource egalitarianism (a variant of equal opportunity) may care about balancing consequences. *See, e.g.*, Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 493-96 (2007) (acknowledging that citizens concerned with equalizing opportunity might, behind the veil of ignorance, support lower inheritance tax rates if doing so would increase funding for a universal, public inheritance or other programs that further equality of opportunity). Nevertheless, some important differences likely remain. *See generally* Ronald Dworkin, *What is Equality? Part I: Equality of Welfare*, 10 J. PHIL. & PUB. AFFAIRS 185, 186-7 (Summer, 1981).. For example, almost all theorists agree that equality of opportunity implies an accessions tax, while this article argues that welfarism implies a comprehensive inheritance tax. *See, e.g.*, Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 502-3 (2007); LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 157 (2002); D. W. Haslett, *Is Inheritance Justified?*, 15 PHIL. & PUB. AFFAIRS 122, 153 (Spring, 1996).; Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419, 431 (1996); David G. Duff, *Taxing Inherited Wealth: A Philosophical Argument*, CANADIAN J. LAW & JURISPRUDENCE 3, 46 (1993).

¹⁶ *See* Appendix C.

¹⁷ This paper does not consider the ideal consumption tax treatment of wealth transfers but it should broadly mirror the ideal income tax treatment. For a more detailed discussion, see Lily L. Batchelder, *How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?* (manuscript, 2007).

Theoretically, wealth transfer taxes may burden a variety of individuals. The most obvious candidates are donors and heirs, but they may also burden those who would benefit from the donor spending her wealth in other ways. This distinction mirrors the distinction in the economic literature between partial and general equilibrium analysis.¹⁸ Partial equilibrium analysis considers the distribution of the burdens of a tax by looking at its effects only on the two parties to the relevant transaction—in this case the donor and heir. General equilibrium analysis is more comprehensive, considering the impact of a tax in multiple markets simultaneously.¹⁹

As Surachai Khitatrakun and I have argued elsewhere in more detail, it is reasonable to assume that the economic burdens of wealth transfer taxes are borne predominantly by heirs.²⁰ This is the case first because general equilibrium analysis appears not to be very relevant for wealth transfer taxes. The main way in which a wealth transfer tax could impact people and markets beyond donors and heirs is if it affected the amount of saving. However, the two main empirical studies to date suggest that the magnitude of reported wealth transfers is only slightly responsive to the wealth transfer tax rate.²¹ Moreover, the results of these studies are fragile and may be the product of tax avoidance responses rather than real changes in the magnitude of wealth transfers.²² At the same time, while a wealth transfer tax should reduce the amount heirs receive, it is unclear whether the marginal propensity to save these funds is greater among heirs or the government. (The government effectively saves wealth transfer tax revenues if it uses the revenues to reduce budget deficits.) Finally, theoretically, wealth transfer taxes could reduce the amount of giving to tax-exempt beneficiaries, principally charities. However, existing evidence suggests that wealth transfer taxes actually tend to increase charitable contributions.²³ Accordingly, it is unclear whether wealth transfer taxes

¹⁸ Tax incidence is the study of the effect of a tax on the distribution of economic welfare.

¹⁹ Gilbert E. Metcalf and Don Fullerton, *Introduction*, in *THE DISTRIBUTION OF TAX BURDENS* (Gilbert E. Metcalf and Don Fullerton, eds.) (2003).

²⁰ See Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (manuscript, 2007).

²¹ David Joulfaian, *The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence*, 59 *Nat'l TAX J.* 253 (June, 2006); Wojciech Kopczuk and Joel Slemrod, *The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors*, in *RETHINKING ESTATE AND GIFT TAXATION* 299 (William G. Gale et al, eds) (2001).

²² Kopczuk and Slemrod, *supra* note 21.

²³ See *infra* note 224.

burden any parties other than heirs and donors, and it seems most reasonable to focus the relative burdens they bear instead.

Turning to the partial equilibrium context, the relative burdens imposed on heirs and donors (and, we will see, the ideal taxation of wealth transfers) depends critically on why the donor worked and saved in order to accumulate the wealth ultimately transferred. This is the case because the donor's accumulation motive affects how much she values the transfer, and how she responds to the tax. Briefly, there are six potential wealth accumulation motives. As discussed below, most wealth transfers presumably stem from some combination, but it is useful to understand each potential motive separately at first.

The first three all involve the donor accumulating wealth without regard to the amount her heirs will ultimately receive. Such wealth transfers are therefore referred to as involving *no bequest motive* or *inelastic transfers*. First, a donor may have worked and saved in order to insure herself against various risks for which private insurance is unavailable, such as uncovered health care costs or the possibility of outliving her savings. If fewer risks materialize than feared, she will have savings left at death. The resultant bequest is considered an *accidental bequest* or to be the product of *life cycle saving*. Second, a donor may have accumulated wealth simply because she enjoyed working or being known as rich and wealthy, and not because she wanted to spend it in any particular way. Transfers from such wealth are considered *egoistic* or derived from *the capitalist spirit*. A third possibility is that her wealth stems from a *pre-tax warm glow*. In this case, she worked and saved because she derived utility from the thought of transferring wealth, but was unconcerned with the specific amount that her heirs ultimately inherited.

The remaining potential motives, in contrast, all involve the donor caring how much her beneficiaries will actually receive after tax. In the case of purely *altruistic* transfers, the donor accumulated wealth because her utility is a direct function of her heirs'. That is, she experiences the well-being that they receive from the transfer to some degree as if it is her own. Alternatively, a donor's utility may be unrelated to her heirs' but nevertheless a function of how much they can ultimately spend. In this case, the transfer is considered to stem from an *after-tax warm glow* motive. For simplicity, warm glow transfers are generally ignored here, on the assumption that pre-tax warm glow transfers are identical to egoistic transfers, and after-tax warm glow transfers are identical to altruistic ones.

Finally, a donor may have worked or saved in exchange for something the heir provided to her, such as taking care of her in old age. Then the transfer would be *compensatory* or *exchange-motivated*. While this final category of gifts and bequests is not a wealth transfer as defined above (because such transfers are not gratuitous), it remains empirically relevant.

The reason wealth accumulation motives matter when determining the relative burden of wealth transfer taxes on donors and heirs is that they affect the elasticity of the amount transferred to the tax rate. If some share of a donor's wealth transfers is inelastic, her heirs must bear the entire tax burden on that share. By contrast, if some share is exchange-motivated, the burden should be split between the donor and her heirs, depending on their relative elasticities of labor supply and demand. Finally, if some share is altruistic, the incidence of the tax remitted on that portion should actually fall on both the donor and her heirs—imposing a double burden—but the total burden should fall more heavily on her heirs. The double burden of the tax arises because, under perfect altruism, a donor's utility equals her heirs'. Heirs should bear a larger burden, though, because they are burdened by the full amount of any reduction in pre-tax transfers by the donor in response to the tax.²⁴ The donor, meanwhile, is only burdened by this reduction to the extent that she values giving a dollar to her heirs more than she values spending it on herself.²⁵

Putting all these possibilities together leaves only one scenario in which donors could bear more of the burden of wealth transfer taxes: The vast majority of wealth transfers would have to be exchange-motivated, and donor demand for such labor would have to be relatively inelastic.

²⁴ This assumes that the heir does not benefit from the donor spending more money on personal consumption, for example, if the donor pays more for nursing home care instead of relying on the heir to do so or to take care of her in old age. As discussed *infra* note 43, however, the vast majority of wealth transfers flow downwards, not upwards, generationally. I am grateful to Ethan Yale for this point.

²⁵ This presumes that donors respond to a tax on altruistic transfers by giving less, not more, as appears to be the case. See David Joulfaian, *The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence*, 59 Nat'l TAX J. 253 (June, 2006); Wojciech Kopczuk and Joel Slemrod, *The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors*, in RETHINKING ESTATE AND GIFT TAXATION 299 (William G. Gale et al, eds) (2001). If a donor instead responded by giving more, the relative burden on her heirs would decline. At the extreme, the donor could increase her pre-tax transfers to a point that fully offset the tax. Then the heir would bear no burden, and the donor's burden would be the value she previously placed on her forgone consumption. I am grateful to David Kamin for this point.

Existing evidence on wealth accumulation motives, however, suggests that compensatory transfers compose a very small share of gifts and bequests, and altruistic transfers only a somewhat larger portion.²⁶ Egoistic and accidental transfers appear to make up the majority.²⁷ Moreover, the economic incidence of a tax is generally assumed to be independent of its statutory incidence. As a result, it should not matter what general form a wealth transfer tax takes and, in particular, whether it is remitted by the donor or the heir.²⁸ Thus, in the real world, heirs should bear the majority of wealth transfer tax burdens regardless of the form of the tax—and perhaps the lion’s share.

The concept of wealth accumulation motives is essential to much of the remaining discussion and often confuses readers unfamiliar with this literature. Accordingly, before moving on it is worth addressing to two common misperceptions. The first is that most wealth transfers must be altruistic. The typical line of argument is that any donor with a will has demonstrated that she is concerned about who inherits what, and donors who die intestate probably care as well. While true to a point, this argument is beside the point. The question posed by this literature (and important for determining the incidence of wealth transfer taxes) is not what drove a donor to divide up her estate in this way or that. It is what motivated the donor to accumulate an estate of that size in the first place.

The second common misperception is that this literature assumes that individuals accumulate wealth only for one reason. In fact, much of the literature is preoccupied with determining what share of an individual’s saving is attributable to each motive, which presumes that individuals save for multiple reasons. Nevertheless, the literature does assume that each dollar transferred is attributable to a unique motive—even if not all dollars transferred by a specific donor are attributable to the same one. As an example of how these unique motives can be disaggregated at a theoretical

²⁶ See *infra* Table 3.

²⁷ *Id.* Empirical studies to date generally look at the relative share of total, not marginal, wealth attributable to different wealth accumulation motives. In fact, it is the relative share of marginal wealth accumulation motives that determines the incidence of the tax on donors versus heirs. Theoretically, donor motives could operate sequentially and compensatory transfers could be marginal for some or all of the population, which would alter the conclusion that heirs bear most of the burden of wealth transfer taxes. However, it is unclear whether donors save sequentially and, if so, which order dominates. For further discussion, see Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (manuscript, 2007).

²⁸ But see *infra* note 109 and accompanying text.

level, suppose all bequests were the product of a combination of altruism and life cycle saving. Then, the share that is accidental would be the share that donors would still transfer even if they knew that all bequests were going to be expropriated (because accidental bequests are perfectly inelastic).²⁹ The remaining portion would be altruistic.³⁰

With a clearer sense of who bears the burden of wealth transfer taxes, we can now turn to the question of whether and how they should be imposed.

B. Ideal Wealth Transfer Taxation

Within a welfarist framework, the goal of government and the fiscal system is to maximize some function of individual well-being. For example, a utilitarian social welfare function aims to maximize total utility. A maximin welfarist seeks to maximize the well-being of the least well-off person. Meanwhile an egalitarian welfarist seeks to equalize the welfare of all. Theoretically, the focus can be on dynastic rather than individual well-being, for example by treating the Smiths and the Joneses over time each as one unit, regardless of their number. Such a dynastic focus raises interesting questions, but is not the focus here.

Welfarism has been criticized as a theory of justice on a number of fronts. For example, some object that welfarism implies rewarding people with expensive tastes at the expense of ascetics who are perpetually dissatisfied. Others criticize welfarism for implying that “utility monsters”—people who seem to have an endless ability to convert money into more and more well-being—should end up with the lion’s share of society’s resources. Still others argue that it is impossible to compare interpersonal well-being. While important questions, these debates can be

²⁹ A more persuasive version of the previous two objections is that although a certain portion of a wealth transfer may be perfectly inelastic, the donor may nonetheless gain some welfare from its transfer. For example, the donor may have valued the insurance that the wealth provided enough that he would still have saved that amount if it was going to be expropriated at death. But he may also have valued the possibility of it going to his heirs, implying that he derived a large amount of consumer surplus from the saving absent wealth transfer taxes. If this is the case, the donor could suffer some welfare loss if his accidental bequest were expropriated. Nevertheless, his welfare loss should still be significantly smaller than the heir’s for the reasons explained above. *See supra* notes 24-25 and accompanying text.

³⁰ This is the amount by which the donor would reduce her wealth transfers if she knew they were going to be expropriated.

bracketed by assuming that they will be dealt with subsequently and focusing on a narrower question instead: what tax treatment of wealth transfers maximizes social welfare if all individuals have the same utility function for potential material resources, or endowment, which exhibits declining marginal utility?

The assumption of identical individual utility functions with declining marginal utility is standard in the optimal tax literature, beginning with Mirrlees,³¹ and in some sense is akin to resource egalitarianism.³² It does not mean that everybody likes the same mix of apples and oranges (or work and leisure, or risk and certainty). Rather, it implies that two people with the same potential earnings at their disposal have the same aggregate and marginal utility, even if they choose to spend their money in different ways. Declining marginal utility also implies that more potential earnings are better. In addition to bracketing some of the more controversial issues for welfarists, this assumption has the further advantage of effectively collapsing several social welfare functions. For example, the utilitarian goal of equalizing marginal utility and the egalitarian goal of equalizing individual well-being become identical.

Where this article diverges from the optimal tax literature is in its second assumption. Traditionally, optimal tax analysis assumes that individual endowments differ only in one imperfectly observable and exogenous dimension that determines the degree to which individuals are well-off. This dimension is variously termed potential earnings, talent, or ability. Here I posit that individuals differ in two imperfectly observable and exogenous dimensions that together constitute endowment: (1) potential earnings, talent, or ability, and (2) material inheritances.

Given these assumptions, the following discussion tracks the standard optimal tax analysis, with a twist. In the standard analysis, ability is the ideal tax base. It is perfectly efficient in the sense that one can't change one's ability so taxing it does not generate any efficiency losses. Moreover, unlike other perfectly efficient tax bases, such as a head tax, it is

³¹ James Mirrlees, *An Exploration in the Theory of Optimum Taxation*, 38 REV. ECON. STUDIES 175 (1971).

³² See Ronald Dworkin, *What is Equality? Part I: Equality of Welfare*, 10 J. PHIL. & PUB. AFFAIRS 185, 186-7 (Summer, 1981); Ronald Dworkin, *What is Equality? Part II: Equality of Resources*, 10 J. PHIL. & PUB. AFFAIRS 283, 284-90 (Autumn, 1981) (describing an auction where each member of society receive an equal share of societal resources over their lifetime, not an equal level of well-being).

the perfect measure of individual well-being and thus the perfect basis for redistribution. The problem, of course, is that ability is not observable directly. The basic question posed by the optimal tax literature is what tax system is optimal given the informational constraint that we can't tax ability. The obvious alternatives are proxies for ability—such as market earnings, consumption or income. But, unlike an ability tax, individuals can respond to these taxes by earning or saving less, thereby potentially generating efficiency losses for the individual or others. The problem optimal tax analysis attempts to solve is what level and structure of this proxy tax, which I will refer to as the *underlying tax*, will maximize social welfare given the equity-efficiency trade-off.³³

The twist here is that the ideal tax base from a fairness perspective is not just ability, but also inheritances. However, the optimal tax base is not necessarily ability and inheritances combined because such a tax base would be perfectly fair but not necessarily perfectly efficient. Unlike ability, material inheritances may respond to taxation because they benefit a party beyond the recipient who has control over them: the donor. Moreover, even if such a combined tax base were perfectly efficient, it would be unattainable because ability continues to be unobservable. Inheritances may provide some information about ability, though, to the extent that the two variables are correlated. Thus, the new problem this paper attempts to solve is what level and structure of taxation of inheritances (if any) will maximize social welfare in light of these additional equity and efficiency considerations. The following discussion considers the fairness and efficiency implications in turn.

1. *Fairness*

Regardless of the social welfare function, welfarist approaches require a method for measuring how well-off different people are. This measure is the basis for redistribution. The most equitable level of redistribution depends, in turn, on the theory of justice underlying the social welfare function. But the ideal tax base depends only on this measure of well-being, and does not require specifying the social welfare function.

³³ For further discussion of how the ideal tax treatment of wealth transfers might differ under an income versus consumption tax, see Lily L. Batchelder, *How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?* (work-in-progress, 2007).

a. Inheritances as Income

Few would dispute that inheritances are just as relevant for measuring an heir's well-being as our proxy measures for ability, such as income from work or savings.³⁴ Thus, purely from a fairness perspective, inheritances should be included in the tax base of heirs. The more complicated questions that arise when inheritances are included in an optimal tax framework are (i) whether inheritances should also be included in a measure of well-being of the donor, and (ii) whether they should be considered to confer more well-being on heirs or donors than other sources or uses of income.

Starting with the first issue, funds used by donors for wealth transfers should be included in a measure their well-being. Welfarists are interested in consumption opportunities when measuring how well-off an individual is. When a donor accumulates and transfers wealth for altruistic or egoistic reasons, she is giving up the opportunity to spend the money on herself. It follows that she values making the wealth transfer as much as if she spent the money on more traditional types of personal consumption. Similarly, when a donor leaves an accidental bequest, she must have valued the insurance provided by the wealth as much as if she had spent the money on herself. In fact, for all three motives, she must value the funds accumulated and transferred slightly more than market consumption, or she wouldn't have saved for these reasons in the first place.

To be sure, there may be efficiency reasons to subsidize a donor's decision to transfer wealth, as discussed in the next section. For example, a donor may have saved altruistically and be giving to someone who would otherwise be dependent on the state. Absent such information, though, the most accurate proxy measure of endowment should include funds used for wealth transfers.

Many find this argument surprising because consumption, in the colloquial sense, typically involves using up resources, not sharing them.³⁵

³⁴ See, e.g., Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); HENRY C. SIMONS, PERSONAL INCOME TAXATION 125, 130 (1938); LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 145-7 (2002).

³⁵ See, e.g., Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L. J. 283, 336-45 (1994). McCaffery does, however, appear to support an inheritance tax in the context of a consumption tax. *Id.* at 350.

But actual use is irrelevant in a welfarist framework. Instead, the goal is to measure well-being, and market consumption is only used as a proxy. The key feature of wealth transfers making them consumption by the donor is the fact that the donor owns the assets, and therefore has the power to decide who gets them.

Nevertheless, there is a more powerful version of this objection. While voluntarily transferring a dollar must confer as much well-being on a donor as spending it, wealth transfers may provide additional information about the donor that is relevant in measuring her well-being. In particular, inheritances have historically functioned as a form of social insurance, providing cross-generational support within the extended family.³⁶ In addition, Mumford has argued that modern society increasingly expects parents to provide continuous care to their children, even to their own detriment.³⁷ Drawing on Alstott's work, she argues that this expectation stands in contrast to prior generations when children were generally an economic boon to their parents, providing labor during working years and supporting them in old age.³⁸ As a result, substantial wealth transfers could be a sign of larger financial demands that an individual bears.³⁹

The problems with this argument are threefold. First, within the extended family, the role of inheritances as a form of social insurance appears to be declining.⁴⁰ With the creation of modern insurance products and the welfare state, individuals have become less and less dependent on extended family members for support and employment.⁴¹ At the same time, while societal expectations of parents may have risen, it is unclear whether this has any implications for how heavily wealth transfers should be taxed specifically, as opposed to how parents should be taxed in general. Wealth

³⁶ JENS BECKERT, *INHERITED WEALTH* 18-19 (2007).

³⁷ Ann Mumford, *Inheritance in Sociopolitical Context: The Case for Reviving the Sociological Discourse of Inheritance Tax Law*, 34 *J. OF LAW & SOCIETY* 569, 583 (Dec., 2007), *citing* ANNE L. ALSTOTT, *NO EXIT: WHAT PARENTS OWE THEIR CHILDREN AND WHAT SOCIETY OWES PARENTS* 50 (2004).

³⁸ *Id.*

³⁹ Admittedly, this argument deviates from this paper's general assumption of identical individual utility functions for potential material resources.

⁴⁰ *C.f.* J. Bradford DeLong, *Bequests: An Historical Perspective*, in *DEATH AND DOLLARS: THE ROLE AND IMPACT OF GIFTS AND ESTATES* (Alicia Munnell and Annika Sunden, eds., 2003) (estimating that 91 percent of wealth was acquired by inheritance in pre-industrial societies and 43 percent now).

⁴¹ JENS BECKERT, *INHERITED WEALTH* 18-19 (2007). Relevant programs and products include Social Security, welfare, public employment, unemployment insurance, disability insurance, health insurance, and life insurance.

transfers are by no means limited to parents. Childless adults appear to accumulate wealth for altruistic reasons just as often as parents,⁴² and about 30 percent of wealth transfers come from donors without children.⁴³ Finally, there is little evidence that wealth transfers are targeted on needy family members. At least among donors who are parents, the vast majority of bequests are split evenly between children.⁴⁴ While it is much more common for *inter vivos* gifts to be targeted on children who are lower-income in a given year,⁴⁵ gifts comprise only about 10 percent of wealth transfers.⁴⁶ It is also unclear whether parents actually split *inter vivos* gifts unequally once one looks over a longer time horizon.⁴⁷

⁴² See, e.g., Michael D. Hurd, *Savings of the Elderly and Desired Bequests*, 77 AM. ECON. REV. 298 (June, 1987).

⁴³ See *infra* Figure 12 and Table A12. In the U.S., children receive about 70 percent of inheritances and in Europe they receive between 60 and 90 percent. Claudine Attias-Donfut, Jim Ogg, and François-Charles Wolff, *Financial Transfers*, in HEALTH, AGEING AND RETIREMENT IN EUROPE 179, 181-2, (Axel Börsch-Supan et al, eds., 2005). The next largest group of heirs is composed of nieces and nephews, and the remainder is generally siblings, grandchildren and parents. Hendrik Jürges, *Gifts, Inheritances and Bequest Expectations*, in HEALTH, AGEING AND RETIREMENT IN EUROPE 188 (Axel Börsch-Supan et al, eds., 2005) (finding that nieces and nephews account for about 8 percent of the recipients of gifts or bequests exceeding €5,000, and that siblings, grandchildren and parents account for about 6 percent). It appears to be quite rare for non-relatives to receive inheritances, and when non-relatives or parents do receive inheritances, it is more often due to financial need than is the case with children and other beneficiaries. Claudine Attias-Donfut, Jim Ogg, and François-Charles Wolff, *Financial Transfers*, in HEALTH, AGEING AND RETIREMENT IN EUROPE 179, 183 (Axel Börsch-Supan et al, eds., 2005); Claudine Attias-Donfut, Jim Ogg, and François-Charles Wolff, *Financial Transfers*, in HEALTH, AGEING AND RETIREMENT IN EUROPE 179, 183 (Axel Börsch-Supan et al, eds., 2005).

⁴⁴ See, e.g., David Joulfaian, *The Distribution and Division of Bequests: Evidence from the Collation Study* (U.S. Treasury Department, Office of Tax Analysis Paper 71, Aug., 1994) (63 percent); Michael D. Hurd & James P. Smith, *Expected Bequests and their Distribution* 9 (Nat'l Bur. Econ. Research Working Paper 9142, 2002) (81 percent); M. O. Wilhelm, *Bequest Behavior and the Effect of Heirs' Earnings: Testing the Altruistic Model of Bequests*, 86 Am. Econ. Rev. 874, 880 (1996) (67% divided exactly evenly, 88% divided approximately evenly). For a summary of the literature, see Henry Ohlsson, *The Equal Division Puzzle—Empirical Evidence on Intergenerational Transfers in Sweden* (Uppsala University Department of Economics Working Paper No. 2007:10, Jan., 2007).

⁴⁵ Kathleen McGarry, *Inter Vivos Transfers and Intended Bequests*, 73 J. PUB. ECON. 321, 335-36 (1999) (finding that only 6 to 25 percent of gifts are shared evenly between children in a given year).

⁴⁶ Internal Revenue Service, Statistics of Income Division, *Estate Tax Returns Filed in 2006 by Tax Status and Size of Gross Estate* (Oct., 2007), available at <http://www.irs.gov/pub/irs-soi/06es01fy.xls> (gifts in excess of the annual exclusion comprise 6 percent of reported wealth transfers); David Joulfaian and Kathleen McGarry,

Inheritances presumably continue to play some social insurance function, however, even if it is much smaller than in the past. As a result, it may be appropriate to exempt relatively small inheritances to needy beneficiaries from the tax base of the donor. Such transfers may be evidence that the donor feels obliged to fill in cracks in the welfare state and is, therefore, worse off than others with similar consumption potential.⁴⁸ As discussed later, such an exemption may also be important on political grounds.⁴⁹

Pulling these considerations together implies that the most accurate proxy measure of endowment—and the fairest tax base—should include wealth transfers in the tax base of both the donor and heir, potentially with a basic exemption.⁵⁰

b. Effects of Inheritances on the Income Distribution

Despite the more straightforward case for including wealth transfers in the tax base of heirs on fairness grounds, most jurisdictions paradoxically include inheritances in the tax base of donors but not recipients.⁵¹ This

Estate and Gift Tax Incentives and Inter Vivos Giving, 57 NAT'L TAX J. 429, 439 tbl.5 (2004) (taxable gifts comprise about 7 to 14 percent of wealth transfers).

⁴⁷ McGarry finds that parents tend to transfer more inter vivos to children who are low-income in a given year, but also more to those who are more educated. Thus, it is possible that parents equalize *inter vivos* transfers over time, but give larger amounts to more talented children when they are in school, and larger amounts to lower-skill children later on. Kathleen McGarry, *Inter Vivos Transfers and Intended Bequests*, 73 J. PUB. ECON. 321, 335-40 (1999).

⁴⁸ One could also argue that such transfers should be considered payment on an insurance contract that the heir implicitly entered into with his family. If so, this would be another argument for a basic exemption from the donor perspective. However, within an income tax and most consumption taxes, it would still imply including the transfer in the heir's tax base.

⁴⁹ See *infra* note 186 and accompanying text.

⁵⁰ As a practical matter, this implies that wealth transfers should be included in the heir's income and (in most circumstances) should not be deductible by the donor if the underlying tax is an income tax. If it is a consumption tax, wealth transfer should be treated as two consumptions: one by the donor when she transfers the funds, and a second by the heir when he spends them. Technically, under a pre-paid consumption tax, this can be accomplished by treating inheritances as labor earnings of the heir and taxing donors on their labor earnings regardless of use. Under a cash-flow consumption tax, it can be achieved by treating the transfer of wealth as dissaving, and the receipt of inheritances as income.

⁵¹ See Appendix C.

exclusion of inheritances from the heir's tax base has important distributional effects. As a result, it is not only normatively troubling, but practically significant. (Unless otherwise noted, all estimates that follow are based on joint work with Surachai Khitatrakun.⁵² Details on our methodology are provided in Appendix A. Tables with data underlying graphs in the text are provided in Appendix B.⁵³)

In 2009, annual bequests will total about \$400 billion in the U.S. To give a sense of the relative magnitude of this figure, \$400 billion represents about 4 percent of all household income, and about half of receipts from labor, saving, and inheritances among households will receive an inheritance in 2009. While the expected flow of gifts is unclear, it should be smaller by an order of magnitude.⁵⁴

In addition to being substantial in size, inheritances are distributed very unequally. Data on lifetime inheritances is limited, but existing evidence suggests that about 40 percent never receive a bequest,⁵⁵ and about two-thirds never receive a substantial gift.⁵⁶ Moreover, among those lucky enough to receive an inheritance, the amount inherited varies widely. As

⁵² Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (work-in-progress).

⁵³ These estimates are very rough because of data limitations that require multiple levels of imputation and because they rely in part on data from 1992.

⁵⁴ As noted, gifts comprise only about 10 percent of wealth transfers. *See supra* note 46.

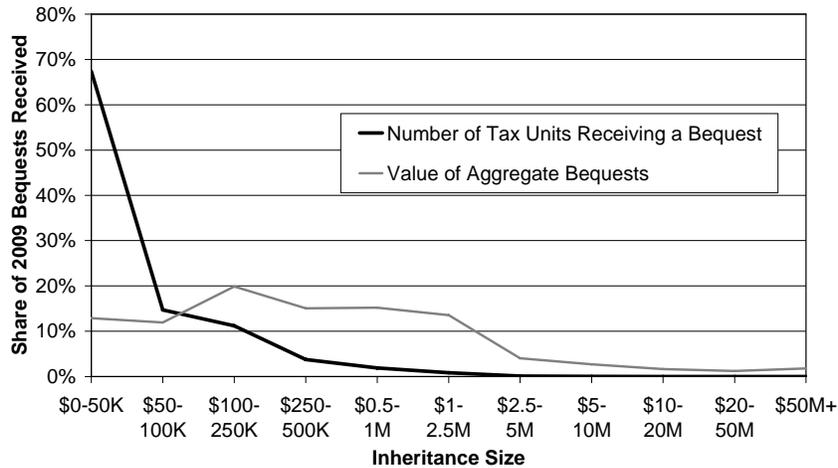
⁵⁵ Michael D. Hurd & James P. Smith, *Expected Bequests and their Distribution* 9 (Nat'l Bur. Econ. Research Working Paper 9142, 2002) (finding that 60 percent of children receive a bequest whether their last parent dies). *See also* Luc Arrondel, Andre Masson, and Pierre Pestieau, *Bequest and Inheritance: Empirical Issues in and France-U.S. Comparison*, in IS INHERITANCE LEGITIMATE? ETHICAL AND ECONOMIC ASPECTS OF WEALTH TRANSFERS 89, 101 (Guido Erreygers and Toon Vandeveld, eds., 1997) (60 percent of French descendants leave bequests); JENS BECKERT, INHERITED WEALTH 15 (2007), *citing* Szydlik, 93 (1999) (55 percent of Germans receive an inheritance).

⁵⁶ Michael Hurd, James P. Smith, and Julie Zissimopoulos, *Inter-vivos Giving over the Life Cycle* 1-2 (RAND Working Paper, Oct. 2007) (about 1/3 of elderly parents make gifts to children with an average gift of \$12,000). *See also* Claudine Attias-Donfut, Jim Ogg, and François-Charles Wolff, *Financial Transfers*, in HEALTH, AGEING AND RETIREMENT IN EUROPE – FIRST RESULTS FROM THE SURVEY OF HEALTH, AGEING AND RETIREMENT IN EUROPE

179, (Axel Börsch-Supan et al, eds., 2005), *available at* http://www.share-project.org/new_sites/SHARE-Website/Documentation/CH4.pdf (about 28% of Europeans report having given more than €250 to someone in their social network within the last 12 months) [hereinafter HEALTH, AGEING AND RETIREMENT IN EUROPE]; Hendrik Jürges, *Gifts, Inheritances and Bequest Expectations*, in HEALTH, AGEING AND RETIREMENT IN EUROPE 186 (Axel Börsch-Supan et al, eds., 2005) (about one third of European households report having received inheritances worth more than €5,000 at least once).

illustrated in Figure 1, about two-thirds of bequest recipients in 2009 will inherit less than \$50,000. Meanwhile, the top 1 percent will inherit more than \$1 million each, and together will inherit a quarter of the value of all bequests received. This group will also probably inherit relatively more in the future because the more one has inherited in the past, the more likely one is to inherit in years to come.⁵⁷

Figure 1: Share of 2009 Bequests Received by Number of Heirs and Value



Theoretically, the exclusion of inheritances the tax base of heirs might not matter if inheritances received did not alter the pre-tax income distribution.⁵⁸ In reality, though, they alter the income distribution in important and unpredictable ways. The direction and magnitude of these effects depends on the measure.

On the one hand, if one focuses on the amount inherited, inheritances tend to widen economic disparities considerably. As illustrated in Figure 2,⁵⁹ lifetime inheritances are more or less evenly distributed

⁵⁷ Hendrik Jürges, *Gifts, Inheritances and Bequest Expectations*, in *HEALTH, AGEING AND RETIREMENT IN EUROPE* 189 (Axel Börsch-Supan et al, eds., 2005).

⁵⁸ This would also require that the income tax was the only federal tax and that it applied only one set of rates.

⁵⁹ Figures 2 through 4 are even more rough than our other estimates because they assume that all individuals receive no gifts and no more than one bequest over their lifetime, and that the roughly 40 percent of individuals who never receive an inheritance are distributed in proportion to those not receiving a bequest in a given year.

among the roughly 97 percent⁶⁰ of households with income from labor and saving (referred to as *earned income*) of less than \$200,000.⁶¹ But the average bequest increases rapidly with earned income thereafter. Moreover, earned income poorly measures economic well-being and understates the regressivity of inheritances, in part because it ignores the value inherited income itself. To partially correct for this distortion, Figure 3 provides estimates of lifetime inheritances by a more comprehensive definition of income that includes annual earned income plus the annuitized value of any bequest received over the recipient's remaining life expectancy (referred to as *economic income*).⁶² Under this partially adjusted measure, the average lifetime inheritance increases from about \$50,000⁶³ for households with economic income of less than \$500,000, to ten times this amount for households whose economic income is greater.⁶⁴ Under an even more accurate measure of economic status, one would see that inheritances are distributed even more regressively.⁶⁵

⁶⁰ Tax Policy Center, Table T05-0118: Distribution of Tax Units by Income Class, 2005 (June 21, 2005), available at <http://www.taxpolicycenter.org/numbers/Content/Excel/T05-0118.xls>.

⁶¹ The specific measure of earned income used is cash income as defined at <http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=574>.

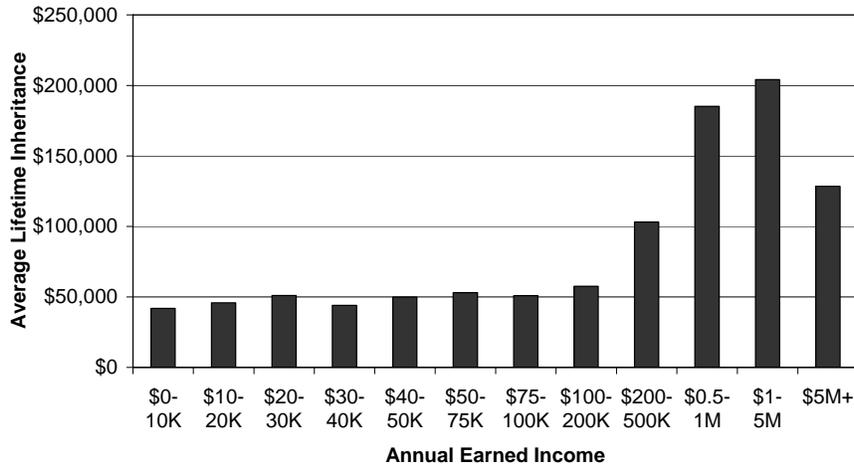
⁶² The advantage of this measure is that it fully converts the stock of an inheritance into an annual income flow. The disadvantage is that spreading inheritances over a lifetime, while not applying the same treatment to non-inherited income (because we are unable to do so), will tend to make the distribution of inheritances more equal than the distribution of non-inherited income because lifetime income is distributed considerably more equally than annual income. DON FULLERTON AND DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 26 (1993). Arguably, spreading bequests over a shorter period of time would therefore be more reasonable. Alternate estimates in which inheritances are spread over 5 years are provided in Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (work-in-progress).

⁶³ If bequests excluded from this paper's definition of a wealth transfer (e.g., educational expenditures) were included, the average bequest would be higher. It is worth noting, though, that only 46 percent of 18 to 19 year olds were attending college as of 2006 (57 percent if those still in high school are excluded). U.S. Census Bureau, *College Enrollment, Table A-5b: The Population 18 and 19 Years Old by School Enrollment Status, Sex, Race, and Hispanic Origin: October 1967 to 2006* (2006), available at <http://www.census.gov/population/www/socdemo/school.html>.

⁶⁴ See Table A3 in Appendix B.

⁶⁵ Figures 2 through 4 do not include gifts, multiple bequests, or accrued gains, all of which are highly concentrated among those receiving the largest inheritances, and thus among the most affluent. In particular, in the U.S. a couple can make up to \$24,000 in non-taxable gifts each year to each heir, which can add up to \$5 million in gifts to each heir over the couple's life. (This assumes the donor couple makes gifts over 50 years, the annual exemption remains constant, and the interest rate is 5 percent). The likelihood that an heir

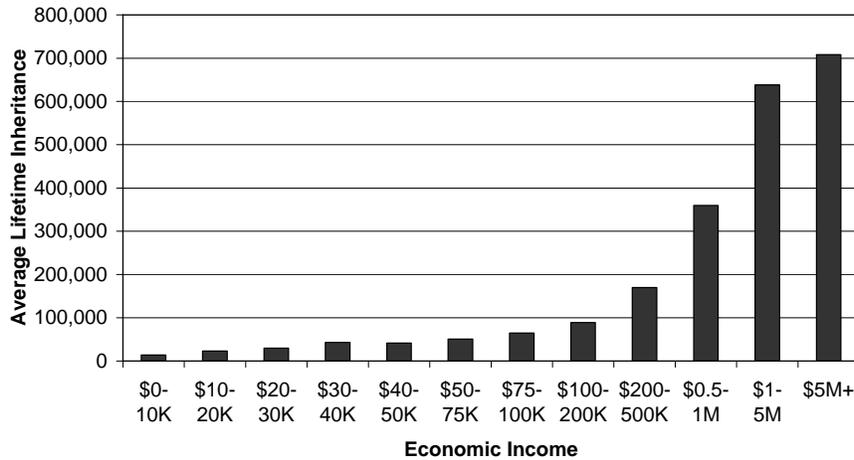
Figure 2: Rough Distribution of Average Lifetime Inheritance by Earned Income



will receive such gifts rises dramatically if the donor is exceptionally wealthy. For example, Joulfaian and McGarry find that the average ratio of actual gifts transferred to potential tax-free gifts was 4 percent overall in 1992, but 59 percent among donors with wealth of more than \$1.5 million. David Joulfaian and Kathleen McGarry, *Estate and Gift Tax Incentives and Inter Vivos Giving*, 57 NAT'L TAX J. 429, 436 tbl.3 (2004).

In addition, heirs tend to work less or retire early in response to receiving an unusually large inheritance. See, e.g., David Joulfaian *Inheritance and Saving* (Nat'l Bur. of Econ. Research Working Paper No. 12569) (Oct. 2006) (finding when people inherit more than \$150,000 in 1989 dollars, their labor force participation on average falls by 9 percentage points and their labor earnings by 12%). See also Jeffrey R. Brown et al, *The Effect of Inheritance Receipt on Retirement* (Nat'l Bur. of Econ. Research Working Paper No. 12386) (July 2006); William G. Gale & Joel Slemrod, *Overview*, in RETHINKING ESTATE AND GIFT TAXATION 1 William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., 2001); Jacob Mikow and Darien Berkowitz, *Beyond Andrew Carnegie: Using a Linked Sample of Federal Income and Estate Tax Returns to Examine the Effects of Bequests on Beneficiary Behavior* (Statistics of Income, Internal Revenue Service, 2000), available at <<http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html>>; Douglas Holtz-Eakin et al, *The Carnegie Conjecture: Some Empirical Evidence*. Q. J. ECON. 413 (May 1993). As a result, a disproportionate share of inheritances income from bequests at the low end of the income spectrum may include some wealthy heirs who have retired early.

Figure 3: Rough Distribution of Average Lifetime Inheritance by Economic Income



On the other hand, if one is concerned with the relative share of income that different individuals have, inheritances tend to narrow economic disparities to some degree. Figure 4 shows that the share of economic income that inheritances comprise gradually declines as economic income rises.⁶⁶ Once again, this estimate is probably biased to make inheritances appear more progressive.⁶⁷ Nevertheless, it implies, at the very least, that inheritances do not dramatically widen inequality in the share of economic income. Thus, depending on whether one is concerned more by disparities in income levels or income shares, bequests either substantially magnify or slightly narrow income inequality.⁶⁸

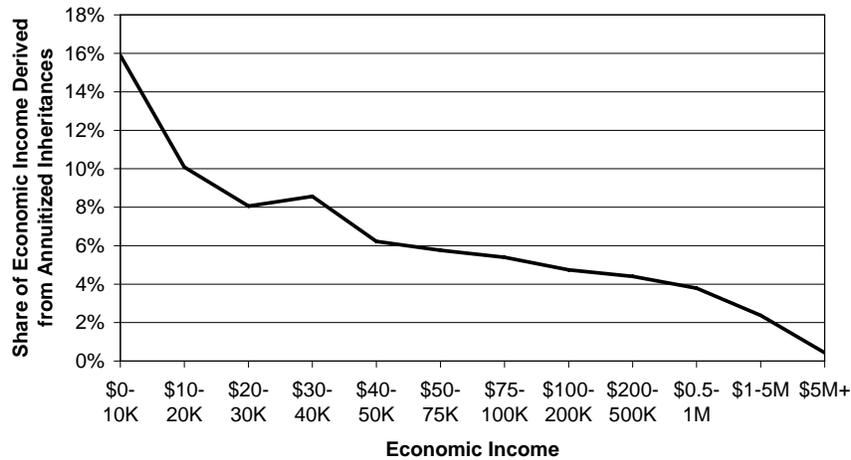
⁶⁶ Annuitized bequests are included in both the numerator and denominator.

⁶⁷ See *supra* note 65. In fact, there is limited evidence that the share of income derived from inheritances is constant across the income distribution once one adjusts for heir labor supply effects. See Edward Wolff, *The Impact of Gifts and Bequests on the Distribution of Wealth*, in DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA 345, tbl.10-9 at 371 (Alicia H. Munnell and Annika Sunden, eds.) (2003) (finding that the share of net worth derived from inheritances is constant or declines with years of education).

The decline is also presumably due to regression to the mean, whereby children of the highest earners do not tend to earn as much as their parents. For children of the super rich, the gap between parent and child earned income may be especially large given the long tail of the income distribution that represents the top one percent.

⁶⁸ Inheritances tend to have similar effects on wealth disparities as they do by income. The average amount inherited rises sharply with household wealth, especially at the high end. Edward Wolff, *The Impact of Gifts and Bequests on the Distribution of Wealth*, in DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA 345, tbl.10-8 at 368-9

Figure 4: Rough Share of Economic Income Derived from Annuitized Inheritances



Regardless of which distributional measure one finds most persuasive at an aggregate level, though, inheritances alter the economic distribution even more substantially at an individual level. The people who benefit are the recipients of large inheritances in each earned income class. Consequently, when tax systems exclude inheritances from the tax base of heirs, they effectively treat heirs as relatively worse-off—and non-heirs as relatively better-off—than each group is in reality.

c. Inheritances as Tags for Utility and Ability

Thus far, we have established that the most accurate proxy measure of endowment should include funds used for or received as wealth transfers, perhaps with a basic exemption for transfers to the needy. Nevertheless, there are several reasons to believe that even this treatment is not sufficient.

(Alicia H. Munnell and Annika Sunden, eds.) (2003). *See also* Hendrik Jürges, *Gifts, Inheritances and Bequest Expectations*, in *HEALTH, AGEING AND RETIREMENT IN EUROPE* 189, 189 (Axel Börsch-Supan et al, eds., 2005). At the same time, the share of wealth that is inherited tends to gradually decline as household wealth rises. Edward Wolff, *The Impact of Gifts and Bequests on the Distribution of Wealth*, in *DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA* 345, tbl.10-9 at 371 (Alicia H. Munnell and Annika Sunden, eds.) (2003). *See also* Hendrik Jürges, *Gifts, Inheritances and Bequest Expectations*, in *HEALTH, AGEING AND RETIREMENT IN EUROPE* 189, 188, tbl.4.A5 (Axel Börsch-Supan et al, eds., 2005); Pirmin Fessler, Peter Mooslechner, Martin Schürz, *How Inheritances Relate to Wealth Distribution? Theoretical Reasoning and Empirical Evidence on the Basis of LWS Data 10* (Luxembourg Wealth Study Working Paper No. 6, June, 2008).

In particular, wealth transfers that are not compensatory potentially should be weighted more heavily than earned income when measuring the well-being of heirs for two reasons.

First, normally heirs should derive more well-being from inherited income than earned income. Unless a wealth transfer is compensatory, heirs don't have to work in order to receive it. Most people don't like working much.⁶⁹ Accordingly, the well-being generated by earned income is the utility generated by the amount received minus the worker's disutility from having to earn it. For inherited income, it is simply the amount inherited.

Second, financial inheritances are correlated with a variety of non-financial inherited assets and traits that powerfully affect earning ability.⁷⁰ For example, Wolff has found that the present value of the average inheritance is 50 percent higher for whites relative to African-Americans and 270 percent higher for college graduates relative to high school dropouts.⁷¹ As illustrated in Figure 2 above, inheritances are also directly correlated with earnings, especially at the high end. Accordingly, inheritances are a useful "tag" indicating unobserved earning potential.⁷²

Akerlof has shown that the traditional Atkinson-Stiglitz result in which a single tax on labor earnings is optimal does not hold when an immutable characteristic is correlated with unobserved earning ability. This is the case because the tag can be used as a basis for redistribution without

⁶⁹ See, e.g., Alan Krueger and Daniel Kahneman, *Developments in the Measurement of Subjective Well-Being*, 20 J. ECON. PERSP. 3, 12 (Winter, 2006).

⁷⁰ See, e.g., Pirmin Fessler, Peter Mooslechner, Martin Schürz, *How Inheritances Relate to Wealth Distribution? Theoretical Reasoning and Empirical Evidence on the Basis of LWS Data 11* (Luxembourg Wealth Study Working Paper No. 6, June, 2008) (finding that average heir households are better educated controlling for age); Robert B. Avery & Michael S. Rendall, *Lifetime Inheritances of Three Generations of Whites and Blacks*, 107 AM. J. SOCIOLOGY 1300, tbl. 5, 1330 (2002) (finding that the mean lifetime inheritance discounted to age 55 is \$70,000 for whites and \$11,000 for blacks).

⁷¹ Edward Wolff, *The Impact of Gifts and Bequests on the Distribution of Wealth*, in DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA 345, tbl.10-9 at 371 (Alicia H. Munnell and Annika Sunden, eds.) (2003).

⁷² George A. Akerlof, *The Economics of "Tagging" as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8 (1978); Kyle Logue and Joel Slemrod, *Genes as Tags: The Tax Implications of Widely Available Genetic Information* (working draft, Aug. 1, 2007).

any efficiency cost, unlike, for example, a tax on earnings.⁷³ Thus, the result accounts for both equity and efficiency effects.

Inheritances do not fit perfectly into this theory because they are changeable from the donor's perspective. Nevertheless, the theory still potentially applies to elastic wealth transfers due to the information they provide about unrealized earning potential.⁷⁴ Moreover, it certainly applies to inelastic wealth transfers, such as egoistic and accidental wealth transfers. As a result—even if ability were the only component of endowment and inheritances had no direct effect on heir welfare—the ideal proxy measure of endowment would include some or all inheritances received.

d. Effects of Inheritances on Earning Ability

The extent to which inheritances should be weighted more heavily than earned income in the tax base depends on how much disutility people experience from working and how closely inheritances are correlated with earning ability. Data on intergenerational economic mobility reveals the surprisingly close relationship between inheritances and earnings potential.

One of the most commonly-cited measures of intergenerational economic mobility is the correlation between the log of parent and child income or consumption. It is between 0.6 and 0.7 in the U.S.⁷⁵—quite a depressing figure for those who believe in equal opportunity. A correlation of 0.7 implies that if A's parents are ten times richer than B's, A will, on average, be five times richer than B. Moreover, this correlation is even higher at the ends of the income distribution. For example, Mazumder has estimated that half of boys with fathers in the bottom income decile will have earnings below the 30th percentile,⁷⁶ while half of boys with fathers in the top decile will have earnings above the 80th percentile. The net result is

⁷³ Kyle Logue and Joel Slemrod, *Genes as Tags: The Tax Implications of Widely Available Genetic Information* 3 (working draft, Aug. 1, 2007).

⁷⁴ C.f., Mikhail Golosov, Narayana Kocherlakota and Aleh Tsyvinski, *Optimal Indirect and Capital Taxation*, 70 REV. ECON. STUD. 569, 570-71, 577 (2003).

⁷⁵ Thomas Piketty, *Theories of Persistent Inequality and Intergenerational Mobility*, in HANDBOOK OF INCOME DISTRIBUTION §§ 2.1, 3 (A. Atkinson and F. Bourguignon, eds., 1998); Bhashkar Mazumder, *The Apple Falls Even Closer to the Tree than We Thought: New and Revised Estimates of the Intergenerational Inheritance of Earnings*, in UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS 80 (Samuel Bowles et al, eds., 2005) (80% are estimated to have income below the 60th percentile).

⁷⁶ Mazumder, *supra* note 75 at 80 (68% are estimated to have income above the median).

striking. Children born in the top decile are 53 times more likely to end up in the top decile than children born to the bottom.⁷⁷

There are many factors driving the high intergenerational correlation between parent and child economic status, and probably all could be considered a form of inheritance. Some, such as parental education and race in a discriminatory society, presumably are not taxable on political grounds. Others are difficult to identify, such as inherited personality traits. Nevertheless, financial inheritances appear to be the single largest driver of the high correlation between parent and child income. Taken together, the correlation between parent and child IQ, personality, and schooling accounts for only 18 percent of the correlation.⁷⁸ By contrast, financial inheritances account for 30 percent.⁷⁹

The powerful impact of financial inheritances on child income and earnings appears to operate in several ways. First, as discussed, inheritances can be viewed as a form of income. As such, they directly limit intergenerational economic mobility by preventing an heir who receives a substantial inheritance from falling below a certain threshold of income, and by increasing the likelihood that he will rank highly in the economic distribution.

Second, and more importantly for our purposes here, wealth is a form of insurance and opportunity.⁸⁰ It can prevent downward spirals in earnings when an individual hits hard times—staving off bankruptcy, foreclosure, or the need to find a new job immediately upon unemployment, even if the new job pays less.⁸¹ At the same time, it can be used to boost

⁷⁷ Tom Hertz, *Rags, Riches and Race: The Intergenerational Economic Mobility of Black and White Families in the United States*, in *UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS* 165, 184 (Samuel Bowles et al, eds., 2005).

⁷⁸ Samuel Bowles, et al, *Introduction*, in *UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS* 1, 18-19 (Samuel Bowles et al, eds., 2005) (estimate is that factors account for 25 percent of intergenerational earnings correlation; author assumes earnings account for 70 percent of intergenerational income correlation).

⁷⁹ Piketty, *supra* note 75. See also Samuel Bowles, et al, *Introduction*, in *UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS* 1, 18-19 (Samuel Bowles et al, eds., 2005); Mazumder, *supra* note 75 at 94.

⁸⁰ D. W. Haslett, *Is Inheritance Justified?*, 15 *PHIL. & PUB. AFFAIRS* 122, 130 (Spring, 1996).

⁸¹ See, e.g., Philip Oreopolous et al., *The Intergenerational Effects of Worker Displacement* 14-16 (Nat'l Bureau of Econ. Research, Working Paper No. 11,587, 2005), available at <http://www.nber.org/papers/w11587> (finding in Canada that family income of households in which the father experiences a job loss is 15 percent lower eight years after the job loss).

earnings potential by relaxing real or perceived liquidity constraints that people face to education or starting a business venture.⁸² Given that inheritances account for only about 4 percent of lifetime income but about 30 percent of the correlation between parent and child income, this second factor appears to be more powerful. Indeed according to the best estimates, between 35 and 45 percent of all household wealth is inherited.⁸³

To summarize, financial inheritances represent a meaningful share of household income and are an even stronger indicator of ability to pay. They alter the economic distribution at both an aggregate and individual level. And they limit intergenerational economic mobility substantially by increasing the likelihood that a child's economic status will resemble that of his or her parents. Given these effects, the most accurate proxy measure for endowment should include inheritances in the tax base of the donor, perhaps with a basic exemption for transfers to the needy, and should weight non-compensatory inheritances more heavily than earned income in the tax base of heirs. In short, all else equal, the fairest way to tax inheritances is through a comprehensive inheritance tax.

All else is, of course, rarely equal. Most importantly for this discussion, the amount of inheritance flows may respond to the tax rate. This is where efficiency comes into play, the subject to which we turn next.

than what it would have been if the displacement had not occurred, that the subsequent income of children from such families is 8 percent lower, and that these results are driven by lower-income households); Ann Huff Stevens, *Long-Term Effects of Job Displacement: Evidence from the Panel Study of Income Dynamics* (Nat'l Bureau of Econ. Research, Working Paper No. 5343, 1995), available at <http://www.nber.org/papers/W5343> (finding that six or more years after an involuntary job loss, wages, and earnings remain reduced by approximately 9% and that these effects are generally larger for workers with less than a college education).

⁸² See, e.g., Sima Ghandi, *Viewing Education Loans Through a Myopic Lens*, BROOKINGS INST. HAMILTON PROJECT DISCUSSION PAPER 2008-08, at 12-16 (June, 2008).

⁸³ James B Davies & Anthony F. Shorrocks, *The Distribution of Wealth*, in HANDBOOK OF INCOME DISTRIBUTION (Anthony B. Atkinson and Francois Bourguignon, eds.) (2001); Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207, note 2 (2007); Edward Wolff, *The Impact of Gifts and Bequests on the Distribution of Wealth*, in DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA 345, 356-360 (Alicia H. Munnell and Annika Sunden, eds.) (2003).

2. *Efficiency*

An efficient tax is one that maximizes the size of the pie for a given distribution between those who are better-off and worse-off. It does so by reducing undesirable, tax-induced distortions to individual choices, and by correcting for market failures, such as externalities, both of which result in less aggregate individual welfare.

Efficiency concerns imply a number of adjustments to the above analysis under any welfarist perspective. The main individual choices that are affected by wealth transfer taxes are those regarding work, saving, and giving. In addition, wealth transfers generate both positive and negative externalities. As noted above, the presence and size of these externalities and effects depends critically on the donor's motivations for working and saving in order to accumulate the wealth transferred.

a. Compensatory Transfers

Starting with compensatory transfers, it is efficient to tax such wealth transfers as income of the donor and, separately, as income of the service provider—just like spending on all personal services is taxed.⁸⁴ As argued above, this tax treatment is also the fairest. No additional tax should apply on equity grounds, unless there is reason to believe that compensation disguised as inheritances is more likely to be received by those with larger endowments. There is no evidence that this is the case.⁸⁵ Thus, the welfare-maximizing treatment of compensatory transfers should be including them in the tax base of both the transferor and recipient (referred to as an *inclusion tax*), but not to subject to them any further taxation.

b. Inelastic Transfers

Turning to inheritances stemming from egoistic and warm-glow pre-tax saving (both referred to as egoistic transfers), by contrast, efficiency considerations imply taxation at a confiscatory rate of 100 percent.⁸⁶ By

⁸⁴ See, e.g., Helmuth Cremer and Pierre Pestieau, *Wealth Transfer Taxation: A Survey* 24 (The Levy Economics Institute of Bard College Working Paper No. 394, Nov. 2003) (reaching the same conclusion).

⁸⁵ It certainly could become the case, though, if the gift tax were eliminated and the income tax exclusion for gifts and bequests received were retained.

⁸⁶ William G. Gale and Joel Slemrod, *Overview*, in RETHINKING ESTATE AND GIFT TAXATION 1, 35 (William G. Gale, James R. Hines Jr., and Joel Slemrod eds.) (2001); Louis Kaplow, *A Framework for Assessing Estate and Gift Taxation*, in RETHINKING

definition, such a confiscatory tax should have no particular impact on donors' motivation to work, save or give because they did not accumulate such wealth with an eye to how much their heirs would receive. Moreover, with respect to heirs, such a confiscatory tax should be efficiency-enhancing. Heirs tend to respond to receiving a large inheritance by working less⁸⁷ because inheritances create an income effect but no offsetting substitution effect (heirs do nothing in order to receive egoistic wealth transfers). This implies that taxing inheritances will, conversely, tend to induce heirs to work more. As a result, the confiscatory tax should raise revenue, both from the heir's additional labor and the confiscated inheritance. This new revenue, in turn, can be used to lower the underlying tax, thereby reducing its inherent efficiency losses.

The same argument can be applied to accidental bequests, with two caveats. First, in the case of accidental bequests, confiscatory taxation is only a second-best solution. The first-best approach is to eliminate accidental bequests entirely by correcting the market failures in the annuities and retiree health insurance markets that give rise to them.

In practice, however, it is unlikely that government can fully correct for these market failures. Government intervention in private insurance markets through pooling arrangements and default rules might address adverse selection problems and inertia. But it is difficult for private insurers to insure against serially-correlated risks that extend far into the future, such as changes in the rate of growth of inflation, longevity, and health care costs. Individuals may therefore fail to insure adequately out of a justifiable fear that the insurer will go bankrupt or cut back on their benefits once the time for payment arises.⁸⁸ The main alternative would be to expand mandatory governmental programs (such as Social Security and Medicare in the U.S.) in order to provide for all retiree income and health needs. But the optimal level of these programs would presumably strike some middle ground between individuals' differing preferences regarding health insurance and income replacement rates in retirement. As a result, wealth transfers from life cycle savings will likely remain a part of an ideal fiscal system and, once they exist, confiscatory taxation becomes the welfare-maximizing response.

ESTATE AND GIFT TAXATION 164, 180 (William G. Gale, James R. Hines Jr., and Joel Slemrod eds.) (2001).

⁸⁷ See *supra* note 65.

⁸⁸ See, e.g., Charles Duhigg, *Aged, Frail, and Denied Care by their Insurers*, N.Y. TIMES (March 6, 2007).

The other potential problem with confiscatory taxation of accidental bequests is that doing so can increase inefficiencies associated with redistributive aspects of the underlying tax through interactions with labor supply decisions.⁸⁹ For example, suppose that there are three generations and some members of the first leave accidental bequests to some members of the second. These bequests are confiscated and redistributed pro rata. If the labor supply of the members of the second generation who otherwise would not have received an inheritance is more elastic, the earnings of the second generation will fall more strongly in response to the new pro rata distribution of bequests. As a result, the third generation will receive fewer accidental bequests. Similarly, if the second generation's non-heirs have a lower propensity to save inherited wealth than its would-be heirs, the savings rate could fall, reducing the supply of accidental bequests. Either way, the third generation is worse off.⁹⁰

While theoretically possible, the limited existing evidence on the labor supply of heirs appears to cut against this theory.⁹¹ At the same time, it is unclear whether non-heirs save inherited wealth at lower rates.⁹² Moreover, many would argue that the social welfare function should not weight the welfare of generations far into the future as heavily as current generations, given generally rising standards of living as a result of economic growth.⁹³

Most importantly, this objection ignores a potential justification for taxing accidental bequests—and all inheritances with no bequest motive—at rates even higher than 100 percent. As argued, such inheritances are powerful “tags” for an heir’s unobserved earning ability. Accordingly,

⁸⁹ See Wojciech Kopczuk, *Optimal Estate Taxation in the Steady State* (working paper, June, 2001); Tomer Blumkin and Efraim Sadka, *Estate Taxation with Intended and Accidental*, 88 J. PUB. ECON. 1, 11 (2003).

⁹⁰ *C.f.*, Tomer Blumkin and Efraim Sadka, *Estate Taxation with Intended and Accidental*, 88 J. PUB. ECON. 1, 11 (2003).

⁹¹ Those receiving ordinary inheritances appear not to change their labor supply; instead the negative labor supply response is concentrated among those inheriting very large amounts. David Joulfaian *Inheritance and Saving* (Nat'l Bur. of Econ. Research Working Paper No. 12569) (Oct. 2006).

⁹² Inheritances are correlated with ability, and those with higher ability tend to save more. See, e.g., Barry Bosworth and Lisa Bell, *The Decline in Household Saving: What Can We Learn from Survey Data?* tbl.5 (Dec. 2005), available at http://www.brookings.edu/~media/Files/rc/papers/2005/0811saving_bosworth/20050811.pdf.

⁹³ See, e.g., Neil Buchanan, *What Do We Owe Future Generations?*, __ GEORGE WASH. L. REV. __ (forthcoming, 2008).

taxing them more heavily will render the tax system simultaneously more equitable and more efficient. The most accurate tag should generally be the amount inherited, but accidental bequests should probably be adjusted for the donor's age.

Thus, unlike compensatory transfers, the welfare-maximizing approach to taxing inelastic should be to tax them separately from earned income (referred to as an *accessions tax*), and at an extraordinarily high rate. For accidental bequests, the ideal tax rate should be around 100 percent (potentially higher or lower), with a portion based on the age-adjusted inheritance. For inheritances from egoistic transfers, it should exceed 100 percent.

c. Altruistic Transfers

The final potential wealth accumulation motive is altruism or an after-tax warm glow (both referred to as altruistic transfers). This is the only scenario in which a gratuitous wealth transfer responds to the tax rate. Thus, a threshold question arises of whether such transfers should ever be subject to tax given the potential long-run effects on saving and giving. In particular, Chamley and Judd have shown that if one assumes that donors value the well-being of their descendants for an infinite number of generations (“Barro-type” altruism), the optimal tax on inheritances may be zero. This is the case because any positive redistributive effects for the current generation are outweighed by the compound effects on future generations of the donor responding by saving and giving less.⁹⁴

While theoretically possible, the argument for disregarding altruistic transfers on these grounds is problematic on several fronts. First, the evidence of Barro-type altruism is weak. Individuals do not appear to optimize over several generations or even, in most cases, their own.⁹⁵ In addition, the model assumes that the private discount function and social discount function are the same. Once again, even if individuals did heavily weight the effects of their decisions on generations far into the future, it is

⁹⁴ Tomer Blumkin and Efraim Sadka, *Estate Taxation with Intended and Accidental*, 88 J. PUB. ECON. 1, 2 (2003); Christophe Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 *ECONOMETRICA* 607, 619 (May, 1986); Kenneth Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 J. PUB. ECON. 59 (1985). I am grateful to Kevin Hassett and Dan Shaviro for raising this point.

⁹⁵ See, e.g., Joseph E. Altonji et al, *Is the Extended Family Altruistically Linked? Direct Tests Using Micro Data*, 82 *AM. ECON. REV.* 1178 (Dec., 1992). See generally *infra* notes 115-132 and accompanying text and table.

unclear why the social welfare function should. After all, future generations will presumably be much better off as a result of economic growth. Finally, the model assumes that each individual's endowment is composed solely of ability and that no individual characteristics provide information about unobserved earning potential. As explained above, this paper more realistically assumes that inheritances are a second fundamental component of endowment and provide a useful tag for ability. When this is the case, a tax on the tag may simultaneously enhance the efficiency and fairness of the tax system—even under Barro-type altruism.⁹⁶ Thus, the case for ignoring wealth transfers within an optimal tax system (i.e., neither taxing nor subsidizing them) seems wrong practically.

Returning instead to the analytic framework developed so far, fairness concerns suggest that altruistic wealth transfers should be treated as income of both the heir and donor (perhaps with a basic exemption for transfers to the needy), and should also be subject to an additional accessions tax. Efficiency considerations, however, imply at least three substantial adjustments to this tax treatment.

First and most importantly, altruistic inheritances create altruistic externalities. For example, suppose an heir gains 50 units of well-being from a \$100 inheritance and the donor values the heir's well-being as if it were her own. The transfer then generates 50 units of well-being for the donor as well, and she will make the transfer so long as using the money in any other way generates than 50 units of well-being. In reality, though, the transfer results in 100 units of well-being—50 for the donor and 50 for the heir. The 50 units that the heir gains are the *altruistic externality* that the donor does not adequately take into account.⁹⁷ This altruistic externality underlies the Chumley-Judd model, but here we will consider a more plausible scenario where the donor only takes into account the well-being of her beneficiary, not an infinite number of potential descendants thereafter.

As explained in part by Kaplow, the efficient way to correct for this altruistic externality is to provide the donor with a subsidy equal to the welfare-weighted value of the heir receiving the inheritance, and to exclude

⁹⁶ *C.f.*, Mikhail Golosov, Narayana Kocherlakota and Aleh Tsyvinski, *Optimal Indirect and Capital Taxation*, 70 REV. ECON. STUD. 569, 570-71, 577 (2003) (reaching this result with respect to savings if it provides information about an individual's underlying ability over time).

⁹⁷ It is worth emphasizing that the altruistic externality is not the value the donor assigns to the transfer because she presumably takes this value adequately into account.

the inheritance from the heir's underlying tax base. (The inheritance should not be included in the heir's tax base because doing so burdens both the donor and the heir, due to the fact that the donor's welfare gain is a function of the heir's.)⁹⁸ For example, if the donor transfers \$100 and society values the heir receiving that amount at \$100, the donor should receive a \$100 subsidy so that she makes the transfer as long as spending \$100 in any other way generates less than 100 units of well-being for her, not 50.⁹⁹

In order to ensure that such an altruistic subsidy is strictly efficiency-enhancing, though, it should not alter the general distribution of tax burdens and benefits between those who are better-off and worse-off in the process of correcting the price of wealth transfers. This can be accomplished by financing the subsidy through what Kaplow terms a "benefit-offsetting tax." Such a tax would mimic the incidence of the subsidy. That is, it would have the same aggregate incidence by endowment¹⁰⁰ as the new consumer and producer surplus created by the subsidy and the externalities from new giving that it generates.¹⁰¹ But it would not be based on the amount of wealth transfers that a specific donor chooses to make. The net result would be greater social welfare and a lower cost of giving.¹⁰²

⁹⁸ This might not be the case if the donor grossed up the inheritance for the heir's underlying tax burden on it, but as discussed above, this does not appear to be the norm empirically. I am grateful to David Kamin for this point.

⁹⁹ See Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469, 470-74 (1995); Louis Kaplow, *A Framework for Assessing Estate and Gift Taxation*, in *RETHINKING ESTATE AND GIFT TAXATION* 164, 178-179 (William G. Gale, James R. Hines Jr., and Joel Slemrod eds.) (2001).

¹⁰⁰ For purposes of the benefit offsetting tax, the endowment of the heir should include his inheritance, not just the proxy for his ability (e.g., income or consumption). The endowment of the donor should also include the amount transferred.

¹⁰¹ See Louis Kaplow, *The Optimal Supply of Public Goods and the Distortionary Cost of Taxation*, 49 NAT'L TAX J. 513, 514, 517 (1996); Louis Kaplow, *On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy*, 18 J. ECON. PERSP., Fall 2004, at 159-60.

¹⁰² An example may help illustrate this point. Suppose society initially consists of five individuals. L1 and L2 have \$100, M1 and M2 have \$200, and H1 has \$300. M1 plans to give \$50 to L1 for altruistic reasons. A 100 percent subsidy for altruistic transfers is offered because more income for L1 produces a lot of social welfare. In response, M1 gives L1 \$100 instead. As a result, L1 ends up \$50 better off than she would without the subsidy, and M1 ends up \$100 better off (the amount of the subsidy). Moreover, L1 now effectively has \$200 and M1 now effectively has \$300 (\$200 of utility from market consumption and \$100 from altruistic or warm glow consumption), which moves them into the middle-class and upper-class respectively. One third of the benefit offsetting tax should therefore be

Overall, the ideal altruistic subsidy would decline as the economic status of the heir rises for two reasons. First, the marginal subsidy should be welfare-weighted. This implies higher marginal subsidies for transfers to low-income heirs, given the assumption of declining marginal utility of money. Second, the net subsidy should also be higher for transfers to those who are relatively low-income. This is the case because lower-income heirs should bear less of the benefit-offsetting tax, resulting in transfers to them receiving higher effective subsidies.¹⁰³

allocated to the middle-class (due to L1's \$50 gain) and two-thirds to the upper-class (due to M1's \$100 gain). The results are as follows. The subsidy improves social welfare because all of the losses are matched or exceeded by gains from someone who was lower-income.

<i>Person</i>	<i>Initial Endowment</i>	<i>After-Subsidy</i>	<i>After Offsetting Tax</i>	<i>Net Gain (Loss)</i>
L1 (heir)	100/150	200 (Middle-Income)	183.4	33.4
L2	100	100 (Low-Income)	100	0
M1 (donor)	200	300 (High-Income)	250 (incl. heir's tax)	50
M2	200	200 (Middle-Income)	183.4	(16.6)
H1	300	300 (High-Income)	266.6	(33.3)

¹⁰³ Lower-income heirs should bear less of the benefit-offsetting tax first because donors gain more from altruistic subsidies. Donors gain the entire value of the subsidy, while heirs only gain to the extent that the donor responds by giving more. As a result, donors bear more of the benefit-offsetting tax than heirs. In addition, wealth transfers tend to flow down the economic distribution.

Another example may help illustrate this point. Suppose in the above example that H1 also planned to transfer \$50 to M2. H1 is only offered a 50 percent altruistic subsidy because transfers to M2 are valued less than transfers to L1. H1 responds to the 50 percent subsidy by transferring \$100 instead. M2 then ends up \$50 better off and H1 ends up \$50 better off, moving them into the upper-class and rich class, respectively. The \$150 benefit offsetting tax would be allocated one-fifth to the middle-class (L1's \$50 gain), three-fifths to the upper-class (M1's \$100 gain and M2's \$50 gain), and one-fifth to the rich (H1's \$50 gain). The net subsidies are as follows:

<i>Person</i>	<i>Initial Endowment</i>	<i>After Subsidy</i>	<i>After Offsetting Tax</i>	<i>Net Gain (Loss)</i>
L1 (heir1)	100/150	200 (Middle-Income)	170	20
L2	100	100 (Low-Income)	100	0
M1 (donor1)	200	300 (High-Income)	225 (incl. heir's tax)	25
M2 (heir 2)	200/250	300 (High-Income)	255	5
H1 (donor2)	300	350 (Rich)	275 (incl. heir's tax)	(25)

The transfer by M1 to low-income L1 results in a \$45 net endowment gain (\$20 for L1 and \$25 for M1). By contrast, the transfer by H1 to middle-income M2 results in both being better off relative to the prior scenario where the subsidy system is in place and only M1 gives. But it results a \$20 net endowment loss (\$5 gain for M2 and a \$25 loss for H1) relative a scenario where there is no subsidy system at all.

Several objections typically arise to subsidizing altruistic externalities. Later sections will discuss those that involve administrative or political constraints.¹⁰⁴ But even in this highly idealized scenario, some object that altruistic subsidies can become infinite. For example, in the above hypothetical, the donor could decide to transfer the subsidy as well, in which case she would be eligible for a further subsidy. It is a misconception that this process would continue indefinitely, though. This is the case because—as the heir’s income rises—the heir and donor will both receive less and less well-being from such transfers, the welfare-weighted marginal subsidy will become smaller and smaller, and their share of the benefit offsetting tax will continually increase. These factors will simultaneously reduce the donor’s pre-tax and post-tax incentive to give.

In addition to altruistic externalities, altruistic wealth transfers create a second type of positive externality if the donor is better-off than the heir. Specifically, if the heir would be an object of active redistribution¹⁰⁵ under the social welfare function, the transfer eliminates this need, thereby permitting lower underlying tax rates, which benefits society as a whole.¹⁰⁶ These social benefits are referred to as a *redistributional externality*. The efficient way to correct for this subsidy is through an additional subsidy that is largest for transfers to the least well-off and declines to zero as the heir’s economic status rises. Once again, it should be financed by a benefit-offsetting tax.¹⁰⁷

Finally, altruistic transfers create a negative externality because heirs tend respond to receiving a substantial inheritance by working less,¹⁰⁸ thereby depressing revenues from the underlying tax. The size of this negative *revenue externality* turns on the heir’s marginal tax rate and the elasticity of his labor earnings with respect to inherited income. As a result, the efficient way to correct for it is to include a portion of the heir’s

¹⁰⁴ See *infra* notes 183-184 and accompanying text.

¹⁰⁵ The redistributional externality could be thought of as part of the altruistic externality. The only difference is that altruistic subsidies address the benefits to society of transfers that society might not otherwise force for efficiency reasons, while redistributional subsidies address the social benefits of transfers that substitute for governmental redistribution that would occur otherwise.

¹⁰⁶ Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469, 474 (1995).

Louis Kaplow, *A Framework for Assessing Estate and Gift Taxation*, in RETHINKING ESTATE AND GIFT TAXATION 164, 200 (William G. Gale, James R. Hines Jr., and Joel Slemrod eds.) (2001).

¹⁰⁷ See *supra* note 101.

¹⁰⁸ See *supra* note 65.

inheritance in his underlying tax base, with the specific amount included turning on the amount by which his labor earnings are expected to decline. Doing so makes the donor internalize the effect of her altruistic transfer on her heirs' contribution to the fisc.

Pulling all of these fairness and efficiency considerations together, the welfare-maximizing treatment of altruistic wealth transfers has four components. First, on fairness grounds, such inheritances should be included in the tax base of the donor, perhaps with a basic exemption for transfers to those most in need. Second, altruistic transfers should be subject to an accessions tax in order to account for the fact that inheritances are powerful "tags" for an heir's unobserved earning ability and level of well-being. Third, in order to correct for altruistic and redistributive externalities, such transfers should generally be excluded from the heir's tax base and eligible for a subsidy that declines from more than 100 percent to zero as the heir's income rises. The subsidy should be financed by an increase in the underlying tax that results in the net subsidy declining to zero for the highest-income heirs even faster. Finally, a portion of the inheritance should be included in the heir's underlying tax base to correct for the revenue externality. The actual portion should turn on the heir's expected labor supply response and ultimately approach zero. In short, altruistic transfers should be included in the donor's tax base, partially included in the heir's, and subsidized at a net rate that declines from around 100 percent to below zero as the heir's economic status rises.

To be clear, none of these efficiency adjustments are warranted when a wealth transfer is compensatory, egoistic or accidental. Each adjustment is intended to alter the price of altruistic transfers relative to other consumption options so that the donor makes the choice based on all of the well-being generated by the transfer, not just her own. In the case of inelastic transfers, such adjustments are unnecessary transfers because correcting the relative price of the transfer would have no effect. In the case of exchange-motivated transfers, they are inappropriate because the recipient has actually worked for the transfer and the donor does not care about the heir's well-being. Put differently, such transfers are really compensation and should be taxed as such.

3. With Perfect Information

Having considered each of the potential donor motives for accumulating wealth transfers, we now can summarize the ideal taxation of

wealth transfers in world with perfect information. There are five potential forms a wealth transfer tax can take, as listed in Table 1.

Table 1: General Approaches to Taxing Wealth Transfers

Type of Tax		Include in Underlying Tax Base		Separate Tax	
		Donor	Heir	Apply	Tax Base
No Wealth Transfer Tax		Yes	No	No	-
Estate and Gift Tax				Yes	Amount Transferred
Inheritance Tax	Accessions Tax		Yes	Amount Received	
	Inclusion Tax		Yes	No	-
	Comprehensive Inheritance Tax			Yes	Amount Received

A tax system can ignore wealth transfers and thus have *no wealth transfer tax*. In this case, donors make wealth transfers with after-tax earnings but inheritances received are excluded from the heir's underlying tax base. A tax system can subject wealth transfers to an *estate and gift tax*, which taxes the amount transferred based on a separate rate schedule. Alternatively, the tax system can apply an inheritance tax, of which there are three types. An *accessions tax* imposes a separate tax based solely on the amount he receives, typically over his lifetime, and excludes the transfer from the tax base of the heir as under an estate and gift tax. Conversely, an *inclusion tax* applies no separate tax but includes the inheritance in the heir's tax base. Finally, a *comprehensive inheritance tax* is a hybrid of the two. It includes wealth transfers above an exemption in the underlying tax base of the donor and heir, and subjects them to a separate tax based on the amount inherited.

In a world with perfect information, the ideal wealth transfer tax is always some type of inheritance tax if the fairness and efficiency arguments laid out above and summarized in Table 2 are accepted. Table 2 illustrates that the specific form, level, and sign of the ideal inheritance tax turns on the donor's marginal wealth accumulation motive, the economic status of the heir, the amount of information provided about the heir's unobserved ability, and the structure of the underlying tax. If a donor's marginal wealth transfers are compensatory, the ideal approach is a positive inclusion tax. If they are inelastic, it is generally a positive accessions tax. And if they are altruistic, it is a negative comprehensive inheritance tax. In all three scenarios, though, the ideal approach is neither an estate tax, nor to disregard wealth transfers entirely.

Table 2: Welfare-Maximizing Wealth Transfer Tax by Wealth Accumulation Motive

Donor Motive	Wealth Transfer Tax Form	Rationale
Compensatory	Full Inclusion Tax	<ul style="list-style-type: none"> • Identical to other earnings
Egoistic or Pre-Tax Warm Glow	Accessions Tax >100%	<ul style="list-style-type: none"> • 100% tax because no behavioral distortions. • Accessions tax to address correlation with ability and greater utility generated.
Life Cycle Savings	Accessions Tax ~100%, Adjusted for Donor's Age	<ul style="list-style-type: none"> • ≤100% tax because no behavioral distortions. • Accessions tax to address correlation with ability and greater utility generated.
Altruistic	Partial Inclusion Tax + Net Accessions Subsidy Declining from ~100% to <0% as Heir Income Rises	<ul style="list-style-type: none"> • Inclusion of small portion of transfer to address revenue externality. • Accessions subsidy of declining from 100%+ to zero as heir economic income rises to address altruistic and redistributive externalities. • Accessions tax to address greater utility generated and correlation with ability. • Benefit offsetting tax on donor's and heir's endowment class.

Moreover, the case for an inheritance tax is strengthened by considering how wealth transfer taxes operate in the real world. Basing the tax on circumstance of the heir, as under an inheritance tax, makes sense because, as argued, heirs bear the burden of wealth transfer taxes in general. It also makes sense because, contrary to conventional economic wisdom, there is some evidence that the statutory incidence of a tax affects its excess burden as people irrationally respond more to a tax they nominally pay.¹⁰⁹ If this is the case, placing the statutory incidence on the heir, as under an inheritance tax, should reduce the excess burden, given the fact that any deadweight loss associated with wealth transfer taxation arises from the behavioral response of donors.

¹⁰⁹ This could occur because the tax is more salient or because the person bearing the statutory burden remits the tax. *See, e.g.,* Joel Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, 61 NAT'L TAX J. 251 (June, 2008); Raj Chetty, Adam Looney, and Kory Kroft, *Salience and Taxation: Theory and Evidence* (Nat'l Bur. Econ. Research Working Paper No. 13330, Aug., 2007); Amy Finkelstein, *EZTax: Tax Salience and Tax Rates* (Nat'l Bur. Econ. Research Working Paper No. 12924, Feb., 2007).

4. *With Imperfect Information*

Unfortunately, the world is full of imperfect information. Accordingly, the ideal just summarized of taxing each inheritance based on the donor's marginal wealth accumulation motive is impossible. Thus, in order to gain a clearer sense of the ideal form and level of wealth transfer taxation given present informational constraints, it is necessary to consider existing evidence and the implications of empirical uncertainty.

Some of the evidence on relevant parameters can be summarized briefly. As discussed, inheritances have a meaningful affect on the income distribution, and are powerfully correlated with earning ability.¹¹⁰ Accordingly, it matters whether they are taxed. Similarly, low-income tax units may receive a larger share of their income from inheritances,¹¹¹ implying that redistributive externalities may exist to the extent that transfers are altruistic. In addition, inheritances appear to induce heirs to earn less, producing a revenue externality, but the estimated effect is relatively small. For example, Joulfaian finds that heirs' labor earnings tend to decline by only about 2 percent for each unit of the natural log of inheritance, with inheritance measured in millions of dollars.¹¹² Our estimates suggest that less than one percent of heirs inherit more than one million dollars in a given year.

Regrettably, the most important parameter for determining the ideal wealth transfer tax, however, is the most contested: the share of wealth transfers attributable to different wealth accumulation motives. Table 3 illustrates this point by partially summarizing the empirical literature on the issue. It shows that there is a long history of research on wealth transfer motives. Initially researchers obtained widely divergent estimates. For example, Kotlikoff and Summers (1981) estimated that only 20 percent of bequests are accidental. Hurd (1987) countered that households with children do not save more and, on this basis, concluded that bequests largely stem from life cycle savings.¹¹³ Still later work questioned Hurd's

¹¹⁰ See *supra* notes 70-83 and accompanying text.

¹¹¹ See Figure 4.

¹¹² Douglas Holtz-Eakin, David Joulfaian, and Harvey Rosen, *The Carnegie Conjecture: Some Empirical Evidence*, 108 Q. J. ECON. 413, 432 tbl.5 (May, 1993).

¹¹³ Michael Hurd, *Savings of the Elderly and Desired Bequests*, 77 AM. ECON. REV. 298 (1987) (finding no support for a bequest motive given declining wealth in retirement and lower savings rates among households with living children).

logic because many childless adults appear to transfer wealth intentionally.¹¹⁴

Table 3: Studies on Wealth Accumulation Motives

Study	Accidental	Egoistic & Pre-Tax Warm Glow	Exchange	Altruistic & After-Tax Warm Glow
Kotlikoff & Summers (1981) ¹¹⁵	19%	81%		
Hurd (1987) ¹¹⁶	Most Bequests		Minority of Bequests	
Modigliani (1988) ¹¹⁷	>80%			<20%
Hurd (1989) ¹¹⁸	Most		Small	
Bernheim (1991) ¹¹⁹	<70-84%			>16-30%
Altonji et al (1992) ¹²⁰	Most			Model Rejected
Wilhelm (1996) ¹²¹	Most			Little Evidence
Laitner & Juster (1996) ¹²²	77-82%			18-23%

¹¹⁴ See, e.g., Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007) (findings consistent with hypothesis that parents do not behave according to a bequest motive any more than households without children); B. Douglas Bernheim, *How Strong Are Bequest Motives?*, 99 J. POL. ECON. 899 (1991) (28-30 percent of households with children purchase life insurance and 16-18% of childless households).

¹¹⁵ Laurence J. Kotlikoff and Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 J. POL. ECON. 706 (1981) (finding life cycle savings accounts for only 10 percent of wealth transfers).

¹¹⁶ Hurd, *supra* note 113.

¹¹⁷ Franco Modigliani, *Measuring the Contribution of Intergenerational Transfers to Total Wealth: Conceptual Issues and Empirical Findings*, 2 J. ECON. PERSP. 15 (1988) (pure bequest motives do not account for more than one-fifth of bequests; pure bequest motive more common among most wealthy).

¹¹⁸ Michael D. Hurd, *Mortality Risk and Bequests*, 57:4 *Econometrica* 779-81 (July, 1989) (estimating that most bequests are accidental and finding no evidence of a bequest motive by looking at the consumption paths of the elderly relative to individual mortality risk).

¹¹⁹ B. Douglas Bernheim, *How Strong Are Bequest Motives?*, 99 J. POL. ECON. 899 (1991) (28-30 percent of households with children purchase life insurance and 16-18% of childless households).

¹²⁰ Joseph E. Altonji et al, *Is the Extended Family Altruistically Linked? Direct Tests Using Micro Data*, 82 AM. ECON. REV. 1178 (Dec., 1992) (strongly rejecting the altruistic model in general and finding that extended family resources only modestly predict household consumption).

¹²¹ Mark O. Wilhelm, *Bequest Behavior and the Effect of Heirs' Earnings: Testing the Altruistic Model of Bequests*, 86 AM. ECON. REV. 874 (Sept. 1996) (finding little support for the altruistic model).

¹²² John Laitner and F. Thomas Juster, *New Evidence on Altruism: A Study of TIAA-CREF Retirees*, 86 AM. ECON. REV. 893, 906 (1996) (estimating that 18 to 23 percent of lifetime saving is altruistically motivated).

Laitner & Ohlsson (2001) ¹²³	Most		Some Evidence
Dynan et al (2002) ¹²⁴	Most		<8%
Hendricks (2002) ¹²⁵	>47%	<53%	
Page (2003) ¹²⁶	Not All		Some
Li Gan (2004) ¹²⁷	Very Large Share		Small
Kopczuk & Lupton (2007) ¹²⁸	47%	53%, Mostly Egoistic	

Nevertheless, over time this literature has begun to reach a fragile consensus that altruistic and compensatory transfers represent a minority of wealth transfers. For example, Laitner and Justner (1996) found that donors exhibit a wide array of motives but estimated that, among their relatively high-income sample, only about 20 percent of wealth accumulated is attributable to a bequest motive.¹²⁹ Similarly, Kopczuk and Lupton (2007) estimated that 47 percent of bequests are attributable to life cycle savings by examining the consumption patterns of the elderly.¹³⁰ They also found evidence of altruistic and exchange-motivated transfers, but it was not statistically significant.¹³¹ On this basis, they concluded that much of the

¹²³ John Laitner and Henry Ohlsson, *Bequest Motives: A Comparison of Sweden and the United States*, 79 J. PUB. ECON. 205 (2001) (finding some support for the altruistic model but a much smaller sign than the model would imply).

¹²⁴ Karen E. Dynan et al., *The Importance of Bequests and Life-Cycle Savings in Capital Accumulation: A New Answer*, 92 AM. ECON. REV. 274 (2002) (reporting survey results that 50 percent consider leaving an inheritance their heirs to be important or very important, but only 8 percent list saving for an estate as one of their top five reasons for saving).

¹²⁵ Lutz Hendricks, *Intended and Accidental Bequests in a Life Cycle Economy* (mimeo, Feb. 6, 2002) (finding that accidental bequests account for at least 47 percent and potentially a much larger share of bequests).

¹²⁶ Benjamin R. Page, *Bequest Taxes, Inter Vivos Gifts, and the Bequest Motive*, 87 J. PUB. ECON. 1219 (2003) (marginal tax rate affects the probability of giving gifts so not all wealth transfers are accidental).

¹²⁷ Li Gan, et al., *Subjective Mortality Risks and Bequests* (Nat'l Bur. Econ. Research Working Paper No. 19789, 2004).

¹²⁸ Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007) (estimating that 47 percent of wealth transfers are attributable to life cycle savings and concluding that egoistic saving is the most plausible explanation for the remainder because evidence of altruistic and compensatory transfers is statistically insignificant).

¹²⁹ John Laitner and F. Thomas Juster, *New Evidence of Altruism: A Study of TIAA-CREF Retirees*, 86 AM. ECON. REV. 893, 906 (Sept. 1996).

¹³⁰ Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007).

¹³¹ Id. See also Benjamin R. Page, *Bequest Taxes, Inter Vivos Gifts, and the Bequest Motive*, 87 J. PUB. ECON. 1219 (2003) (finding a positive relationship between the marginal

remaining 53 percent of bequests is probably egoistic.¹³² Overall, the literature seems to suggest that about 50 percent of wealth transfers are accidental, about 20 percent altruistic, and the bulk of the remainder egoistic.

Ideally, the level and form of wealth transfer taxes would be calibrated to each donor's marginal wealth accumulation motive. Given that such perfect information is unavailable, the second best option would be for any tax to vary with various "tags" correlated with different wealth accumulation motives. Unfortunately this information is unavailable as well. Despite the progress in determining the aggregate share of wealth transfers attributable to different bequest motives, existing studies do not appear to permit one to draw any conclusions about how to identify these motives at an individual level. Indeed, the difficulties in identifying wealth accumulation motives at an individual level are part of the reason why the literature on the aggregate prevalence of different bequest motives has been so contested.

Most of the most obvious proxies for a donor's bequest motive have been largely disproven empirically. For example, having living children appears not to provide any information on wealth accumulation motives. The studies to date find that childless adults save for altruistic reasons just as often as parents.¹³³ Likewise, expected remaining wealth in very old age is not well correlated with the share of bequests that are accidental because a large share of life cycle savings may be for unexpected health care costs at the end of life, not day-to-day retirement consumption needs.¹³⁴

Other potential proxies for wealth accumulation motives simply have not been studied enough to draw any conclusions, however rough. For

tax rate on bequests and inter vivos gifting, implying that some portion of bequests is altruistic or exchange-motivated).

¹³² *Id.*

¹³³ See, e.g., Hurd, *supra* note 113; Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007) (findings consistent with hypothesis that parents do not behave according to a bequest motive any more than households without children).

¹³⁴ See, e.g., Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, *The Importance of Bequests and Life-Cycle Saving in Capital Accumulation: A New Answer*, 92 AM. ECON. REV. 274 (2002); Hendrik Jürges, *Do Germans Save to Leave an Estate? An Examination of the Bequest Motive*, 107 SCANDINAVIAN J. ECON. 391, 392 (Sept. 2001); Michael G. Palumbo, *Uncertain Medical Expenses and Precautionary Saving Near the End of the Life Cycle*, 66 REV. ECON. STUD. 395 (1999).

example, it is possible that marginal wealth accumulation motives vary with the wealth of the donor. Perhaps individuals start by accumulating wealth to provide for themselves in old age, then save for their children, and only finally save for egoistic reasons if and when they have accumulated an extraordinary amount. But this is pure speculation and other possibilities are equally plausible. Donors might instead aim to provide their children with some standard of living that is a function of their own, in which case the share of their saving that is altruistic would be invariant with wealth.

Similarly, it seems possible that altruism is correlated with transferring wealth as a gift, given that gifts should not be accidental¹³⁵ and donors are more likely to give during life than at death to heirs with lower earnings.¹³⁶ But again there are no studies directly on the issue. Moreover, other evidence suggests that gifts may stem less often from altruism than bequests. For example, gifts are far more prevalent among the wealthiest donors.¹³⁷ This may be because the wealthiest donors altruistically respond more to existing tax incentives to transfer wealth as a gift.¹³⁸ But it may also be because they may save more for egoistic reasons than altruistic reasons or life cycle savings needs,¹³⁹ in which case they would be indifferent between transferring wealth before or after death. Thus, even this potential proxy for wealth accumulation motives is unsupported to date.¹⁴⁰

In short, for the time being, we have a rough sense of what share of inheritances are attributable to different wealth accumulation motives in

¹³⁵ They may be if the donor saves for future potential personal consumption needs and then discovers new information about her mortality risk, for example that she has a terminal illness. See Wojciech Kopczuk, *Bequest and Tax Planning: Evidence from Estate Tax Returns*, 122(4) Q. J. ECON. 1801 (2007).

¹³⁶ See, e.g., Kathleen McGarry, *Inter Vivos Transfers and Intended Bequests*, 73 J. PUB. ECON. 321, 321-24 (1999); Joseph E. Altonji et al, *Is the Extended Family Altruistically Linked? Direct Tests Using Micro Data*, 82 AM. ECON. REV. 1178, 1188-94 (Dec., 1992).

¹³⁷ See, e.g., David Joulfaian and Kathleen McGarry, *Estate and Gift Tax Incentives and Inter Vivos Giving*, 57 NAT'L TAX J. 429, 436 tbl.3 (2004).

¹³⁸ See *infra* note 172 and accompanying text.

¹³⁹ *C.f.* Wojciech Kopczuk, *Bequest and Tax Planning: Evidence from Estate Tax Returns*, 122(4) Q. J. ECON. 1801 (2007).

¹⁴⁰ Another possibility is that transfers of property with annuitized characteristics, such as a remainder interest in a house, are a useful tag for altruistic transfers. Once again, there is no evidence on this issue. In addition, historically such transfers may have stemmed from a lack of financial products permitting donors to avoid such transfers, given the fact that reverse mortgages are a relatively recent innovation. See *Reverse Mortgages Provide More Seniors with a Safety Net*, L.A. TIMES, at K-1 (Feb. 24, 2008). I am grateful to David Schizer for this point.

aggregate, but no sense of which inheritances stem from which motive at the individual level. Future research on this issue would be a valuable contribution. But, until then, even the second best solution of calibrating wealth transfer taxes to “tags” correlated with the different motives remains unattainable.

Faced with such empirical uncertainty, it is tempting to throw up one’s hands and decide to ignore wealth transfers entirely. For the numerous reasons set forth above, this would be a mistake. When the empirical evidence relevant to structuring a tax or subsidy is unclear, the best solution is not to assume there are no empirical effects. Instead, it is to structure the tax or subsidy optimally based on the best evidence to date. Doing so minimizes the expected deadweight loss of the tax system given that the cost of a poorly calibrated tax or subsidy rises with the square of the error.¹⁴¹

For example, suppose that the optimal tax on wealth transfers is a subsidy of 100 percent for 70 percent of wealth transfers and a tax of 100 percent for 30 percent of wealth transfers, but the two types cannot be separated. If the tax system ignores all inheritances, the expected deadweight loss will be larger than if it applies a 40 percent subsidy to all.¹⁴² This is because ignoring wealth transfers would result in the tax system applying a tax rate that is more inaccurate in most cases and less inaccurate in a few cases. The greater deadweight loss associated with the former would exceed the smaller deadweight loss associated with the latter. In order to minimize the expected deadweight loss, the subsidy should be set at the probability-weighted average.

¹⁴¹ C.f. Lily L. Batchelder, Fred T. Goldberg, and Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 44-46 (2006) (making this argument in the context of uncorrected externalities). One caveat to this conclusion is that this assumes linearity of the relevant supply and demand curves. I am grateful to Louis Kaplow for this point. Another caveat is that it may be optimal to more heavily weight behavior that is relatively inelastic or a complement to leisure. *See id.* at 45; Emmanuel Saez, *The Optimal Treatment of Tax Expenditures*, 88 J. PUB. ECON. 2657, 2666-67 (2004). However, these considerations have been taken into account through the efficiency-motivated confiscatory tax on egoistic and accidental transfers, and the additional tax imposed to account for the correlation between inheritances and unobserved earnings ability.

¹⁴² In the former case, the deadweight loss would be 10,000 ($0.7*(-100^2)+0.3*(100^2)$). In the latter case it would be 8,400 ($0.7*(-60^2)+0.3*(140^2)$).

a. Form of Tax

Applying this theory to the evidence on wealth accumulation motives implies that the ideal form for taxing wealth transfers should be the probability-weighted average of the ideal tax treatment for each motive for accumulating wealth—which turns out to be a comprehensive inheritance tax. As Table 2 showed, the ideal form is an inclusion tax if transfers are compensatory, a negative comprehensive inheritance tax if transfers are altruistic, and generally an accessions tax if transfers stem from egoism or life cycle savings. Moreover, the literature on wealth accumulation motives, summarized in Table 3, suggests that actual inheritances stem from some mix of all four of these motives, and that the motive for a specific wealth transfer cannot be identified. As a result, the probability-weighted average is some type of comprehensive inheritance tax, regardless of the relative proportions of each motive in aggregate.

The existing evidence on these relative proportions permits us to draw some further conclusions. In particular, it should make a difference as a theoretical matter whether a wealth transfer tax is structured as a comprehensive inheritance tax, and both its accessions tax and inclusion tax elements should be significant.

Starting with the first claim, the form of a wealth transfer tax only matters if the ideal rate structure is not flat (otherwise, all of the types are identical). However, this is highly unlikely to be the case. One component of the probability-weighted ideal could be flat—the efficiency-motivated 100 percent tax on inheritances from egoistic and accidental transfers. But the other components should not be.

For example, a number of elements of the ideal wealth transfer tax should turn on the heir's economic status. These include the basic exemption, altruistic subsidy, and redistributive subsidy for altruistic transfers.¹⁴³ Meanwhile, several other components turn on the rate structure of the underlying tax, including the inclusion tax for compensatory

¹⁴³ The altruistic subsidy should not be flat because it should be welfare-weighted. A flat net altruistic subsidy would also require the benefit-offsetting tax to be flat. As discussed *supra* note 103, the benefit offsetting tax could only be flat if donors passed on the entire amount of the altruistic subsidy to heirs, and if inheritances were just as likely to flow up the economic distribution (to heirs who were more affluent than the donor) as downward. There is no evidence on the former question and the latter is contradicted by the existing empirical evidence. *See* Figure 4.

transfers, and the tax correcting for revenue externalities associated with altruistic transfers. While the literature on the shape of the optimal underlying tax is highly contested, no studies to date suggest that it should exhibit a flat rate structure.¹⁴⁴ Therefore, these components of the ideal wealth transfer tax should not be flat either. In addition, there is little reason to believe that the equity-motivated accession tax imposed on altruistic, egoistic and accidental transfers would be flat. The rationale for this tax is to address the correlation between inheritance size, on one hand, and utility and earnings endowment on the other. Accordingly, it should only be flat if the marginal disutility from working, the optimal underlying tax, and the correlation between inheritance and ability are all constant with inheritance size and earnings. None of these conditions seems likely to hold either.

Turning to the second claim, the ideal wealth transfer tax form should also contain substantial elements of both an accessions tax and an inclusion tax, thereby rendering it functionally distinct from both. Admittedly, the validity of this contention depends in part on definitions. Thus far, an accessions tax has been defined as a separate tax based solely on the amount the heir receives, while an inclusion tax has been defined as one that applies no separate tax but includes the inheritance in the heir's underlying tax base.¹⁴⁵ Under these definitions, it is true that only a small portion of the ideal tax would be an inclusion tax because direct inclusion is only warranted for compensatory transfers and addressing the revenue externalities associated with altruistic transfers, both somewhat minor phenomena.¹⁴⁶ Nevertheless, a substantial portion would not be an accessions tax under these definitions either. Instead, it would be a tax on the amount inherited that was linked to the heir's earned income.

¹⁴⁴ Early work by Mirrlees and others suggested that the optimal consumption tax has declining marginal rates, with all the revenue used to finance a basic cash grant that everyone receives (a "demogrant"). See, e.g., James A. Mirrlees, *An Exploration of the Theory of Optimal Income Taxation*, 38 REV. ECON. STUD. 175 (1971). More recent work, deriving optimal tax rates from labor elasticities, has suggested that the optimal income tax may have declining marginal rates between low and moderate levels of income, but rising marginal rates between moderate and high levels of income. See, e.g., Emmanuel Saez, *Using Elasticities to Derive Optimal Income Tax Rates*, 68 REV. ECON. STUD. 205, 223 (2001). Still other work has found that if labor supply decisions tend to be made at the extensive margin (whether to work or not), the optimal rate structure may also rise at lower levels of consumption, potentially starting with a negative marginal rate for those with the least earnings. See, e.g., Emmanuel Saez, *Optimal Income Transfer Programs: Intensive versus Extensive Labor Supply Responses*, Q. J. ECON. 1039, 1059-65 (Aug. 2002); Peter Diamond, *Income Taxation with Fixed Hours of Work*, 13 J. PUB. ECON. 101 (1980).

¹⁴⁵ See Table 1 and accompanying text.

¹⁴⁶ See *supra* notes 112 and 131, and Table 3.

Such a tax seems more similar to an inclusion tax than an accessions tax. While it is not directly linked to the tax rate of the heir, it is directly linked to his earned income. In this sense, it could be considered akin to an alternate income tax schedule for certain kinds of income, like the alternative minimum tax,¹⁴⁷ the rate schedule for long-term capital gains,¹⁴⁸ or the penalty rates that apply to early withdrawals from retirement savings vehicles.¹⁴⁹ If the reader agrees, then a substantial portion of the ideal tax should indeed be an inclusion tax, including the basic exemption, altruistic subsidy, and redistributive subsidy for altruistic transfers, and possibly the equity-related tax for altruistic, egoistic and accidental transfers. Meanwhile this final tax should also vary with inheritance size, so it is partially an accessions tax as well.

In short, given existing imperfect information, the ideal wealth transfer tax form should be a comprehensive inheritance tax where the tax base is the amount inherited and the tax rate rises with both the amount inherited and the heir's earned income. As a theoretical matter, this form should make a difference, and as illustrated below, it should make a difference empirically as well. Different forms of wealth transfer taxes impose fundamentally different burdens at an individual level in practice. This ideal comprehensive inheritance tax should therefore be essential for achieving the welfare-maximizing distribution of fiscal burdens more generally.

b. Level of Tax

In addition to its form, the other critical feature of a tax in achieving the welfare-maximizing distribution is its level. Indeed, one could argue that the level of a tax is more important. After all, it is possible that the ideal comprehensive inheritance tax would raise so little revenue that it matters little if that approach is adopted or wealth transfers are disregarded entirely.

This article cannot provide a precise estimate of the optimal level of wealth transfer taxation. The nominal level of the optimal underlying tax is a hotly-contested issue, and the ideal wealth transfer tax level is linked to this underlying rate structure. It also depends on some unexamined questions, such as how much well-being heirs gain from not having to work for their inherited consumption. Nevertheless, this article can offer some

¹⁴⁷ I.R.C. §§ 55-58 (2008).

¹⁴⁸ I.R.C. § 1(h) (2008).

¹⁴⁹ I.R.C. § 72(t) (2008).

preliminary thoughts on the sign and order of magnitude of the ideal tax, and whether current fiscal systems are close to or far from it.

The most important determinant of whether the ideal wealth transfer tax is positive or negative across the economic distribution is, once again, the prevalence of different wealth accumulation motives. In particular, two features—the tax of roughly 100 percent on egoistic and accidental transfers and the subsidy of up to about 100 percent for altruistic transfers—should determine the ideal level of tax for regular heirs to a large degree. As noted above, a very rough summary of the literature on wealth accumulation motives suggests that about 50 percent of wealth transfers are accidental, about 20 percent are altruistic, and the bulk of the remainder are egoistic. This implies that the probability-weighted ideal tax rate should start at something on the order of 60 percent, and rise with inheritance size and heir earned income as equity-motivated accessions tax rises and the altruistic subsidy rate declines.¹⁵⁰ It should top out at above something on the order of 80 percent because, for the most affluent heirs, the altruistic subsidy should effectively become zero.¹⁵¹

This very rough conclusion could certainly change in light of further empirical evidence, especially that altruistic or compensatory transfers are more prevalent. Nevertheless, so long as the existing evidence does not change dramatically, the analysis presented here implies that the ideal inheritance tax is positive and quite large. Further evidence could also change the shape of the ideal wealth transfer tax. But so long as wealth transfers exhibit some mix of donor motives and the underlying tax is not flat, it will always entail some inclusion and accessions elements. Thus, the superiority of a comprehensive inheritance tax to no tax on wealth transfers—or to an estate tax standing alone—seems robust to however the relevant empirical parameters are expanded or modified.

Having established this general picture of the ideal, the next section summarizes the structure, advantages, and disadvantages of existing wealth transfer taxes, focusing on the U.S. estate tax system. Doing so permits

¹⁵⁰ If these assumptions held, the deadweight loss would be 6,400 ($0.8*(40^2)+0.2*(160^2)$), as compared to 10,000 if wealth transfers are ignored ($0.2*(-100^2)+0.8*(100^2)$).

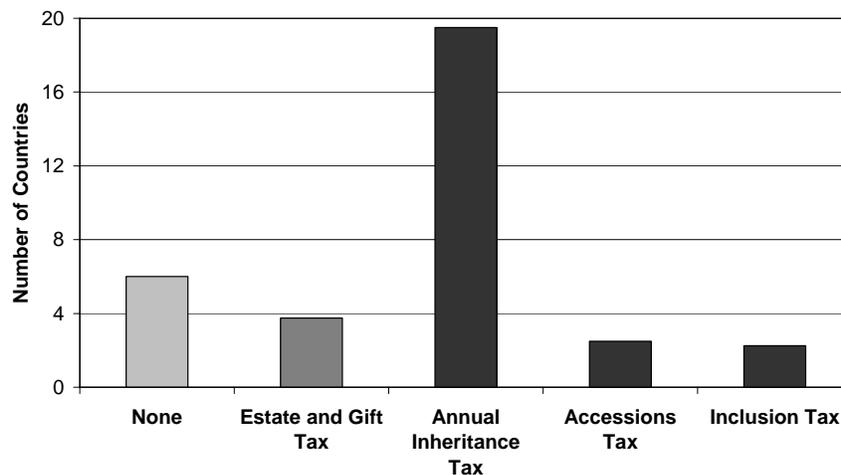
¹⁵¹ The top rate should be above 80 percent because altruistic transfers to extremely wealthy heirs should be subject to a positive tax with two components—a small inclusion tax to correct for revenue externalities, and an accessions tax to incorporate the information they provide about the heir's unobserved earnings ability.

Sections IV and V to turn to how these taxes might be improved in the real world, given its often strict administrative and political constraints.

III. WEALTH TRANSFER TAXATION

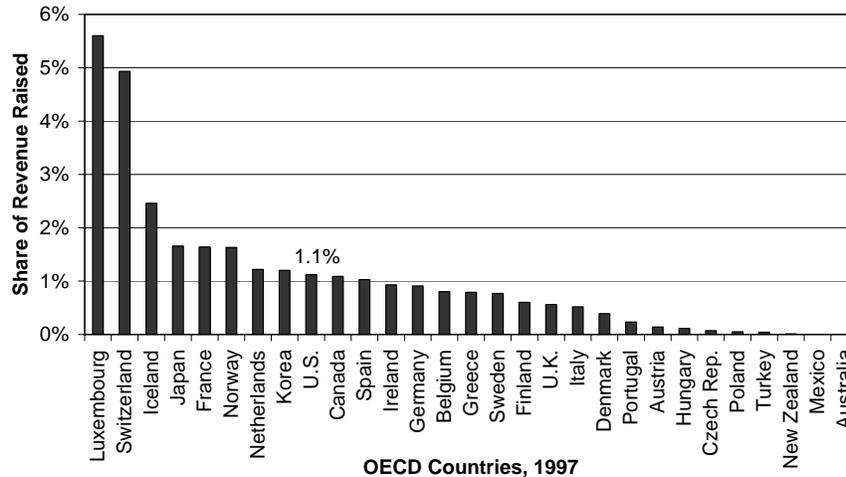
Presently no jurisdiction in the world imposes a wealth transfer tax on the order of 60 percent and none apply a comprehensive inheritance tax. Most developed countries do apply some wealth transfer tax but, as illustrated in Figure 5, the most common form is an annual inheritance tax. This is an accessions tax that does not aggregate inheritances over time, but rather applies a new rate schedule to inheritances received each year.

Figure 5: Form of Wealth Transfer Tax in OECD Countries¹⁵²



¹⁵² International Bureau of Fiscal Documentation, *Asia-Pacific Tax Surveys* (2006); International Bureau of Fiscal Documentation, *European Tax Surveys* (2006); Chris Edwards, Repealing the Federal Estate Tax (Cato Inst. Tax and Budget Bulletin No. 26, June, 2006), available at <http://www.cato.org/pubs/tbb/tbb-0606-36.pdf>; HUGH J. AULT AND BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* (2nd ed., 2004); Ministry of Finance and Economy, *Korean Taxation* (2007), available at http://english.mofe.go.kr/issues/laws/financial_list.php?sect=laws_tax. The countries included are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France Germany, Greece, Hungary, Iceland, Italy, Ireland, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, U.K. and U.S.

Figure 6: Share of Revenue Raised from Wealth Transfer Taxes and Recurrent Wealth Taxes in OECD Countries



In addition, Figure 6 shows that most OECD countries raise between 0.5 percent and 2 percent of revenues from wealth transfer taxes. Given that inheritances compose about 4 percent of household receipts this implies that inheritances are taxed a much lower rates than earned income, and nowhere near 60 percent.¹⁵³ Indeed, the U.S. effective tax rate on inheritances is about 4 percent, or one-quarter of the rate applied to earned income. Comparisons to existing tax rates are inherently suspect because there is little reason to believe that any country's existing tax system is close to the optimal tax. Nevertheless, these differences are striking.

A. The U.S. Estate Tax System

Focusing on the current U.S. federal tax treatment of wealth transfers, it has five elements, together referred to as the *U.S. estate tax system*. They are the estate tax, the gift tax, the generation-skipping transfer tax, the basic income tax treatment, and the income tax treatment of accrued gains.

The first element, the estate tax, was enacted in 1916 shortly after the income tax. As of 2008, it taxes lifetime gifts and bequests transferred in

¹⁵³ The average effective tax rate in OECD countries ranges from 20 to 50 percent. See OECD CENTRE FOR TAX POLICY AND ADMINISTRATION, REVENUE STATISTICS 1965-2006, at 39, Chart A (2007)

excess of \$2 million at a 45 percent rate.¹⁵⁴ Effectively, this means that a married couple can transfer \$4 million to their children or other beneficiaries over their lifetimes, and all of the transfers will be tax free. The \$2 million per donor exemption is scheduled to rise to \$3.5 million in 2009 before the estate tax disappears in 2010. As illustrated in Table 4, the estate tax is then reinstated in 2011 at its 2001 levels, with a \$1 million exemption and a top marginal tax rate of 55 percent.

Table 4: Scheduled Changes to the U.S. Estate Tax System¹⁵⁵

	Tax Rate		Exclusions			Basis Provisions
	Estate & GST	Gift	Annual Gifts	Lifetime Estate & GST	Lifetime Gifts	
2008	45%	41-45%	\$12,000	\$2 million	\$1 million	Gifts: Carryover Bequests: Stepped-up
2009	45%	41-45%	\$12,000	\$3.5 million		
2010	0%	35%	\$12,000	N/A		Carryover for both. Exemption for up to \$4.3M capital gains.
2011 onward	41-55%		\$12,000	\$1 million		

The second component of the U.S. estate tax system is the gift tax. It has been a stable fixture of the U.S. tax system since its enactment in 1932, and prevents donors from avoiding the estate tax by making transfers to their heirs during life. As of 2008, gifts exceeding \$1 million over the donor's lifetime are subject to a 41 percent tax rate, with the tax rate rising to 45 percent for the portion of gifts in excess of \$1.5 million.¹⁵⁶ In addition, each year a donor can disregard \$12,000 of gifts to a given heir (\$24,000 for a married couple), meaning that these gifts do not count toward the lifetime exemption.¹⁵⁷ Unlike the estate tax, the gift tax is scheduled to stay fairly constant in the coming years, although the top marginal rate is also scheduled to rise to 55 percent in 2011.

¹⁵⁴ IRC § 2010(c) (2008).

¹⁵⁵ The annual gift tax exclusion is inflation-adjusted so it may rise above \$12,000 after 2008. In 2011 and on, for estates between \$1 million and \$3 million, the marginal tax rate will rise from 41 to 55 percent. For estates exceeding \$3 million, the marginal tax rate will generally be 55 percent. However a surtax that eliminates the lower brackets technically will result in an effective marginal tax rate of 60 percent on taxable estates between \$10 million and \$17.184 million.

¹⁵⁶ IRC § 2012 (2008).

¹⁵⁷ IRC § 2503(b) (2008).

Third, there is the generation-skipping transfer (GST) tax. Congress enacted the GST tax in 1976 in response to concern that transfers directly to a donor's grandchildren were taxed only once under the estate and gift taxes, while transfers to a donor's grandchildren through her children were taxed twice. The GST tax imposes a second layer of tax on transfers to recipients who are two generations younger than the donor, and additional layers if the recipient's generation is further removed.¹⁵⁸ Its exemptions and rates mirror those of the estate tax.

Collectively, these three taxes are traditionally referred to as the U.S. wealth transfer taxes. As noted previously, under all three, a large portion of wealth transfers are tax exempt. Transfers to spouses and charities are not taxed.¹⁵⁹ Amounts paid during life for education, medical, or basic support expenses of heirs are similarly tax exempt.¹⁶⁰ 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, as explained in more detail below.

In addition to these three wealth transfer taxes, the final elements of the estate tax system are the basic income tax treatment of gifts and bequests, and the income tax treatment of accrued gains on wealth transfers. As discussed, donors do not receive an income tax deduction for wealth transfers (other than those to charitable organizations). However, recipients may exclude amounts inherited from taxable income.¹⁶¹ Accrued gains on assets gifted during life receive carryover basis while bequests receive stepped-up basis.¹⁶² Like the estate tax, stepped-up basis is scheduled to disappear in 2010 and then return in 2011. During the bizarre year of 2010, recipients of bequests are scheduled to receive a carryover basis, but the tax due on up to \$4.3 million in accrued gains on inherited property is scheduled to be forgiven.

At the state level, roughly half of states have a wealth transfer tax, and the vast majority of these apply an estate and gift tax. Seven, however, apply annual inheritance taxes.¹⁶³ Historically, the federal estate tax offered

¹⁵⁸ IRC § 2611 (2008).

¹⁵⁹ IRC §§ 2055, 2056 (2008).

¹⁶⁰ IRC § 2503(e) (2008).

¹⁶¹ IRC § 102(b) (2008).

¹⁶² IRC §§ 1014, 1015 (2008).

¹⁶³ 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. In all seven states, the tax only applies to bequests and a representative of the estate files the return. The seven states

a dollar-for-dollar credit for state wealth transfer taxes up to a limit, which effectively shared federal estate tax revenue with the states. This credit was repealed at the beginning of 2005 and replaced with a deduction for state wealth transfer taxes, although the credit is scheduled to reappear in 2011.¹⁶⁴ Because the deduction is worth less than the credit, a number of U.S. states have repealed their wealth transfer taxes or allowed them to lapse in recent years, although fewer have done so than anticipated.¹⁶⁵

B. Benefits and Drawbacks

The ongoing uncertainty about the future of the U.S. estate tax system creates large and costly tax planning incentives over the next several years, as well as morbid incentives on the eve of 2011. As a result, it is highly unlikely that the next President and Congress will allow current law to unfold as scheduled. The need for legislative action is unfortunate, but it does create a window of opportunity for reform. This opportunity should be grasped because, while the current system has a number of advantages, it also has a number of disadvantages that can and should be addressed.

with an inheritance tax are Indiana, Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania. CCH, FINANCIAL PLANNING TOOL KIT, NEBRASKA ESTATE TAXES (2006), available at http://www.finance.cch.com/pops/c50s15d170_NE.asp; COMPTROLLER OF MARYLAND, INHERITANCE TAX (2006), available at <http://individuals.marylandtaxes.com/estatetax/inherit.asp>; INDIANA DEPARTMENT OF REVENUE, INDIANA INHERITANCE TAX: GENERAL INSTRUCTIONS (Sept. 2001), available at <http://www.in.gov/dor/taxforms/pdfs/ih-6inst.pdf>; IOWA DEPARTMENT OF REVENUE, AN INTRODUCTION TO IOWA INHERITANCE TAX (2005), available at <http://www.state.ia.us/tax/educate/78517.html>; KENTUCKY REVENUE CABINET, A GUIDE TO KENTUCKY INHERITANCE AND ESTATE TAXES (2003), available at http://revenue.ky.gov/NR/rdonlyres/6D844DC9-B300-4EE7-963E-DB141FC0AED6/0/guide_2003.pdf; NEW JERSEY DIVISION OF TAXATION, TRANSFER INHERITANCE AND ESTATE TAX (2006), available at http://www.state.nj.us/treasury/taxation/pdf/other_forms/inheritance/itrbk.pdf; PENNSYLVANIA DEPARTMENT OF REVENUE, INSTRUCTION FOR FORM REV-1500: PENNSYLVANIA INHERITANCE TAX RETURN, RESIDENT DECEDENT (2006), available at <http://www.revenue.state.pa.us/revenue/lib/revenue/rev-1501.pdf>.

¹⁶⁴ IRC §2058 (2006); Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPPERDINE L. REV. 835, 840 (2006).

¹⁶⁵ 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 were tied to and contingent on the federal estate tax credit. Robert Yablon, *Defying Expectations: Assessing the Surprising Resilience of State Death Taxes*, 59 TAX LAWYER 241, 278 (Fall, 2005).

1. Better Measuring Ability to Pay in Aggregate

The principal advantage of the current estate tax system is its effect on the distribution of tax burdens at an aggregate level. Indeed, one could argue that its only flaw on this dimension is that it is not large enough. As illustrated in Figure 7, the average effective tax rate on inherited income in the U.S. will be about 4 percent in 2009. This stands in contrast to the average tax rate of 18 percent on income from work and saving (*earned income*) and the ideal posited above of a tax on the order of 60 percent.

Notwithstanding, its low effective rate, the estate tax does contribute importantly to the fairness of the tax system at an aggregate level. The solid lines in Figure 8 show the effective income tax rate on heirs in 2009 by earned income and economic income. Together, they illustrate that the income tax exclusion for inheritances results in heirs bearing a substantially smaller share of fiscal burdens than they would if all their income was counted. Overall, heirs' average tax rate falls from 20.4 percent to 19.1 percent as the focus shifts from earned income to economic income. Moreover, this calculation disregards the additional information that inheritances provide about an heir's ability and well-being. As argued above, if anything heirs should be treated as having more ability to shoulder fiscal burdens than individuals who earn the same amount.

Figure 7: Average Estate, Income and Payroll Tax Rate on Inheritances and Earned Income

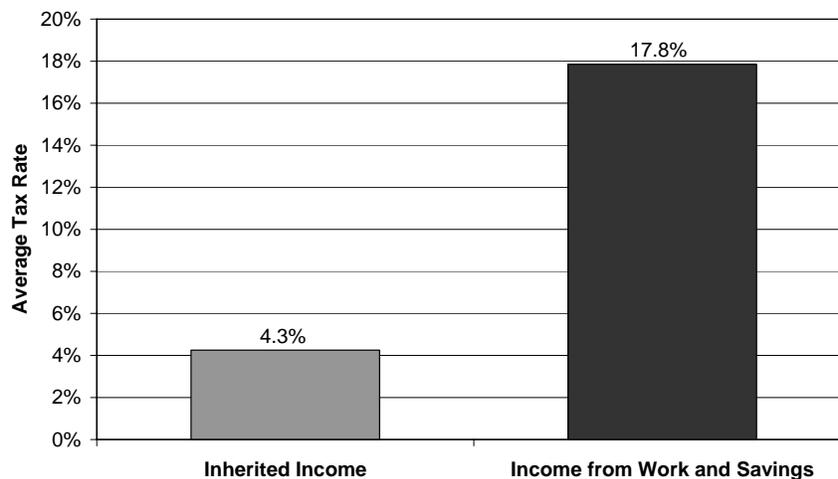
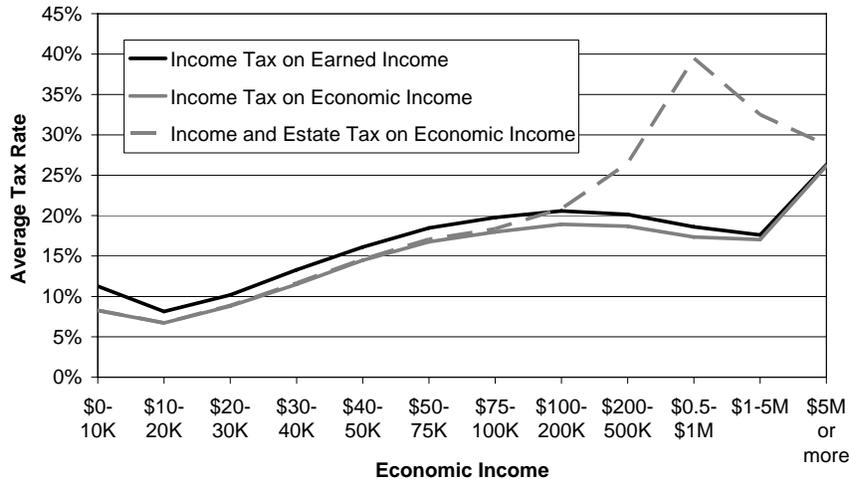


Figure 8: Average Tax Rate on Earned Income and Economic Income of 2009 Heirs



The estate tax steps in to partially correct these inequities. The dotted line represents the effective income *and* estate tax rate on heirs by economic income. It illustrates that when estate tax burdens are assigned to heirs, their combined fiscal burden rises substantially if they are very well-off—more than offsetting the benefit of the income tax exclusion for inheritances. For example, the average tax rate on heirs with economic income exceeding \$200,000 rises from 22 percent to 30 percent.¹⁶⁶ Meanwhile, the estate tax has essentially no effect on heirs with economic income below this amount. The estate tax, therefore, effectively reduces the extent to which heirs, as a group, are taxed at substantially lower rates than those who are self-made, given what we know about each group's endowment. This is the case because the estate tax's economic burdens fall predominantly on heirs, and because it is the only component of the federal tax system that directly takes inherited wealth into account.

¹⁶⁶ The actual rise may be even higher. This figure and those that follow assume that wealth transfer tax burdens are borne pro rata by heirs. This may not be the case if donors tend to leave specific bequests to some heirs and the residual to others. Then those receiving the residual bear the entire burden of the tax that is borne by heirs. It seems reasonable to suppose that donors tend to allocate a fixed dollar amount to heirs receiving small bequests, although I have not identified any studies on the issue. If this is the case, heirs receiving relatively small bequests would bear even smaller estate tax burdens, and those receiving relatively large bequests would bear larger burdens.

2. Inequities for Individual Heirs

While the estate tax does a good job of making the tax system more equitable at an aggregate level, it is intrinsically much less effective at doing so among individuals. Figures 9 and 10 illustrate this point. Figure 9 shows the number of heirs burdened by the estate tax by inheritance size, and Figure 10 shows the percentage of heirs inheriting different amounts that are burdened by the estate tax. Together, they illustrate that about 22 percent of heirs burdened by the estate tax have inherited less than \$500,000, while about 21 percent inheriting more than \$2,500,000 bear no estate tax burden. Further estimates in Appendix B illustrate that about half of heirs subject to the estate tax have economic income under \$200,000. While these heirs account for only 10 percent of estate tax revenue, the point nevertheless remains that many low-income and low-inheritance heirs are burdened by the estate tax, while many heirs who are much better off are not.

Figure 9: Number of Heirs Burdened by 2009 Estate Tax by Inheritance Size

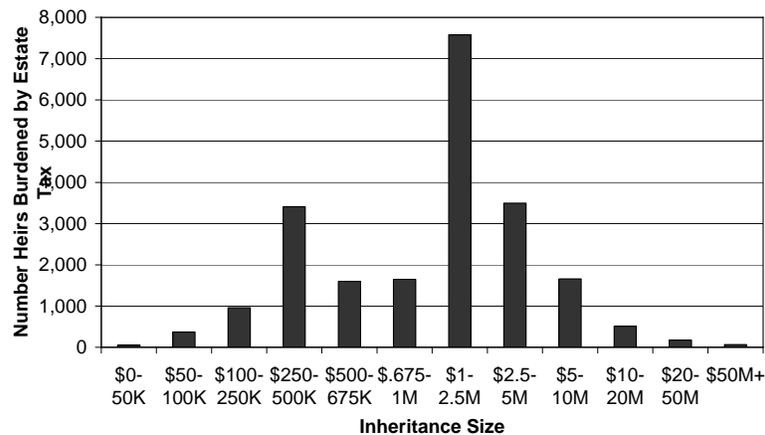
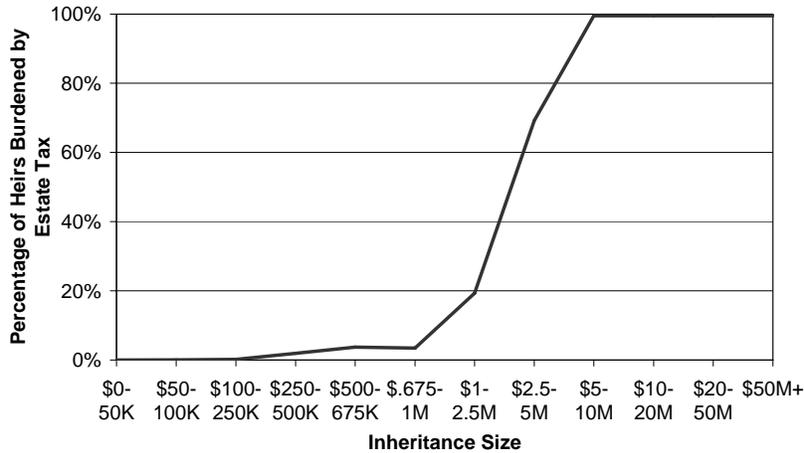


Figure 10: Percentage of Heirs Burdened by 2009 Estate Tax by Inheritance Size



The source of these individual-level inequities is the fact that the estate tax applies to the amount transferred rather than the amount received. Surprisingly, estate size is not a very good proxy for inheritance size. Figure 11 illustrates this point by plotting the inheritance of each heir relative to the size of the estate from which he inherited. The correlation is only 0.66.¹⁶⁷ This divergence does not appear to be driven by parents treating children differently. Most wealth transfers are made to children and split evenly between them. Instead, it appears to be driven by the fact that donors have different numbers of children, and a substantial share have none. For example, Figure 12 shows that about 30 percent of inheritances come from donors with no children,¹⁶⁸ and the plurality of these donors give to five or more beneficiaries. The net result of these varied giving patterns is that the estate tax system provides a “rough justice” approach to distributing tax burdens according to a comprehensive measure of income. But it systematically misallocates fiscal burdens amongst individuals.

¹⁶⁷ The correlation remains surprisingly low at 0.83 if the data are weighted by inheritance size in order to focus on bequests with more revenue potential.

¹⁶⁸ This percentage can be calculated from the accompanying data in Table 6 in Appendix B.

Figure 11: Inheritance Size versus Donor’s Taxable Estate Size¹⁶⁹

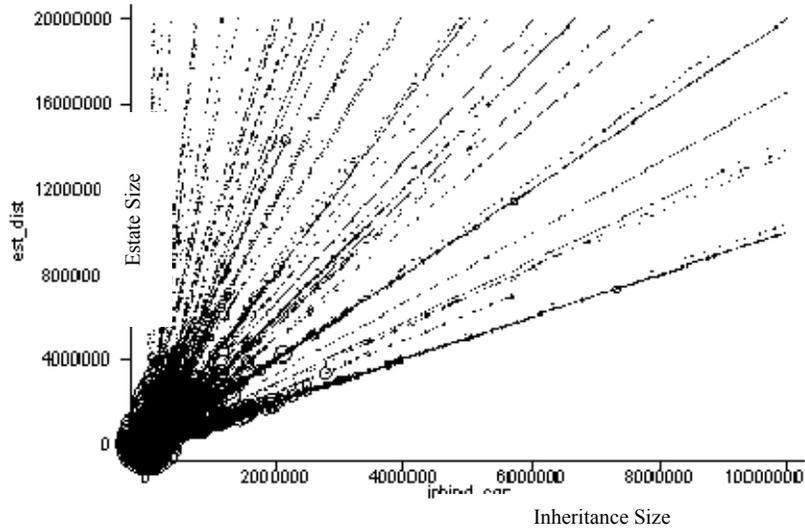
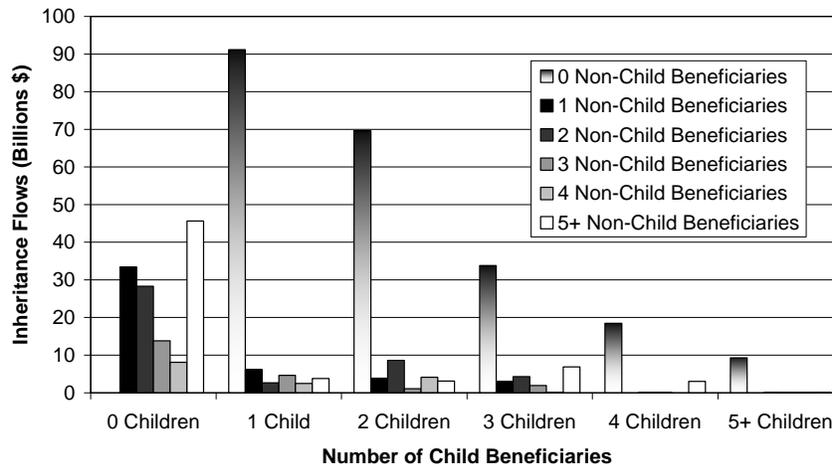


Figure 12: Inheritance Flows by Number of Estate’s Child and Non-Child Beneficiaries



¹⁶⁹ To improve readability, current inheritance amounts over \$10 million and distributable estates larger than \$20 million are excluded. The donor’s taxable estate is the donor’s gross estate before taxes but after other expenses and spousal and charitable transfers. The diagonal lines in the scatterplot are the result of our imputation strategy described in Appendix A.

3. *Unnecessary Complexity*

In addition to creating inequities at the individual level, the current estate tax system involves a fair amount of unnecessary complexity. There is little evidence to suggest that the estate tax (or any wealth transfer tax) is systematically more complex than the income tax at comparably high income levels.¹⁷⁰ Nevertheless, it is worth considering whether complexity can be reduced as part of any reform effort. There are five principal sources with the current estate tax system.

First, spouses presently face an incentive to each transfer an amount equal to the lifetime exemption to their heirs in order minimize to their joint tax liability. This incentive arises because any unused exemption does not carry over from one spouse to the other. For those who take advantage of this incentive, complexities arise. For example, if a surviving spouse may need access to some of the transferred assets, tax advisors typically advise couples to create a credit shelter trust. This permits the first-to-die to treat assets as going to their heirs even though the surviving spouse still has some ongoing control.¹⁷¹

Second, gifts are generally taxed much more lightly than bequests under current law. This is the case 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, the current estate tax rate on a pre-tax transfer is 45 percent, while the top gift tax rate on the same transfer is effectively 31 percent.¹⁷² Gifts are also tax preferred because only the nominal value of gifts counts toward the lifetime exemption. This means that a donor can avoid paying tax on the asset's appreciation between the time of transfer and her death through gifts.

To confuse matters further, a third source of complexity is the fact that, while gifts are generally taxed more lightly than bequests, this is not always the case. Presently, the lifetime exemption under the estate tax is larger than under the gift tax. In addition, when transferred property is appreciated, bequests may be taxed more lightly because any tax due on the

¹⁷⁰ William G. Gale & Joel Slemrod. *Overview*, in *RETHINKING ESTATE AND GIFT TAXATION I*, __ (William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., 2001).

¹⁷¹ PAUL R. MCDANIEL, JAMES R. REPETTI, AND PAUL R. CARON, *FEDERAL WEALTH TRANSFER TAXATION* 617-77 (5th ed., 2003).

¹⁷² 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.

accrued gains is forgiven for bequests through stepped-up basis, but only deferred in the case of gifts.¹⁷³

Fourth, current law creates substantial incentives to transfer wealth in the form of closely-held businesses.¹⁷⁴ For example, certain business assets can be valued at less than their normal market value.¹⁷⁵ There is also a special deduction for certain qualified family-owned business interests, which sunset in 2004 but is scheduled to return in 2011.¹⁷⁶ In addition, payment of any estate taxes attributable to a closely-held business can also be deferred for five years and then spread over ten more years at a below-market interest rate.¹⁷⁷ While ostensibly intended to protect family businesses from forced sales, these provisions tend to subsidize closely-held businesses, thereby creating incentives to invest in such assets purely for tax reasons.

Finally, a substantial portion of the complexity of our current system arises from the fact that wealth transfer taxes are imposed at the time of transfer, not when inheritances are received. While this feature does not necessarily create opportunities to undervalue transferred assets overall, it does create opportunities to allocate an unreasonably large proportion of the amount transferred to tax-exempt beneficiaries or beneficiaries taxed at low rates. In response to such tax planning historically, an enormously complicated body of rules has developed over time. For example, the rules governing grantor trusts, charitable trusts, spousal trusts, generation-skipping trusts, and Crummey trusts¹⁷⁸ 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 subject to lower or zero tax rate.

4. Lack of Transparency

Finally, the current estate tax system has substantial disadvantages from the perspective of political transparency. The fact that the estate and

¹⁷³ IRC §§ 1014, 1015 (2008).

¹⁷⁴ The IRS Commissioner may also permit deferral of wealth transfer tax liabilities at her discretion. IRC § 6161 (2008).

¹⁷⁵ IRC § 2032A (2008).

¹⁷⁶ IRC § 2057 (2008).

¹⁷⁷ IRC § 6166 (2008). The interest rate is 2 percent on the tax attributable to roughly the first \$1 million of transferred and 45 percent of the federal tax underpayment rate thereafter. IRC §§ 6601(j), 6166 (2008).

¹⁷⁸ *E.g.*, IRC §§ 676, 664, 666, 678 (2008).

gift taxes focus by design on the donor tends to lead the public to believe that their economic burdens also fall on donors in practice. In addition, because all other major sources of income are subject to the income tax, many erroneously believe that heirs are taxed on their inherited income under the income tax as well.

These understandable misconceptions have been exploited by advocates of estate tax repeal who have framed the estate tax as a double tax on the frugal, hard-working, generous donor who is confronted by the taxman at the moment of death.¹⁷⁹ This portrayal is far from accurate. As explained, the estate tax in fact predominantly burdens heirs. It is also generally the only tax that applies to extraordinarily large inheritances.¹⁸⁰

Nevertheless, the public could probably better understand the estate tax system's effects if its form more transparently embodied its function. Doing so would enable the public to make a more informed decision about how much heirs should have to share their inheritances with society relative to those who personally earn their wealth.

IV. A BETTER WAY

The U.S. estate system clearly stands far from the ideal outlined in Section II. Its rates turn on the amount transferred rather than the amount received or the heir's earned income. They are also far below the level that existing empirical evidence suggests would be welfare-maximizing. In addition, while the estate tax contributes critically to the fairness of the tax system in aggregate, it creates a variety of inequities at an individual level. It entails a fair amount of unnecessary complexity. And it may distort public decision-making. Many of these disadvantages are understandable given administrative and political constraints. Nevertheless, there is a better way.

A number of commentators have proposed replacing the estate tax with an accessions or inclusion tax.¹⁸¹ By contrast, the remainder of the

¹⁷⁹ See, e.g., MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 82 (2005).

¹⁸⁰ The income tax may also burden inheritances to the extent that donors reduce wealth that is ultimately transferred in response to the income tax.

¹⁸¹ See, e.g., Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469 (2007); David G. Duff, *Taxing Inherited Wealth: A Philosophical Argument*, CANADIAN J. LAW & JURISPRUDENCE 3 (1993); Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967); HENRY C.

article proposes to replace it with a comprehensive inheritance tax, which has never been proposed.¹⁸² For the reasons explained above, this type of inheritance tax should be more equitable and efficient than a pure accessions or inclusion tax. More importantly, the specific tax proposed would build on the strengths of the current system, while addressing its weaknesses, wherever possible.

A. Ideal Taxation with Administrative and Political Constraints

Section II argued that the ideal wealth transfer tax given existing imperfect information is a tax on the amount inherited with a rate that starts on the order of 60 percent and rises with the amount inherited and the heir's other income. The real world, however, involves not just imperfect information but also administrative and political constraints. In order to develop a viable proposal, it is therefore necessary to take these restrictions into account.

Administratively, there are several limits on any wealth transfer tax. First, it must include a significant annual exemption. The fact that transfers to spouses and support expenses for minor children are not counted as wealth transfers addresses this issue to a large extent. Nevertheless, an annual exemption is necessary even for adult children and other relatives to prevent individuals from having to keep track of ordinary gifts, such as those for holidays, birthdays, and weddings.

In addition, there are reasons to doubt whether the ideal altruistic subsidy would be administrable. One issue is the possibility of gaming. For example, two friends might each "give" each other the same \$100 back and forth 1,000 times in order to generate \$100,000 worth of subsidies. Theoretically, this strategy could be prevented by disregarding reciprocal

SIMONS, PERSONAL INCOME TAXATION 125, 130 (1938); Franklin D. Roosevelt, *Message to the Congress on Tax Revision (June 19, 1935)*, in PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT VOL. 4 (1916). See also Maya MacGuineas and Ian Davidoff, *Tax Inheritance, Not "Death"*, WASH. POST, (July 4, 2006); Gary Becker, *Should the Estate Tax Go?*, BECKER-POSNER BLOG (May 15, 2005), available at www.becker-posner-blog.com/archives/2005/05/should_the_esta.html.

¹⁸² Some commentators have favorably alluded to the possibility. See, e.g., Gary Becker, *Should the Estate Tax Go?*, BECKER-POSNER BLOG (May 15, 2005), available at www.becker-posner-blog.com/archives/2005/05/should_the_esta.html; Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income Inclusion System and Abandoning the GST*, 56 SMU L. Rev. 551.(2003).

gifts altogether because it is not clear whether they are altruistically-motivated. But administratively, it might be difficult to do so, especially more than two parties are involved. If so, the ideal subsidy should be smaller across the board.¹⁸³ Another issue is whether the perfect benefit-offsetting tax could ever be implemented as a practical matter. If it cannot, the ideal subsidy may be even smaller.¹⁸⁴

Thus, once administrative constraints are taken into account, the probability-weighted ideal wealth transfer tax becomes a comprehensive inheritance tax with an annual exemption for small inheritances, but even higher rates for larger ones.

Accounting for political constraints modifies the ideal tax even more dramatically. As summarized at the outset, this paper assumes multiple political constraints. It assumes that any reform proposal must raise the same amount of revenue as the 2009 estate tax, and devote the same amount to charitable subsidies. This appears to be the most likely political compromise if the estate tax is not replaced.¹⁸⁵ It also assumes that there must be very large annual and lifetime exemptions. Such exemptions appear to be necessary for maintaining wealth transfer taxes given the emotional reaction they generate.¹⁸⁶ In addition, the paper assumes that any inclusion

¹⁸³ In the extreme, if the altruistic subsidy is based on gross and not net transfers and there are enough circular transfers, the subsidy could become infinite.

¹⁸⁴ Theoretically, it is not clear whether the optimal subsidy should then be smaller or larger if the benefit-offsetting tax is not implemented; the answer depends on whether the actual financing structure is more or less distortionary than the benefit-offsetting tax. However, if all taxes entail administrative and compliance costs, then it should generally be smaller. See Batchelder et al, *supra* note 141, at 44-46.

¹⁸⁵ The conclusion is based on conversations with various individuals involved in the estate tax debate, as well as the fact that it is the proposal advanced by Senators Obama and Clinton. Senator McCain has proposed a 15 percent tax rate and a \$5 million exemption (\$10 per couple). Meg Massey, *The Estate Tax: McCain v. Obama*, CNNMONEY.COM (Aug. 6, 2008); Patrick Healy, *New Program for Savings Is Proposed by Clinton*, N.Y. TIMES (Oct. 10, 2007).

¹⁸⁶ This reaction may stem in part from the value many place on privacy within the family. It may also stem from the historic function inheritances served as form of social insurance, and the social valuable role that parental support of children continues to serve.

As Mumford argues, the state may be sending conflicting messages when it taxes wealth transfers. On the one hand, the state appears to expect parents to support their children and extended family members to their own detriment. On the other hand, taxing ordinary wealth transfers sends a signal they are frowned upon. Ann Mumford, *Inheritance in Sociopolitical Context: The Case for Reviving the Sociological Discourse of Inheritance Tax Law*, 34 J. OF LAW & SOCIETY 569, 583 (Dec., 2007). While it is certainly a controversial proposition that modern parents raise children to their own detriment, limited

tax aspect of the tax should be maximized and that the top marginal rate applied to inherited wealth cannot exceed 50 percent—both because it is a highly point for opposition to taxes and because it is, roughly speaking, the top rate applied to earned income.¹⁸⁷ Doing so should further undercut political opposition to wealth transfer taxes by making it appear that inheritances are not being taxed in any unusual way. Finally, the paper assumes that accrued gains on inherited wealth generally cannot be taxed at the same point in time as the inheritance (though, perhaps, later),¹⁸⁸ and that any proposal must eliminate the possibility that an heir would ever need to sell an inherited family business to pay the associated tax liability, given the politically explosive debate about family businesses and farms.

Notably, this paper does not adopt the assumption embodied in some important prior work that constitutional, administrative, or political constraints prevent the U.S. from taxing capital income at socially-desirable rates through the individual and corporate income taxes,¹⁸⁹ or a periodic

evidence from life satisfaction surveys and declining fertility rates suggests that this could be the case. *See, e.g.*, Daniel Gilbert, *Does Fatherhood Make You Happy?*, TIME MAGAZINE (June 19, 2006); Rafael Di Tella et al, *The Macroeconomics of Happiness*, 85 REV. ECON. & STATISTICS 809, 812-13, tbls.3-5 (2003); Alan Krueger and Daniel Kahneman, *Developments in the Measurement of Subjective Well-Being*, 20 J. ECON. PERSP. 3, 13, tbl.2 (Winter, 2006).

A third potential explanation for the emotional reaction many have against wealth transfer taxes, however, is that it is ephemeral—the result of effective lobbying and framing of an issue, which otherwise would not be very publicly salient. *See generally* MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126-29 (2005).

¹⁸⁷ For example, if a married couple has \$360,000 of ordinary capital income and the husband decides to work, his marginal federal tax rate will initially be 50.2 percent (15.3 percent payroll tax plus 37.8 percent income tax on his earnings excluding the employer share of the payroll tax due to the personal exemption phase-out). *See* I.R.C. § 151 (2008); Rev. Proc. 2007-66.

As another example, if an individual invests his labor earnings in stocks or bonds that distribute dividends or interest over time, the effective top marginal tax rate he could face on those distributions is between 45 and 58 percent. *See* I.R.C. § 1 (2008).

¹⁸⁸ This assumption is based in part of the Canadian experience where many view wealth transfer tax repeal as a reaction to the enactment of realization at death. *See, e.g.*, Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 OSGOODE HALL L. J. 133, 133 (1978), *citing* E. BENSON, SUMMARY OF 1971 TAX REFORM LEGISLATION 31 (Ottawa, Dept. of Finance, 1971); David Duff, *The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia and New Zealand*, 3 PITTSBURGH TAX REV. 72, 99-107 (2005). It is also based on the fact that repeal of stepped-up basis is often considered as the principal alternative to the estate tax in the U.S. context.

¹⁸⁹ Income taxes have a notoriously difficult time taxing capital income due to a combination of political and administrative constraints. *See, e.g.*, Henry J. Aaron, Leonard

wealth tax, thereby leaving wealth transfer taxes as the third best option.¹⁹⁰ This choice was made in part to avoid the debate about whether an income or consumption tax is superior,¹⁹¹ and in part because first or second best options appear to be constitutional, administrable and potentially politically feasible.¹⁹² It was also made because the implications of this assumption have been well addressed by others.¹⁹³

These assumptions obviously limit the reform options considerably. They imply that the ideal approach should be a comprehensive inheritance tax that rises with inheritance size and the heir's earned income and is expected to raise the same amount of revenue as 2009 law. It should have large annual and lifetime exemptions, and fully include inheritances in income thereafter, with a rate that tops out around 50 percent. Finally, it should not treat transferring wealth as a realization event, and it should not entail forced sales of illiquid assets. With these numerous constraints in mind, we turn to the specific proposal next.

E. Burman, and C. Eugene Steuerle, *Introduction*, in *TAXING CAPITAL INCOME* i, xxii-xxvi (Henry J. Aaron et al, eds., 2007); LEONARD E. BURMAN, *THE LABYRINTH OF CAPITAL GAINS TAX POLICY: A GUIDE FOR THE PERPLEXED* 137-38 (1999).

¹⁹⁰ See, e.g., Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 *YALE L. J.* 259 (1983); William D. Andrews, *The Accessions Tax Proposal*, 22 *TAX L. REV.* 589 (1967).

¹⁹¹ Such an argument for wealth transfer taxes is based on the assumption that an income tax or hybrid income-consumption tax is optimal.

¹⁹² For example, at least four countries (France, Norway, Spain, Switzerland) currently apply a periodic wealth tax, and many others have in the recent past (e.g., Finland, Iceland, Luxembourg, Sweden). See INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *EUROPEAN TAX SURVEYS* (2008). At least five countries (Australia, Canada, Estonia, Ireland, and the U.K.) tax accrued gains on gifts or bequests at the time of transfer. See Appendix C. In addition, capital income could be taxed at higher effective rates through such strategies as raising income tax rates on capital gains, dividends and interest, repealing business tax expenditures, ending deferral for foreign source income of U.S. residents, and more far-reaching business income tax reform. See, e.g., Harry Grubert and Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in *FUNDAMENTAL TAX REFORM: ISSUE, CHOICES, AND IMPLICATIONS* (John W. Diamond and George R. Zodrow, eds., forthcoming); Edward D. Kleinbard, *Rehabilitating the Business Income Tax*, BROOKINGS INST. HAMILTON PROJECT DISCUSSION PAPER 2007-09 (June, 2009); Stephen E. Shay, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (June 22, 2006), available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5061>.

¹⁹³ See, e.g., Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 *YALE L. J.* 259 (1983); William D. Andrews, *The Accessions Tax Proposal*, 22 *TAX L. REV.* 589 (1967).

B. The Comprehensive Inheritance Tax

1. Overview

The inheritance tax system proposed here represents a fundamental shift in the approach to taxing wealth transfers. There would no longer be a wealth transfer tax system that operates independently of the income tax, and the focal point of taxation would no longer be the amount transferred. Instead, wealth transfers would be subject to a comprehensive inheritance tax that would be integrated into the income tax, and the focus would be the amount received. To address the political constraints described above, the proposal includes inheritances above a large lifetime exemption of \$1.9 million in income and subjects them to a 15 percent surtax that is roughly equivalent to the payroll tax, capital gains, and dividend rates. It is designed to raise approximately the same amount of revenue as the 2009 estate tax by varying the lifetime exemption level.

The specific features of the proposal are as follows. First, if a taxpayer inherits more than \$1.9 million over the course of his lifetime, he would be required to include amounts inherited above this threshold in his taxable income under the income tax. The portion above this \$1.9 million threshold would also be subject to a 15 percent surtax.¹⁹⁴ To state the obvious, \$1.9 million is a lot of money. An individual who inherits \$1.9 million at age twenty-one can live off his inheritance for the rest of his life without him or his spouse ever working, and his annual household income will still be higher than that of nine out of ten American families.¹⁹⁵ Thus, the proposal would effectively exempt all transfers that are conceivably made to take care of a low-ability family member by providing an exemption that permits them to live quite well, without ever working.

If the political constraint limiting the amount of revenue raised is relaxed in light of mounting projected budget deficits, a lower exemption

¹⁹⁴ While the top marginal tax rate of 50 percents exceeds that imposed on the vast majority of earned income due to the regressivity of the payroll tax, it is theoretically possible that an individual's earned income can be subject to this marginal tax rate if he has a large amount of ordinary capital income. *See supra* note 187.

¹⁹⁵ Author's calculations based on a 7 percent inflation-adjusted interest rate and U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, 1968 TO 2006 ANNUAL SOCIAL AND ECONOMIC SUPPLEMENTS, TABLE A-3. SELECTED MEASURES OF HOUSEHOLD INCOME DISPERSION, *available at* www.census.gov/hhes/www/income/histinc/p60no231_tablea3.pdf. \$1.9 million would produce inflation-adjusted annual income of about \$125,000 to age 97.

would be preferable. Table 5 lists the lifetime exemption that would be revenue-neutral against alternative baselines. For example, a lifetime exemption of \$1 million would raise \$29 million—66% more than 2009 law. This amount would also permit purchase of a lifetime annuity providing annual income well above median household.¹⁹⁶

Table 5: Estimated Revenue Effects in 2009 of Estate Tax System and Proposal under Alternate Revenue Baselines*

Estate Tax			Bush Income Tax Cuts	Revenue-Neutral Inheritance Tax		Revenue (billions)
Law	Exemption (millions)	Rate		Exemption (millions)	Surtax	
<i>2009</i>	<i>\$3.5</i>	<i>45%</i>	<i>Yes</i>	<i>\$1.9</i>	<i>15%</i>	<i>\$17.5</i>
2009	\$3.5	45%	Yes	\$1.6	10%	\$17.5
2008	\$2.0	45%	Yes	\$1.1	15%	\$26.2
2008	\$2.0	45%	Yes	\$1.0	10%	\$26.2
2011	\$1.0	41-55%**	No	\$0.5	15%	\$50.2
2011	\$1.0	41-55%**	No	\$0.4	10%	\$50.2
2011	\$1.0	41-55%**	Some***	\$0.5	15%	\$50.2
-	-	-	Yes	\$1.0	15%	\$29.0

* Proposal in bold and italics. **Phase-out of lower brackets disregarded.

*** Tax cuts to top two income tax brackets eliminated.

Under the proposal, bequests that are included in income could be spread out over the current year and the previous four years in order to smooth out the income spike and corresponding tax burden, while minimizing work disincentives. Losses would be disregarded in calculating the tax rate on inherited income in order to limit tax planning incentives.¹⁹⁷ In addition, each year \$12,000 in gifts and \$60,000 in bequests could be disregarded entirely, meaning that they would not count toward the \$1.9 million exemption. This would effectively lower the current annual exclusion for couples (because it applies on a per donor basis), while

¹⁹⁶ Author's calculations based on identical assumes as *supra* note 195. \$1 million would produce inflation-adjusted annual income of about \$66,000 to age 97. In 2007, median household income was \$55,200 and median household income was \$67,600. U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, 1968 TO 2006 ANNUAL SOCIAL AND ECONOMIC SUPPLEMENTS, TABLE H-6. REGIONS--ALL RACES BY MEDIAN AND MEAN INCOME, available at <http://www.census.gov/hhes/www/income/histinc/h06AR.html>.

¹⁹⁷ Otherwise, heirs who knew when they were likely to receive a bequest would face incentives to generate losses, for example from closely-held businesses, in the years running up to receiving the inheritance.

maintaining some continuity with current law. It would also eliminate reporting obligations on more than two-thirds of the individuals who actually receive a bequest.¹⁹⁸ In order to further limit reporting obligations for wedding gifts and the like, a taxpayer would not have to count gifts received from a given donor over the course of the year that totaled less than \$2,000 towards the annual exclusion, even if the annual sum of such gifts from multiple donors exceeded \$12,000. All of these thresholds and the amount of prior inheritances would be adjusted for inflation. The following example illustrates how the proposal would work for a regular heir.

Example 1: Regular Beneficiary

Facts: Heir A receives a bequest of \$3 million above the \$60,000 annual exemption and has not received inheritances exceeding the annual exemptions in any prior year.

Tax Treatment: Heir A would only have to include \$1.1 million of the bequest in his taxable income. The \$1.1 million would be taxed under the same rate structure as his other ordinary income plus 15 percentage points. Because the income tax brackets rise with income, this might mean that the taxable portion of his bequest would fall within a higher tax bracket than his earned income because he received it all at once. To limit this effect, the taxpayer could also elect to file as if he received only \$220,000 of taxable inheritance in the current year and the previous four years.

From an administrative perspective, the heir would be responsible for filing an annual return reporting cumulative gifts and bequests exceeding the annual exemptions. Because third-party reporting is essential for maximizing compliance, donors or their estates would also have to report information on transfers above these annual exemptions and remit a withholding tax. The heir would be responsible for claiming any excess tax withheld and for paying any excess tax due if his lifetime reportable inheritances exceeded \$1.9 million.

Despite the fundamental change to the form of wealth transfer taxation, the proposal would continue to rely on much of the extensive body of laws, regulations and guidance that have been developed under the U.S. estate tax system. For example, the existing rules governing when a transfer has occurred, how it is valued, and what transfers are taxable would remain

¹⁹⁸ See Figure 1.

unchanged. In addition, the proposal would not tax a large portion of wealth transfers, as under current law. Transfers from spouses and for basic support expenses for minor children would continue to be disregarded entirely. The income tax treatment of donors would remain unaltered as well. To the extent that the current tax treatment of accrued gains, generation-skipping transfers, illiquid assets, charitable contributions, and gifts made during life for education and medical expenses are considered desirable or politically necessary, these exemptions could be maintained. These issues, however, are considered in the next section.

Moving to a comprehensive inheritance tax would also permit a different and simpler method for taxing split or contingent transfers, for example through trusts. As explained above, such contingent transfers are the source of some of the greatest complexity in current law. Rather than following the current approach, the proposal would apply the approach developed by Andrews¹⁹⁹ and wait to see who gets what before taxing transfers for which the taxable status of the beneficiary is unclear. In the meantime, it would impose a withholding tax. When an heir eventually received his inheritance, he would receive a refund if the amount withheld on his share of the funds was more in present-value terms than the tax he actually owed (using an interest rate equal to the rate of return earned on the transferred assets). Essentially, this approach is economically equivalent to the tax system having perfect foresight regarding which potential beneficiaries will receive what. Example 2 illustrates how it would work.

Example 2: Contingent Beneficiary

Facts: Donor B transfers \$10 million to a trust and the trustee has discretion to determine the ultimate beneficiary. Ten years pass, the trust assets double, and the trustee distributes all the trust assets to Heir C.

Tax Treatment: At the time of the transfer, a withholding tax would be imposed on the amount above a single beneficiary's lifetime exclusion, or \$8.1 million, and at the highest possible rate of 50 percent. Thus, the amount withheld would be \$4.05 million, the effective withholding tax rate would be 40.5 percent, and the trust assets after the withholding tax would be \$5.95 million.

¹⁹⁹ William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967); William D. Andrews, *Reporter's Study of the Accessions Tax Proposal*, in American Law Institute, FEDERAL ESTATE AND GIFT TAXATION, RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE AND REPORTERS' STUDIES 446 (1969).

After ten years, the trust assets have doubled to \$11.9 million. Heir C would calculate a credit ratio equal to the amount of tax withheld (\$4.05 million) divided by the trust value after the withholding tax (\$5.95 million), or 68 percent. He would then receive a refundable credit equal to the amount distributed (\$11.9 million) times the credit ratio (68 percent), or \$8.1 million. The refundable credit would be considered part of his inheritance, bringing his taxable inheritance on distribution to \$20 million. He would then pay tax on his taxable inheritance with the exemption amount equal to the exemption in place at the time of transfer, but indexed to the rate of return on the funds.

Suppose his effective tax rate on inheritances with this exemption is 30 percent. Then he would initially owe \$6 million in taxes. However, after claiming the credit, he would receive a net refund of \$2.1 million (the \$8.1 million refundable credit minus the \$6 million initially owed in taxes). His after-tax inheritance would be the amount distributed (\$11.9 million) plus the refund (\$2.1 million), or \$14 million. In present value terms, this is the same amount he would have received if Donor B had transferred the original \$10 million to him directly, instead of through a discretionary trust, if his income tax and the surtax rates have remained unchanged.

Finally, the proposal would tax transfers to grandchildren (and more distant lineal descendants) as if the amount inherited had first passed first to their parents (and any additional skipped generations) and only then to the actual heirs. In practice, this would be accomplished by applying an implicit tax to the skipped heir at the top tax rate, unless the recipient presented evidence of what the skipped heir would have owed if the funds had actually passed to them initially.²⁰⁰ This treatment should apply regardless of whether the transfer is made directly or through a trust. The rationale for retaining a tax on generation-skipping transfers is explained below.

Table 6 summarizes the main differences between the proposal and current law.

²⁰⁰ For example, a grandchild might show that his parent died before the transfer by the grandparent and had not received any other substantial inheritances. In this case, the grandchild would also have to agree with his siblings, if any, how their parent's lifetime exemption was going to be allocated amongst them. For further details on implementing a generation-skipping transfer tax within an inheritance tax adopting the wait-and-see approach, see Halbach, *An Accessions Tax*, 23 REAL PROP. PROBATE & TRUST J. 211 240-48 (1988).

Table 6: Comparison of 2009 Law and Proposal

	2009 Law	Proposal
Tax on bequests	45% to extent lifetime gifts and bequests made exceed \$3.5 million.	Income tax rate plus 15 percentage points to extent lifetime gifts and bequests received exceed \$1.9 million.
Tax on gifts	45% to extent lifetime gifts made exceed \$1 million.	
Annual exclusion	\$12,000 of gifts made per recipient.	\$12,000 of gifts received. \$60,000 of bequests received.
Transfers where tax rate of beneficiary unclear	Rules governing grantor trusts, marital trusts, charitable trusts, and Crummey trusts.	Wait and see.

2. *Advantages*

Shifting from the current system to the proposed inheritance tax would have a number of advantages. It would more fairly allocate economic burdens among heirs. It would improve the incentives faced by donors and heirs, and likely reduce the level of tax complexity to some degree. Finally, by more transparently taxing heirs, it could strengthen political support for taxing inheritances in the first place. Over time, the wealth transfer tax system might then move closer to the unconstrained ideal.

a. More Equitable

The most important benefit of the proposal is that it would enhance social welfare by more accurately measuring ability to pay. By directly including large inheritances in the tax base, it captures the information about endowment that large inheritances provide both directly and indirectly. As a result, it generates a more equitable allocation of fiscal burdens and benefits. As explained above, the estate tax does a good job of performing this function within the federal tax system as a whole. But the proposal would do a much better job.

In aggregate, the distributional effects of the proposal are fairly similar to the estate tax system. As illustrated by Figures 13 and 14, the proposal is somewhat more progressive by economic income and inheritance size, but the differences are not dramatic. Heirs with economic income of less than \$500,000 or inheritances below \$2.5 million bear higher average tax rates under the estate tax. Meanwhile, those with economic income or inheritances exceeding these amounts bear higher burdens under the proposal.

In reality, the proposal would probably be even more progressive than the current system because these estimates assume no behavioral response. To the extent that donors respond to the incentives created by the proposal to give more widely and to those with less pre-inheritance income, pre-tax inheritances should become more progressive if the proposal were adopted. However, as explained below, there is little, if any, evidence on which to base an estimate of this response.

Figure 13: Average Tax Rate on All Inheritances by Heir Economic Income

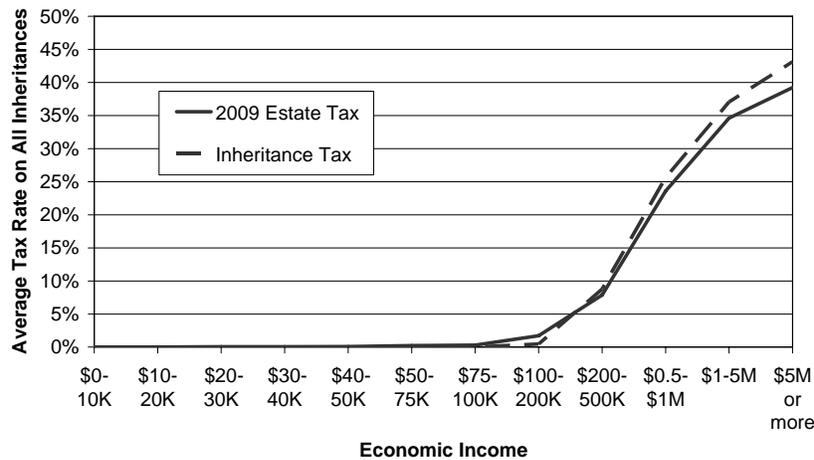
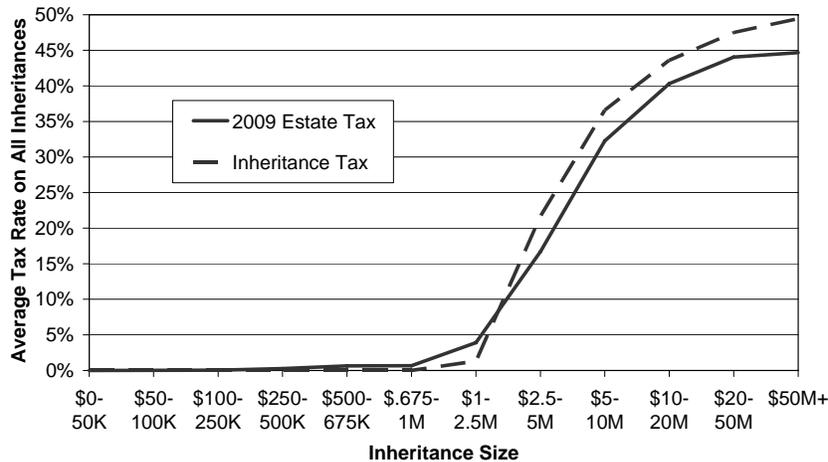


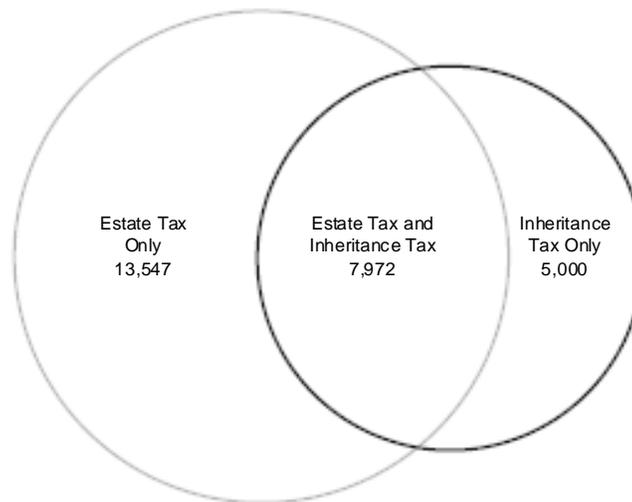
Figure 14: Average Tax Rate on All Inheritances by Inheritance Size



While the two approaches have fairly similar distributional effects in aggregate, however, the proposal would allocate burdens much more fairly

at an individual level.²⁰¹ For example, Figure 15 shows that, among all of the heirs who would be burdened by either tax in 2009, only 30 percent would be burdened by both. Indeed, a full 63 percent of heirs who are burdened by the estate tax would bear no tax burden whatsoever under the proposal, implying that about two-thirds of those burdened by the estate tax have inherited less than \$1.9 million. Meanwhile, another large group—one-quarter of the number burdened by the estate tax—would only be burdened by the proposal, implying that they have inherited more than \$1.9 million but bear no estate tax burden.

Figure 15: Number of Heirs Burdened by 2009 Estate Tax and Proposal



The essential reason why these differences arise is that not all large inheritances come from the largest estates, and not all smaller inheritances come from smaller ones, as illustrated in Figure 11 and explained by Figure 12. For example, consider two taxable estates of \$9 million where the donors have not made any prior gifts. Both would be subject to an average estate tax rate of 28 percent. However, one estate could be left entirely to a single heir who is in the top income tax bracket and who has received \$1 million in prior inheritances, while the other could be left pro rata to six heirs with no prior inheritances. In the former case, the inheritance tax rate would be 45 percent, but in the latter it would be zero.

²⁰¹ Interestingly, these individual-level differences between the estate tax and the proposal would not be narrowed if the estate tax were revised so that the donor could claim exemptions for the number of children she had in addition to an exemption for herself. See Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (manuscript, 2007).

Taking the opposite perspective as an alternative, suppose two heirs both have economic income of \$1.2 million if one-fifth of bequests are included when measuring economic income. One might have earned \$200,000 in income and inherited \$5 million from an estate worth \$5 million. The other might have the same amount of earned income and inheritance, but have inherited from an estate worth \$30 million. Both would bear the same inheritance tax burden of 31 percent. But the former's estate tax rate would be 14 percent, while the latter's would be 40 percent.

In aggregate, if there were roughly the same amount of heirs of both types, the estate and inheritance tax rates would be quite similar. But at an individual level, their tax rates would vary dramatically.

The differences between the estate tax system and the proposal can be understood still further by considering the effects on heirs who would be burdened by both taxes. These heirs account for the lion's share of revenue raised under either tax (about 90 percent). However, many would be subject to a very different tax rate under the proposal. As a result, 30 percent of the burden of the new tax in dollar terms would fall on different heirs.

This variance in tax burdens can be seen in Figure 16, which focuses on those heirs who would be burdened by either tax (*i.e.*, in one of the circles in Figure 15) and plots the average tax rate under the estate tax and proposal that each heir would face.²⁰² Along the y-axis are heirs who are burdened only the inheritance tax. Along the x-axis are heirs who are burdened only by the estate tax. In between are heirs burdened by both. On average, the estate tax rate rises with the inheritance tax rate, and vice versa. However, Figure 16 illustrates that the 30 percent of individual heirs who are burdened by both tax systems often face dramatically different rates under one system versus the other. Indeed, the correlation²⁰³ in Figure 16 is only 0.71 (or 0.33 when it isn't weighted by inheritance size),²⁰⁴ which is

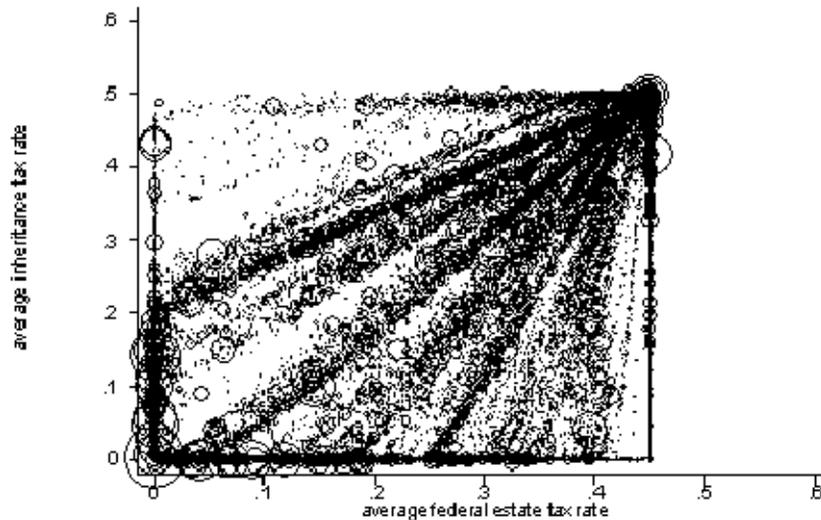
²⁰² Each point represents an heir and each circle represents multiple heirs. Every point in between the two axes represents the 30 percent of burdened heirs who are subject to both taxes. The correlation statistic for Figure 16 is 0.71. If the figure is not weighted by inheritance size, the correlation statistic is 0.33.

²⁰³ Correlation is a measure of the tendency of two variables to increase or decrease together.

²⁰⁴ It is more appropriate to weight the figure by inheritance size if one is interested in how many inherited dollars, versus people, are taxed at different rates. In addition, weighting by inheritance size may be more appropriate if donors tend to allocate a fixed dollar amount to heirs receiving small bequests (with the remainder going to their more important heirs) or if donors respond to the incentives created by an inheritance tax to give more to more people.

quite low. The square (the R^2) suggests that only 50 percent of the inheritance tax rate of individual heirs is directly accounted for by factors which determine the heir's estate tax rate, and vice versa.²⁰⁵

Figure 16: Average Tax Rate on Inheritance of Individual Heirs under Estate Tax and Proposal (Weighted by Inheritance Size)



Finally, the individual-level differences between the two systems can be understood by considering the winners and losers from the proposal. Overall, our estimates suggest that there would be more than twice as many heirs who are winners (18,000) as there are losers (8,000) each year. The vast majority of winners would be individuals inheriting less than \$2.5 million. Moreover, as illustrated by Figures 17 and 18, the amounts gained and lost would be substantial. Heirs who inherit more than \$50 million would owe about \$5.3 million more in taxes on average. Similarly, those with economic income of more than \$5 million who lose under the proposal would pay about \$2.2 million more on average. On the other hand, heirs with economic income in the current year of less than \$200,000 on average would save \$62,000—more than a third of their income. While very few in this group are burdened by the current estate tax system, this group represents about 95 percent of heirs.

In former case, heirs receiving relatively small bequests bear no tax burden under the estate tax or the proposed inheritance tax. In the later case, heirs receiving relatively small bequests benefit rather than being burdened by the inheritance tax. Either way, they should be weighted less heavily than heirs receiving relatively large inheritances.

²⁰⁵ The figure is 11 percent if the variables are not weighted by inheritance size.

These substantial distributional differences in the burdens of the estate tax and the proposal essentially quantify the proposal's advantages from a fairness perspective. Each time the proposal applies a higher or lower tax rate to an heir, it is more accurately measuring economic income and, in doing so, more equitably allocating fiscal burdens and benefits.

Figure 17: Average Change in After-Tax Income of Winners and Losers by Economic Income

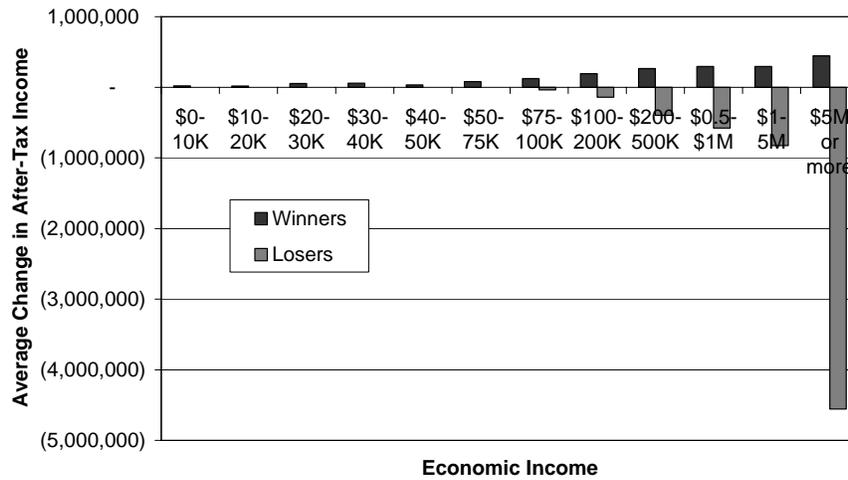
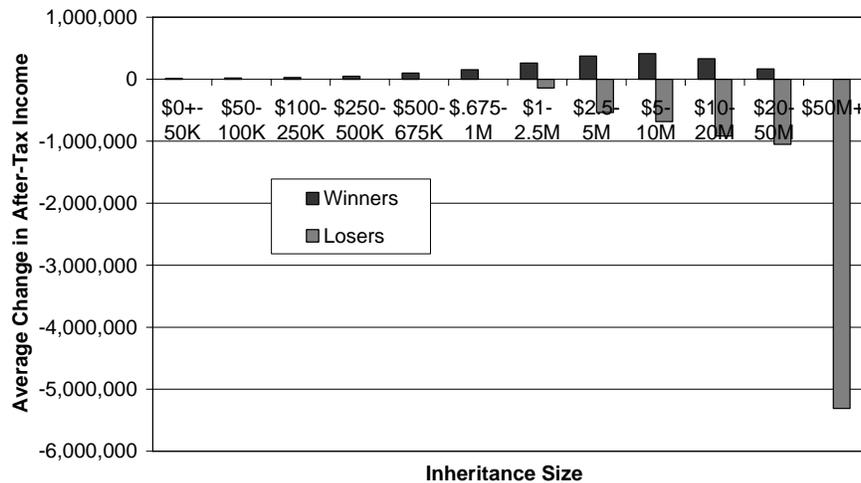


Figure 18: Average Change in After-Tax Income of Winners and Losers by Inheritance Size



b. Better Incentives

In addition to allocating fiscal benefits and burdens among heirs subject to tax more fairly, the proposal could result in a fairer allocation of pre-tax income by creating a more equitable and efficient pattern of incentives for donors and heirs. On the one hand, its substantial exemption would protect and encourage all of the familial economic support that an individual could conceivably need. On the other hand, by gradually taxing inherited wealth in excess of this amount, it would encourage extremely wealthy donors to share further wealth transfers with individuals who otherwise would not be so fortunate. It would also encourage their existing heirs to use their talents to earn additional wealth instead of relying on further familial largess. Neither an estate tax, nor a tax system that ignores wealth transfers, can create this pattern of incentives.

How much donors would actually respond to these changed incentives is uncertain—there are essentially no studies regarding the price elasticity of how wealth transfers are distributed among non-spousal, non-lineal heirs. Some donors do seem willing to adjust gifts for their children's income, but doing so is much less common for bequests,²⁰⁶ which comprise the lion's share of wealth transfers. Instead, the norm for bequests is equal sharing among children, presumably because donors are concerned about sibling tensions or hurt feelings that they cannot discuss after their death. There is also some evidence that donors are willing to transfer more to grandchildren and other lineal descendants when they face financial incentives to do so. For example, donors frequently use up the generation-skipping tax exemption.²⁰⁷ However, the proposal would only create incentives to give to non-lineal relatives and non-relatives, and donor responsiveness on this margin may differ systematically. Finally, there is limited evidence that wealth transfers are distributed more broadly in countries with an inheritance tax than in the U.S.²⁰⁸ But this may stem from the fact that these other countries tend to have lower levels of economic

²⁰⁶ See, e.g., Kathleen McGarry, *Inter Vivos Transfers and Intended Bequests*, 73 J. PUB. ECON. 321, 321-24 (1999).

²⁰⁷ See, e.g., Robert H. Sitkoff and Max M. Schanzenbach, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465 (2006); Robert H. Sitkoff and Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L. J. 356, 359 (2005).

²⁰⁸ See John Laitner and Henry Ohlsson, *Bequest Motives: A Comparison of Sweden and the United States*, 79 J. PUB. ECON. 205, 212-19 (2001)

inequality more generally. As a result, inheritances should be distributed more evenly throughout their economies, even if received only by children.

In short, there is no empirical basis for estimating how much donors would respond to the proposal's incentives to give more broadly. This is why such a behavioral response is not included in the revenue and distributional estimates of the proposal. Nevertheless, given the general human tendency to respond to financial incentives, donors should respond by distributing inheritances more widely, if only slightly. To the extent they do, pre-tax inheritances would be distributed more equally, and the fairness advantages of the proposal would grow.

c. Less Complex

The third subtle but important advantage of the proposal is its potential for simplification. In general, there are 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 burdens—which are typically more costly—by creating incentives to structure transactions in ways that are economically identical but taxed more lightly.

The proposal could slightly increase direct compliance costs because more tax units will have to file returns, especially on an informational basis. There would be about twice as many taxable returns under the proposal. While this is a substantial increase in percentage terms, both taxes only burden a tiny fraction of the population. About 5 in 1,000 heirs bear some estate tax burden annually, and about 3 in 1,000 would bear any inheritance tax burden.²⁰⁹ The more important source of new filing burdens would be the requirement that heirs and donors report (but not pay tax on) gifts and bequests falling above the annual exclusions. As noted, however, more than two-thirds of heirs receive bequests smaller than the \$60,000 exemption.²¹⁰ Those who receive a bequest over \$60,000 would simply have to report its receipt.

Turning to the more costly indirect types of compliance burdens, the proposal should reduce compliance costs on net. Admittedly part of the

²⁰⁹ See Table A15 in Appendix B.

²¹⁰ See *supra* note 198 and accompanying text.

way it would do so is by reducing tax planning incentives that could be addressed just as well within the current system but have not been to date.

For example, the example would eliminate the need for careful planning of spousal transfers in order to maximize use of the lifetime exemptions. This complexity could be addressed under current law by permitting spouses to carryover the lifetime exemption. However, under the proposal, even carryovers would be unnecessary. Any tax would be based on the amount the heir receives, regardless of whether it was from the mother or father. As a result, it would not matter which spouse transfers what.

In addition, the proposal would significantly narrow the current substantial differences in how gifts and bequests are taxed. Unlike the current estate tax system, the same lifetime exemption would apply, the tax rate would apply to the pre-tax inheritance, and all accrued gains on appreciated property would eventually be taxed. Indexing the lifetime exemptions to inflation would also reduce the incentive to transfer (or appear to transfer) wealth earlier in time, when the present value of the exemption is higher. Again, these problems could be addressed within current law. However, in some cases, the solution would be less intuitive and thus might more difficult to achieve politically. For instance, in order to apply the same tax rate to gifts and bequests in an estate tax system, gifts have to be grossed up by the tax due when applying the tax rate. In an inheritance tax system, where the tax is paid by the heir, this is unnecessary

In other respects, however, the proposal would reduce tax planning incentives in important ways that an estate tax system never could. In particular, by waiting to see how much is received by whom, it would reduce the incentive to try to shift value to tax-exempt spouses and charities when the ultimate beneficiary is unclear. This wait-and-see approach would create more valuation points, which could potentially create further opportunities for valuation games if not dealt with correctly. But any new planning costs should be swamped by the fact that the wait-and-see approach eliminates the need for a wide swath of existing valuation rules. These include the rules governing marital trusts, charitable trusts, grantor trusts, and Crummey trusts, which together compose one-fourth of a leading casebook.²¹¹ An estate tax can't accomplish this simplification because it can't adopt the wait-and-see approach. Because its tax rate is based on the

²¹¹ PAUL R. MCDANIEL, JAMES R. REPETTI, AND PAUL R. CARON, FEDERAL WEALTH TRANSFER TAXATION (5th ed., 2003).

amount transferred, and not on the amount received, it has to be levied at the time of transfer.

Finally, the administrative costs for the government that typically accompany compliance costs should decline in response to the proposal. At first blush, one might think that the proposal 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 has been successfully implemented at the state or federal level in the United States or in other countries as illustrated in Appendix C. Indeed, the United States had an inheritance tax during parts of the late nineteenth and early twentieth centuries²¹² and seven U.S. states and twenty-three countries currently impose some kind of inheritance tax.

Thus, overall, the proposal should decrease compliance burdens by reducing a number of necessary and unnecessary sources of complexity within an estate tax system. Together, these planning opportunities likely impose much greater compliance burdens than any new filing obligations. Furthermore, this reduction should be mirrored at the governmental level. With fewer rules to enforce and fewer tax planning strategies to address, administrative costs should also decline.

d. More Politically Transparent

The final benefit of the proposal is that it would render the tax system more politically transparent. This transparency may be valued in its own right—a government whose workings are more transparent should have more democratic legitimacy. If one agrees that the current level of wealth transfer taxation is too low, it may also be valued instrumentally.

Few voters currently understand how wealth transfers are taxed, and with what effects.²¹³ This is probably due in part to low levels of knowledge

²¹² *Id.* at 3-4.

²¹³ *See, e.g.*, MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126-29 (2005).

about the tax system in general.²¹⁴ But it also likely due to the fact that the form of our wealth transfer tax system disguises its effects.

By taxing the donor on her estate, the estate tax system appears to burden the person giving, a person who may have earned all of her wealth and just died. It appears to tax generosity and success. The proposal, by contrast, places the statutory burden of the tax on the recipients of large windfalls, who generally only received the inheritance because of their lucky birth. It appears to tax affluence and advantage. In short, its form more clearly embodies its function.

One may object that form should have little impact because wealth transfer tax rates differ little cross-nationally and most other countries have an inheritance tax. However, the form of these inheritance taxes is also important—only a few countries include gifts in taxable income and none include bequests.²¹⁵ As a result, the fact that large inheritances are exempt from the income tax remains largely hidden. Thus, the final advantage of the proposal is that it could expose this exclusion and, in the process, potentially reinvigorate public support for taxing inheritances in the first place.

3. *Potential Questions and Concerns*

Despite these advantages, the proposal is likely to generate a number of questions and concerns because it represents such a fundamental change to our current system. This sub-section considers six.

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

One common initial reaction to the idea of replacing the estate with 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 above, heirs bear most of the burden of wealth transfer taxes, not donors. In addition, the view taken in this paper is that wealth transfer tax rates should turn on the amount inherited, both for efficiency

²¹⁴ *Id.* at 122.

²¹⁵ *See* Appendix C.

reasons and because of their direct and indirect effects on heir well-being and earning potential. In this view, it is eminently fair for gifts and bequests by donors with larger families and the same net worth to bear lower tax burdens.

For example, if one child has nine siblings and they each inherit \$1 million from their parents, that child is substantially less well-off than a child who has no siblings and inherits \$10 million from his parents. Not only has he received less financially, but he is also likely to have received less time and attention from his parents, and thus less human and social capital. Indeed, studies have found that individuals with few siblings earn, on average, 50 percent more than individuals with many.²¹⁶

b. 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. Often, the tax rate rises 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 stems from the general social approval accorded to giving to one's loved ones, and concern that otherwise an inheritance tax would create incentives to give to strangers.

²¹⁶ Anders Bjorklund and Markus Jantti, *The Impact of the Number of Siblings on Men's Adult Earnings:*

Evidence from Finland, Sweden and the United States 9, 11, tbl.2 (Sept., 1998), available at, <http://www.ciln.mcmaster.ca/papers/cc98/fiseus.pdf>. The Bjorklund and Jantti study finds that individuals with zero to two siblings on average have 50 percent higher earnings than those with seven or more siblings when controlling for age and age squared. Once other controls are introduced, the effect is about half as small. However, arguably the uncontrolled statistic is more instructive because the controls include things like parental education, for which taxes generally cannot be adjusted politically. For further studies on the subject, see Sandra E. Black et al, *The More the Merrier? The Effect of Family Size and Birth Order on Children's Education*, 120:2 Q. J. ECON. 660, 695-96 (May, 2005); DALTON CONLEY, *THE PECKING ORDER* (2004).

While this concern is 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 financial capacity and not let the most advantaged off the hook at the expense of regular people who don't receive large inheritances.

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. 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.

c. Why Include a Generation-Skipping Transfer Tax?

While existing inheritance taxes typically tax transfers to relatives more lightly, the U.S. estate tax system does the reverse and taxes one type of familial wealth transfer more heavily: those from grandparents to grandchildren. This raises a third (and opposite) question: why not tax inheritances from closer relatives more heavily? After all, doing so should break up hereditary class structures more quickly, and should account for the fact that inheritances received from close relatives probably provide better indirect information about the heir's endowment than those received from distant relatives and strangers.²¹⁷

The proposal does not adopt this approach because it seems too politically ambitious given the reverse norm in most jurisdictions with an inheritance tax. Nevertheless, it does follow the U.S. practice of taxing transfers from grandparents to grandchildren more heavily through a generation-skipping transfer (GST) tax.

As explained above, a GST tax effectively imposes two layers of tax on a transfer from a grandparent to a grandchild, treating the transfer as if it passed through the parent (and more layers of tax if it skips more

²¹⁷ See, e.g., Jere R. Behrman and Paul Taubman, *Is Schooling Mostly "In the Genes"? Nature-Nurture Decomposition Using Data on Relatives*, 97:6 J. POL. ECON. 1425, 1430, tbl.1 (1989) (finding that intergenerational earnings correlations decline as the genetic and non-genetic relationship between two individuals becomes more attenuated).

generations). One could argue that a GST tax is unfair as a theoretical matter. But, on balance, it seems necessary to limit tax planning costs, as the associated inequities and inefficiencies that they generate.

Starting with equity concerns, a GST tax is only ideal within the normative framework of the paper if a parent receives as much welfare from a generation-skipping transfer as if she had received the inheritance herself. If she would have received more welfare by being able to spend the funds on market consumption, the transfer should be subject to less than two layers of tax. And if she receives no welfare from a generation-skipping transfer, it should be subject to only one.

Unfortunately, this is once again an area in which there is little or no evidence so we must rely on proxies. In general, about 40 percent of all wealth is inherited.²¹⁸ This implies that about 40 percent is passed on from generation to generation. However, the wealthiest heirs appear to save and pass on a much larger share of their inherited wealth.²¹⁹ As a result, it is reasonable to suppose that parents inheriting extraordinarily large amounts (and thus subject to tax under the proposal) tend to pass on more than 50 percent of their inheritances to their children. If this is the case, they must, on average, value their children receiving the full inheritance at more than 50 percent of its value.²²⁰

Given this admittedly shaky evidence, one option would be to impose something between one and two levels of tax on generation-skipping transfers. However, this is where tax planning concerns come into play. Generation-skipping transfers appear to be particularly responsive to tax incentives, and a relatively simple planning device.²²¹ For example, if a

²¹⁸ James B Davies & Anthony F. Shorrocks, *The Distribution of Wealth*, in HANDBOOK OF INCOME DISTRIBUTION (Anthony B. Atkinson and Francois Bourguignon, eds.) (2001); Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207, note 2 (2007).

²¹⁹ See David Joulfaian *Inheritance and Saving* 12-13 (Nat'l Bur. of Econ. Research Working Paper No. 12569) (Oct. 2006).

²²⁰ This is case because if they tend to give up 50 percent of the market consumption value of their inheritances to their children, they must value their children receiving half the amount they inherit as its full value.

²²¹ Specifically, Sitkoff and Schazzenbach have found that an increasing number of donors established perpetual trusts funded up to the GST exemption once states began repealing the rule against perpetuities in order to attract such trust assets. See Robert H. Sitkoff and Max M. Schanzenbach, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465 (2006); Robert H. Sitkoff and Max M. Schanzenbach,

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, absent a GST tax, the child would only be taxed on the amount she actually withdrew, not the entire bequest, and more would be left after-tax for the grandchild.

Given the availability of such strategies, failing to impose a full GST tax may therefore induce a large increase in generation-skipping trusts. The winners would be donors and their heirs who would reduce their tax burden—and of course tax attorneys. The losers would be the fisc, and donors and heirs who were not savvy enough to employ such tax planning strategies. Such a result is neither equitable nor efficient. Thus, while imposing a GST tax is not ideal in a world of perfect information, on balance, it seems to be the best approach.

d. How Would the Proposal Impact Charitable Giving?

A fourth potential area of concern is how the proposal would impact charitable giving. Each year, Americans give about \$200 billion to charity,²²² and roughly 8 percent of this giving occurs through charitable bequests.²²³ The estate tax is an important driver of charitable giving. It tends to increase charitable giving (both during life and at death) by decreasing the price of charitable transfers relative to the price of transfers to taxable heirs. Moreover, most studies suggest that net charitable transfers would fall if the estate tax were repealed even though donors would be wealthier.²²⁴ Thus, this substitution effect appears to dominate the income effect.

Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 YALE L. J. 356, 359 (2005).

²²² Jon M. Bakija and William G. Gale, *Effects of Estate Tax Reform on Charitable Giving* 1 (Urban-Brookings Tax Policy Center Tax Policy Issues and Options #6, July, 2003).

²²³ *Id.* Presently about 11 percent of the value of estates filing estate tax returns is distributed to charitable organizations. Internal Revenue Service, Statistics of Income Division, *Estate Tax Returns Filed in 2005 with Total Gross Estate Greater Than \$1.5 Million* (Nov., 2005), available at www.irs.gov/pub/irs-soi/05es01fym.xls.

²²⁴ Most studies estimate that eliminating the estate tax would reduce charitable contributions, but the estimates vary from 0 percent to 37 percent. See Robert McClelland, *Charitable Bequests and the Repeal of the Estate Tax* (Congressional Budget Office

Because the proposal is revenue-neutral, it generally should not change the level of charitable giving. Indeed, in some respects, it would expand incentives for charitable transfers. For example, transfers to all nonprofits would be exempt under the proposal because the tax is imposed on the recipient, not the donor. This differs from the estate tax under which transfers to many nonprofits, such as 501(c)(4)s, are ineligible for the unlimited deduction.

In other ways, however, the proposal could weaken incentives for charitable giving. Under the estate tax, donors can avoid taxation only by giving to charity (and for certain other uses). Under the proposal, they could also do so by giving to individuals who have not reached the lifetime exemption—for example, siblings or good friends. As discussed above, there is no empirical basis for estimating how much donors would respond to this new incentives, but a reasonable guess is that they would slightly.

Even if donors do give more broadly amongst individuals in response to the proposal, however, charitable donations should not decrease substantially. Presumably a portion of this giving would come from existing charitable contributions and a portion from transfers to taxable beneficiaries. To the extent that it came from transfers to taxable heirs, the lifetime exemption would have to be lowered in order to maintain revenue-neutrality. This, in turn, should result in even broader giving amongst individuals (which is, itself, charity in some sense). More importantly for those concerned about charitable organizations, it should drive charitable giving back up to close to its present level. In short, the effects of the proposal on charitable giving should be minor, and even more so when compared to the substantial negative effects on charitable giving that would result from wealth transfer taxes being reduced or repealed.

e. How Would the Proposal Impact State Revenues?

Technical Paper 2004-8, July, 2004), available at <http://www.cbo.gov/ftpdocs/56xx/doc5625/2004-8.pdf>; McClelland 2004; Bakija and Gale, *supra* note 222; Pamela Greene and Robert McClelland, *Taxes and Charitable Giving*, 54 NAT'L TAX J. 433 (Sept., 2001); David Joulfaian, *Estate Taxes and Charitable Bequests by the Wealthy*, 53 NAT'L TAX J. 743 (Sept. 2000); Gerald E. Auten and David Joulfaian, *Charitable Contributions and Intergenerational Transfers*, 59 J. Pub. Econ. 55, 64 (1996). *But see* Schervish and Havens (2003).

A further potential question that may arise is what impact the proposal would have on the states. Historically, the federal estate tax offered a dollar-for-dollar credit for state wealth transfer taxes up to a limit. This allowed states to receive a share of federal estate tax revenue without actually imposing economic burdens on their residents. Although the credit was in place for more than eighty years (and is scheduled to reappear in 2011), it was replaced in 2005 with a deduction for state wealth transfer taxes. The effect was to cut back on federal revenue sharing because the credit was worth more than this deduction. Eliminating the credit also created an incentive for elderly residents to move to a state without any wealth transfer tax. As a result, the number of states with wealth transfer taxes declined from all fifty in 2001 to twenty-eight by late 2005, although state wealth transfer taxes proved more resilient than some observers expected.²²⁵

If the proposal was implemented, it should either improve state finances or have no effect. Any desired level of federal revenue sharing could still be achieved. For example, a credit or deduction could just as easily be offered for state wealth transfer taxes.²²⁶ Moreover, the proposal should improve state's fiscal capacity independent from such revenue sharing. States would likely piggyback on the federal reporting requirements and conform their wealth transfer taxes to an inheritance tax base (as they have under the federal estate tax system, even when imposing an inheritance tax). As they did so, states should find their wealth transfer tax base becoming more resilient to tax competition, because it is generally easier for a retired individual to move to a state without a wealth transfer tax, than it is for all of her heirs.²²⁷

f. Wouldn't Transition Costs Eliminate the Benefits of the Proposal?

The final potential concern one might raise is whether any transition costs associated with the proposal would swamp its benefits. In many areas

²²⁵ Robert Yablon, *Defying Expectations: Assessing the Surprising Resilience of State Death Taxes*, 59 TAX LAWYER 241, 243, 278 (Fall, 2005).

²²⁶ If the state imposed an estate tax, the deduction or credit would be for the heir's share of the state estate tax imposed.

²²⁷ The same argument would apply to the federal wealth transfer tax base vis a vis other countries.

of tax, this is entirely possible.²²⁸ However, the transition costs associated with shifting from the estate tax system to the proposal should be relatively small.

Only one critical transition rule would need to be established if a comprehensive inheritance tax were adopted. Namely, (1) inheritances received after a date prior to enactment (such as the date the bill was introduced) should count towards the new lifetime exemption under the inheritance tax, and (2) heirs should be able to claim a credit for any estate or gift taxes paid on inheritances received after that date. If this rule were not established, an heir could effectively claim two lifetime exemptions, rather than one. He could do so by having his donor first transfer an amount equal to the gift tax lifetime exemption once enactment seemed likely, and then transfer an amount equal to the inheritance tax lifetime exemption once the new regime actually went into effect. A transition that is effective prior to enactment minimizes this tax planning incentive, and the inequities it would generate.

Beyond this fundamental rule, there are two principle approaches Congress could take. The first would be to count all inheritances an heir had previously received towards his lifetime inheritance tax exemption, and simultaneously give him credit for any estate and gift taxes that had been paid on these amounts inherited. Effectively, the transition date would then be the heir's date of birth. The second would be to exclude all inheritances received prior to the introduction date from the lifetime inheritance tax exemption and give heirs no credit for estate and gift taxes paid on those inheritances.²²⁹ Effectively, the transition date would then be the introduction date.

While the first approach is more precise, on balance, the second is probably better because it should result in less tax planning and administrative and compliance costs. Under the second approach, there would be no need for the heir, donor or IRS to track down records regarding wealth transfers that occurred many years in the past. In particular, the heir would not need to know whether any estate tax was paid on the transfer, and the IRS would not need to have records of inheritances on which no tax was

²²⁸ See, e.g., Alan J. Auerbach, *Tax Reform in the 21st Century* (May 6, 2006), available at <http://www.econ.berkeley.edu/~auerbach/reform.pdf>.

²²⁹ 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 should also be excluded from the lifetime exemption of the inheritance tax.

due. This approach would also prevent heirs who have kept good records from whipsawing the government and reporting prior inheritances on which estate and gift taxes were paid, while failing to report inheritances that were tax-free. Finally, Ireland applied a transition rule similar to the second approach when it transitioned from an estate tax to a lifetime accessions tax, and did not encounter any major problems.²³⁰

Nevertheless, both approaches are reasonable and the stakes should be relatively small. Among children who receive a bequest greater than \$1.7 million, the bequest on average represents 94 percent of their lifetime inheritances to date.²³¹ The comparable figure for non-child beneficiaries is 99 percent.²³² Accordingly, relatively few inequities should result from the first approach, and relatively little evasion from the second.

* * *

Overall, the proposal thus offers a number of benefits. It would more equitably allocate tax burdens amongst heirs in the short-term. It would simplify the law on net. And it could strengthen the fairness of the tax system more broadly by setting up a dynamic that would generate a fairer distribution of pre-tax and post-tax income and inherited advantage in the long-term. At the same time, the proposal appears to be robust to a number

²³⁰ Ireland's inheritance tax, the Capital Acquisitions Tax ("CAT"), was enacted in 1976 after publication of the 1974 White Paper on Capital Taxation. 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. See Lynda A.M. Carroll, *Ireland: Inheritance and Gift Tax*, 34 EUROPEAN TAXATION 374 (1974). This date was viewed as providing sufficient time after publication of the White Paper for taxpayers to adjust their wills or other estate plans. Ireland Department of Finance, Capital Taxation, Laid by the Minister for Finance before Each House of the Oireachtas 60 (Feb. 28, 1974). Prior to the CAT, Ireland did not have a gift tax. The CAT subjected all gifts made on or after the date of the White Paper publication date to a new gift tax, although taxes were not collected until after its 1976 enactment. While gifts received between 1969 and the White Paper publication date were not themselves subject to tax, they were aggregated with gifts after that date for the purpose of determining gift tax liability. Capital Acquisitions Tax Act, Second Schedule, Part I (1976). This final feature was attacked as inequitable because it was a retrospective tax. See, e.g., Seanad Éireann, Parliamentary Debates, *Capital Acquisitions Tax Bill. Certified Money Bill: 2nd Stage*, Office of the Houses of the Oireachtas, Leinster House, 13th Seanad, Vol. 83, at 1407-14 (Mar. 18, 1975), available at <http://historical-debates.oireachtas.ie/S/0083/S.0083.197603180004.html>. I would not suggest adopting it.

²³¹ This calculation is based on data from the Survey of Consumer Finances.

²³² 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. See IRS 1992 Collation Study data.

of concerns and objections that could be raised. Before concluding, however, this paper considers one final question: whether the proposal should go farther and address a number of related issues.

V. RELATED ISSUES

Serious consideration of the proposal might spur lawmakers to revisit a number of issues related to the tax treatment of wealth transfers. The three existing wealth transfer taxes currently contain a number of tax preferences, including for closely-held businesses, charitable giving, educational expenses and health expenses. In addition, the income tax treatment of charitable contributions, retirement savings, life insurance, and accrued gains on inherited wealth all have important implications for the magnitude of wealth transfers, and the effective tax rate imposed on them.

This final section provides suggestions for how to address these issues, taking into account administrative and political constraints. While the following suggestions are not part of the core proposal and have not been incorporated into our revenue and distributional estimates, these issues are likely to arise in any reform debate.

A. Accrued Gains

The most important issue that will likely arise from a fiscal perspective is whether to alter the tax treatment of accrued gains on inherited wealth. While the income tax realization requirement creates incentives to hold on to all appreciated assets, these lock-in incentives are particularly acute in the case of property transferred as a gift or bequest. Gifts of appreciated property receive a carryover basis. If the assets continue to appreciate after transfer, this results in the heir's accrued tax liability—and lock-in incentive—becoming larger and larger over time. Bequests receive a stepped-up basis, which results in even larger lock-in incentives for donors because any accrued tax liability will be forgiven entirely if the donor holds on to the property until death.

The ideal approach to taxing appreciated property would be to eliminate lock-in incentives through an accrual tax or, if this is not possible, reduce them by treating gifts and bequests as a realization event—assuming that the optimal underlying tax is an income tax (a large caveat). All accrued gains would then be taxed at the time of transfer.

This repeal of stepped-up and carryover basis would render the income tax more equitable, efficient, and transparent. It would be more equitable because these provisions disproportionately benefit wealthier individuals. For example, untaxed appreciation represents 36 percent of the value of all bequests but 56 percent of the value bequests exceeding \$10 million.²³³ Meanwhile, it would entail less inefficient transactional complexity because the provisions also unfairly privilege sophisticated taxpayers.²³⁴ It would be more transparent because few members of the public are aware of how important and costly these provisions are. In addition, contrary to public perception, repeal would be administrable. Five countries successfully treat gifts or bequests as realization events, including Canada.²³⁵ Finally, repeal could raise a significant amount of revenue. Under some estimates, treating gifts and bequests as a realization event would raise one-quarter the revenue raised by the estate tax system.²³⁶

Nevertheless, this paper does not suggest advocating for repeal of stepped-up and carryover basis because doing so would probably entail political opportunity costs that exceed its substantial benefits. In particular, discussions with U.S. experts and the experience of Canada both suggest that wealth transfer taxation is unlikely to survive if coupled with realization at the time of transfer. The reason is that any wealth transfer tax would then be even more likely to be seen as a “double tax.”²³⁷

²³³ James Poterba and Scott Weisbenner. 2001. The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death, *in* RETHINKING ESTATE AND GIFT TAXATION 439-40 William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds., 2001).

²³⁴ For example, less well-advised donors may realize accrued gains prior to death to the detriment of their heirs, and less well-advised heirs may realize accrued gains upon receipt of a gift to their own financial detriment.

²³⁵ 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. HUGH J. AULT AND BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 184 (2nd ed., 2004); INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *ASIA-PACIFIC TAX SURVEYS* (2006); INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *EUROPEAN TAX SURVEYS* (2006).

²³⁶ See Office of Management and Budget, *Historical Tables, Budget of the United States Government, FY 2001*, at tbl.2.5 (2000), available at <http://www.gpoaccess.gov/usbudget/fy01/pdf/spec.pdf>; Congressional Budget Office, *Budget Options 2000*, at 311-12 (March, 2000), available at <http://www.cbo.gov/ftpdocs/18xx/doc1845/wholereport.pdf> (citing JCT revenue estimate). Percentage based on revenue estimate after policy change is in effect for three years.

²³⁷ 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

Taxing inherited income is more important than taxing accrued gains at transfer for several reasons. First, repeal would likely raise less revenue than the proposal. Indeed, if tax rates on capital income continue to decline, it could eventually raise virtually none. Treating gifts and bequests as a realization event would also not target heirs with high economic income as effectively. For example, the highest rate an heir who inherits \$100 million could face generally would be 15 percent under current capital gains rates. And if his inherited assets contained no accrued gains, he would owe no tax on his inheritance whatsoever. Meanwhile, heirs receiving small inheritances could face significant new burdens because estates of all sizes frequently include appreciated assets.²³⁸ Replacing the estate tax system with realization also would make it far more difficult for Congress to subsequently apply a positive tax rate to inherited income. For all these reasons, if we face such a political choice, retaining wealth transfer taxes is the better option.

Nevertheless, this paper does recommend one alternative approach: replacing stepped-up basis with carryover basis. Assuming the political constraint is that accrued gains on inherited wealth cannot be taxed at the same time as inheritances are taxed, it should still be possible politically to tax such accrued gains at a later point in time.²³⁹ This could be accomplished by applying carryover basis to all wealth transfers.

Applying carryover basis to bequests would reduce the inefficiency and inequity that arises from treating bequests of appreciated assets more favorably than bequests of other assets. It would ensure that all capital income is taxed once,²⁴⁰ regardless of how sophisticated the donor. It would

on capital gains. See Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 OSGOODE HALL L. J. 133, 133 (1978), *citing* E. BENSON, SUMMARY OF 1971 TAX REFORM LEGISLATION 31 (Ottawa, Dept. of Finance, 1971). U.S. observers believe this would happen if the wealth transfer tax took the form of an inheritance tax as well.

²³⁸ Poterba and Weisbenner, *supra* note 233 at tbl.10.

²³⁹ Another possibility is to treat receipt of gifts and bequests above the lifetime exemption as a realization event for the heir. If part of an inheritance fell below the threshold and part above, the accrued gains on the inheritance could be allocated pro rata. This option would also probably face formidable political obstacles, although conceivably it might not if realization replaced the 15 percent surtax. However, doing so would likely reduce the amount of revenue raised and the effective tax rate on heirs with the highest economic income unless a large share of the accrued gains on large inheritances are ordinary.

²⁴⁰ To avoid actual double taxation, one technical adjustment is necessary. If an heir inherits an appreciated asset exceeding the lifetime exemption and counts the fair market value as the amount inherited, he is essentially paying inheritance tax on the capital gains tax that he must subsequently pay on the asset. This issue could be addressed by following

also reduce incentives for investors to hold on to underperforming assets purely for tax reasons as they near the end of life. In addition, it would likely raise a significant amount of revenue—the equivalent of about 12 percent of that raised by the estate tax system.²⁴¹

U.S. tax attorneys frequently object that carryover basis is inadministrable, but this view appears to be unduly influenced by the unique history of carryover basis in the U.S. The U.S. enacted carryover basis in 1976 and then repealed it due to concerns about implementation before it went into effect. Those concerns, however, appear to have stemmed from features of that specific bill and not any fundamental administrative barriers.²⁴² Indeed, at least five countries currently provide for carryover basis for bequests, including such large economies as Germany, Australia, and Japan.²⁴³ Our own system is scheduled to apply carryover basis to bequests for the strange year of 2010.²⁴⁴

In order to ensure that carryover basis entails minimal administrative and compliance costs, donors or their estates should be required to supply the heir with basis information if it is commonly available, and relief

current law for ordinary income that has not been taxed to the donor. The heir would treat the fair market value of the appreciated asset as an inheritance at the time of receipt, and would also be taxed on the accrued gain when he subsequently sells the asset. However, he could deduct against his capital gain income an amount equal to the share of his 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 (2008), and has been a reasonably successful “rough justice” solution to the problem. I am grateful to Joseph Kartiganer for this suggestion.

²⁴¹ See Office of Management and Budget, *Historical Tables, Budget of the United States Government, FY 2001*, at tbl.2.5 (2000), available at <http://www.gpoaccess.gov/usbudget/fy01/pdf/spec.pdf>; Congressional Budget Office, *Budget Options 2000*, at 311-12 (March, 2000), available at <http://www.cbo.gov/ftpdocs/18xx/doc1845/wholereport.pdf> (citing JCT revenue estimate). Percentage based on revenue estimate after policy change is in effect for three years.

²⁴² 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. See Ira H. Lustgarten, *Book Review: Carryover Basis under the 1976 Tax Reform Act*, by Thomas J. McGrath and Jonathan G. Blattmachr, 78 COL. L. REV. 679 (1978).

²⁴³ HUGH J. AULT AND BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 184 (2nd ed., 2004).

²⁴⁴ IRC §1022 (2008).

provisions should be available if it is not. One possibility would be to permit stepped-up basis for appreciated assets that were not held for the production of income—such as personal jewelry and furniture— and are worth less than, for example, \$10,000.²⁴⁵

In short, if designed correctly, replacing stepped-up basis with carryover basis would further enhance the equity, efficiency and transparency benefits of the proposal. Moreover, it would do so without substantial compliance and political costs.

B. Illiquid Assets

A great deal of money is at stake in deciding how to treat accrued gains. Nevertheless, the most important reform issue that will likely arise from a political perspective is whether the tax treatment of illiquid assets—especially family businesses and family farms—should be changed. Michael Graetz and Ian Shapiro argue in their book on the 2001 bill that the failure of estate tax supporters to adequately address this issue was a prime reason for estate tax repeal advocates' success.²⁴⁶ Indeed, when the author testified about the proposal before the Senate Committee on Finance, ten of the thirty questions submitted for the record by the Senators concerned this topic.

The problems the estate tax creates for family businesses have been greatly exaggerated in the public debate. 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.²⁴⁷ More generally, business assets can create liquidity problems only if they constitute a large portion of a wealth transfer and this is rarely the case. The Tax Policy Center has estimated that less than 3 percent of taxable estates are composed of more than 50 percent business assets.²⁴⁸ Moreover, we estimate that less than 3 in

²⁴⁵ 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.

²⁴⁶ MICHAEL J. GRAETZ AND IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* 32-40 (2005).

²⁴⁷ *Id.* at 126.

²⁴⁸ Urban-Brookings Tax Policy Center, *Table T06– 0020: Current Law: Distribution of Gross Estate and Net Estate Tax By Size of Gross Estate* (Jan. 23, 2006), available at <http://www.taxpolicycenter.org/numbers/Content/PDF/T06-0020.pdf>; Urban-Brookings Tax Policy Center, *Table T06– 0022: Current Law: Distribution of Gross Estate and Net Estate Tax By Size of Gross Estate* (Jan. 23, 2006), available at <http://www.taxpolicycenter.org/numbers/Content/PDF/T06-0022.pdf>. Taxable returns with

1,000 heirs would be subject to the proposed inheritance tax in the first place. Accordingly, far fewer than 400 heirs²⁴⁹ could conceivably need to sell part of an inherited business in order to pay the proposed tax—even if *all* of the existing relief provisions governing illiquid assets were repealed.

Nonetheless, the mere possibility that the estate tax could precipitate such sales has been a principal argument against the estate tax. To the extent that Congress considers it necessary to address this theoretical possibility, this article recommends replacing the existing relief provisions with one that permits indefinite deferral at a market interest rate to the extent that an heir's tax liability exceeds the value of liquid assets that he inherits (subject to some reasonable cushion). Doing so should address the concern that taxing inheritances may force the sale of family businesses, while minimizing incentives or disincentives to hold assets in illiquid forms.

The twin goals of any relief provision should be to prevent forced sales of illiquid assets and to treat such assets neutrally. Politics aside, preventing forced sales of inherited assets is efficient to the extent that such assets are most productively held in the heir's hands. However, treating illiquid assets neutrally by not subsidizing them is also necessary from an efficiency, fairness, and simplification perspective. Preferences for closely-held businesses and illiquid assets tend to distort investment decisions, and favor heirs inheriting business assets over others. They tend to benefit heirs receiving the largest inheritances the most because the portion of estates composed of business assets tends to rise with the estate size.²⁵⁰ There is also no hard evidence that inherited businesses are more beneficial to the economy than other businesses; in fact, there is fairly strong evidence that

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 Tax Policy Center, *Table T06- 0020: Current Law: Distribution of Gross Estate and Net Estate Tax By Size of Gross Estate* (Jan. 23, 2006); Urban-Brookings Tax Policy Center, *Table T06- 0022: Current Law: Distribution of Gross Estate and Net Estate Tax By Size of Gross Estate* (Jan. 23, 2006); Urban-Brookings Tax Policy Center, *Table T06- 0023: Current Law: Distribution of Gross Estate and Net Estate Tax By Size of Gross Estate* (Jan. 23, 2006).

²⁴⁹ Three percent of 12,972 (the number of heirs we estimate will be burdened by the proposal) is about 400. The number of heirs eligible should be much fewer than 400 because only heirs inheriting assets worth over \$190 million (fewer than 70 annually) would be subject to a 50 percent effective tax rate under the proposal.

²⁵⁰ *Id.*

businesses owned or managed by heirs tend to perform relatively worse.²⁵¹ Thus, liquidity relief should be provided without providing subsidies.

Current law does a relatively poor job of achieving these objectives. It heavily subsidizes closely-held businesses. For example, certain business assets can be valued at much less than their normal market value.²⁵² Payment of any estate taxes attributable to a closely-held business can be deferred for five years and then spread out over ten more years at a below-market interest rate.²⁵³ There is also a special deduction for certain qualified family-owned business interests, which sunset in 2004 but is scheduled to return in 2011.²⁵⁴ At the same time, current law fails 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 objective appears to be met in practice,²⁵⁵ it depends on a number of factors, including whether the family continues to manage the business and how soon they plan to sell the business after the donor's death.

The relief provision recommended here would avoid these pitfalls. If an heir inherited liquid assets sufficient to pay the tax (with an appropriate cushion), he would pay the tax with these assets and inherit any closely-held business or other illiquid assets tax-free.²⁵⁶ If not, he would be required to

²⁵¹ See, e.g., Francisco Pérez-González, *Inherited Control and Firm Performance*, 96 AM. ECON. REV. 1559 (2006);

Morten Bennesen et al, *Inside the Family Firm: The Role of Families in Succession Decisions and Performance* (Nat'l Bur. Econ. Research Working Paper No. 12356, June, 2006); Belen Villalonga and Raphael Amit, *How Do Family Ownership, Control, and Management affect Firm Value?* 80 J. FIN. ECON. 385 (May, 2006); Randall K. Morck, David A. Strangeland, and Bernard Yeung, *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease?*, in CONCENTRATED CORPORATE OWNERSHIP 319 (Randall K. Morck, ed., 2000); Brian F. Smith and Ben Amoako-Adu, *Management Succession and Financial Performance of Family Controlled Firms*, 5 J. CORP. FIN. 341 (1999). But see Daniel L. McConaughy et al, *Founding Family Controlled Firms: Efficiency and Value*, 7 REV. FIN. ECON. 1 (1998).

²⁵² IRC § 2032A (2008).

²⁵³ IRC § 6166 (2008). 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 (2008). The IRS Commissioner may also permit deferral of wealth transfer tax liabilities at her discretion. IRC § 6161 (2008).

²⁵⁴ IRC § 2057 (2008).

²⁵⁵ See *supra* note 247 and accompanying text.

²⁵⁶ The rationale for limiting the deferral election to the portion of the heir's inheritance tax liability that exceeds his readily marketable inherited assets is threefold. First, this feature may be necessary to minimize behavioral distortions and maintain revenue neutrality within the budget window if heirs irrationally perceive the deferral election as

use the liquid assets that he did inherit (again subject to some reasonable cushion) to pay a portion of the associated tax liability.²⁵⁷ He could then elect for the remainder to accrue at a market interest rate until he sold part or all of the business, received distributions from it, or inherited other liquid assets. If none of these possibilities arose, the tax liability and interest would accrue indefinitely.²⁵⁸ Example 3 illustrates how the election would work.

Example 3: Inheriting a Closely-Held Business

Facts: Heir C is in the highest income tax bracket, receives a bequest of \$10 million, and has received no prior inheritances. Three quarters of the bequest is a closely-held business and one quarter is liquid assets, such as publicly traded stock.

Tax Treatment: C's total tax liability would be \$4.05 million. He could choose to defer \$1.55 million of the taxes due (plus a reasonable cushion) until the business was sold. Thus he would face no pressure to sell the business if he operated it profitably, but he also would face no incentive to hold on to it.

The net result of the provision would be that heirs would never have to sell an inherited business in order to pay the associated tax liability and interest. In addition, the provision would not create liquidity constraints for

advantageous. Second, the limit avoids creating a cliff effect and the associated planning costs. Under current law, if closely held business interests exceed 35 percent of the value of the estate, taxes on all such assets can be deferred; if they constitute 34 percent, no deferral is available. IRC § 6166 (2008). 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 them falling below the threshold. See American Bar Association Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes* 138-39 (2004). While the current law provision admittedly differs in offering a lucrative below-market loan, such gaming might continue for less rational reasons. Third, the limit is 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 he chooses to do so, there are no inequities created by requiring him to use his other assets to pay the tax due upfront.

²⁵⁷ Illiquid assets could be defined fairly broadly so long as a market interest rate was applied. 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. See Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1199 (1978).

²⁵⁸ Theoretically, if the heir held onto an illiquid asset for life and ultimately bequeathed it to someone else, the associated tax could carry over to the new heir.

inherited businesses because the tax due would be a liability solely of the heir, and thus does not need to be reported on the business' books. At the same time, tax subsidies for illiquid assets would be avoided.

This recommended election should reduce transactional complexity relative to current law because far fewer heirs would be eligible for the election. They also would not face any net tax benefit or penalty for making the election, so the decision of whether to sell an inherited business could be made purely based on business and personal considerations—not for tax reasons.

The provision would require ongoing monitoring by the IRS. In order to minimize evasion, the IRS could require each heir making the election to submit a form annually stating whether he had received any distributions from the business, or sold all or a portion of it, perhaps with confirmation from the business. The definition of distributions and sales could parallel those under the current law deferral provision.²⁵⁹ However, it is critical that, unlike current law, interest would accrue at a market rate, and the taxpayer would be required to use all distributions and proceeds from sales first to satisfy the accrued tax liability and interest. Once again, this annual filing requirement should not be a large burden on the heir or business. Few would be eligible for the election and the filing requirement would simply require confirmation of a fact of which both should be well aware—whether the heir has sold or received cash from the business.

Annual appraisal of the business after it was inherited also should be unnecessary. However, if the heir did not report distributions and sales proceeds sufficient to satisfy the tax liability and interest for a number of years, the question would arise of whether he was evading the tax by withdrawing cash for personal consumption in other ways. For example, if an heir controlled an inherited business, he could be forcing it to sell assets at a nominal price to another business he controlled, and then forcing that second business to distribute the assets to him. Alternatively, he could be causing an inherited business he controls to pay him an extraordinarily high salary, without performing commensurate services in exchange. One way to address these potential tax shelters would be to grant to the IRS a lien or right to foreclose upon the business in such circumstances. Another option, which would never entail forced sales, would be to treat compensation

²⁵⁹ See IRC § 6166(g).

above a certain level, and sales to other businesses controlled by the heir, as *de facto* distributions to the heir after a period of years.²⁶⁰

In summary, unlike current law, this deferral provision should fully address the concern that taxing inheritances can force the sale of family businesses. At the same time, it should reduce the tax planning, compliance, and efficiency costs associated with the current set of provisions that subsidize wealth transfers composed of illiquid assets and closely-held businesses.

C. Tax Incentives

The final issue that may arise in conjunction with consideration of the proposal is whether tax incentives associated with wealth transfers should be changed. Currently the estate tax system provides unlimited deductions for transfers to charity, and gifts used for health or educational expenses.²⁶¹ In addition, the income tax includes deductions and exclusions for charitable contributions, retirement savings, and life insurance, all which strongly affect the magnitude of wealth transfers and tax rate imposed on them.

The current set of tax incentives in the tax system as a whole is far from ideal.²⁶² Most operate through deductions, exclusions, and occasionally nonrefundable credits. As Fred Goldberg, Peter Orszag and I have argued elsewhere, ideally tax incentives should be calibrated to the size of the positive externality (if any), and the default should be a uniform refundable credit—unless there is evidence that the externality of elasticity

²⁶⁰ I am grateful to Noel Cunningham for raising these issues.

²⁶¹ The estate tax system also provides an unlimited deduction for spousal transfers, but I consider this to be less a tax incentive than a provision designed to avoid administrative issues in measuring the tax base. Arguably all household earnings are due to the efforts of both spouses even if one is the primary market worker. If so, it is unclear whether and when wealth left to a spouse should be considered a transfer versus a return to his or her labor.

²⁶² Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 1 (2006); Jason Furman, *Two Wrongs Do Not Make a Right*, 59 NAT'L TAX J. 491 (Sept., 2006); Aaron S. Edlin, *The Choose-Your-Charity Tax: A Way to Incentivize Greater Giving*, 2 THE ECONOMIST'S VOICE (2005); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1 (2002); Boris Bittker and George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299 (1976).

of the activity varies across the economic distribution.²⁶³ This raises the question of whether tax incentives that relate to wealth transfers should be reformed. In an ideal world, they would be.

Starting with charitable contributions, the ideal tax incentive probably would be a flat refundable credit. To date, there is no evidence that the price elasticity of charitable giving varies systematically across the economic distribution.²⁶⁴ Charitable bequests do, however, appear to be more tax sensitive than charitable contributions made during life²⁶⁵ so some additional subsidy may be merited for them. Ideally, policymakers would also reconsider whether the social benefits of giving to some charities are greater than others—an issue that was raised by Leona Helmsley’s recent charitable bequest of \$8 billion for the care of dogs.²⁶⁶

For spending on health and education, by contrast, it appears that the ideal tax incentive would be a progressive refundable credit.²⁶⁷ In this case, there is evidence that elasticities do vary by income: lower-income individuals appear to respond more strongly.²⁶⁸ This greater responsiveness presumably stems in large part from the fact that they spend less on health and education currently, and thus less of any subsidy must be devoted to subsidizing their existing behavior.

²⁶³ This assumes that the provision is intended to induce a behavioral change, and not to more accurately measure income (e.g., deductions for business expenses) or ability to pay (e.g., the standard deduction).

²⁶⁴ See e.g., John Peloza and Piers Steel, *The Price Elasticities of Charitable Contributions: A Meta-Analysis*, 24:3 J. PUB. POLICY & MARKETING 260, 267 (Fall, 2005).

²⁶⁵ *Id.*

²⁶⁶ See, e.g., Gary Becker, *Cats and Dogs and Sensible Bequests*, BECKER-POSNER BLOG (July 13, 2008), available at http://www.becker-posner-blog.com/archives/2008/07/cats_and_dogs_a.html; Richard Posner, *Should Dogs Get \$8 Billion from the Helmsley Estate?*, BECKER-POSNER BLOG (July 13, 2008), available at http://www.becker-posner-blog.com/archives/2008/07/should_dogs_get.html. Indeed, the question of how to tax charitable contributions in some respects is identical to the question of how to tax gifts and bequests, implying that if we knew the ultimate beneficiaries of each charitable organization, ideally we would tax transfers to each charity as if they were transfers to its beneficiaries.

²⁶⁷ An additional benefit of an inheritance tax is that it permits tax incentives for these purposes for gifts and bequests. Under current law, the exclusions for amounts paid for support for minors and education and medical expenses do not apply to bequests because doing so would create the same valuation issues that arise for other tax-exempt transfers. An inheritance tax, with its wait-and-see approach, could eliminate these valuation issues.

²⁶⁸ See, e.g., Leonard E. Burman et al, *The Distributional Consequences of Federal Assistance for Higher Education: The Intersection of Tax and Spending Programs*, URBAN-BROOKINGS TAX POLICY CENTER DISCUSSION PAPER NO. 26 (Aug., 2005).

Turning finally to tax incentives for retirement savings and life insurance, it is unclear whether they currently produce any social benefits and, if so, what they are. The principal potential social benefits associated with retirement savings appear to be the possibility that such savings ensures that individuals have adequate income in retirement, so that they do not become a burden on government or experience sharp declines in their standard of living in old age. If so, any subsidy should be limited to savings for retirement spending—not transfers to the next generation. Meanwhile, the primary potential social benefit associated with life insurance appears to be supplementing Social Security payments for dependents who truly can't support themselves. If so, any subsidy should be limited to life insurance covering such beneficiaries. Lower-income households appear to respond more strongly to tax subsidies for both retirement savings and life insurance.²⁶⁹ Thus, it appears that the ideal tax incentives for these activities, if any, would be progressive refundable credits limited to funds used to purchase life annuities, retiree health insurance, and life insurance policies covering those unable to work.

Clearly the ideal structure of these tax incentives stands far from reality. It is unlikely that policymakers would want to reconsider their fundamental structure at the same time they reconsider the fundamental structure of wealth transfer taxes. As a result, despite the advantages of reform, this article recommends saving these issues for a separate debate. In the meantime, the current structure of tax incentives in the estate tax system could be replicated within the proposal.

VI. CONCLUSION

This article has argued, based on existing evidence, that the ideal wealth transfer tax should be much higher than current law and take the form of a comprehensive inheritance tax. The current political moment present a unique opportunity for the U.S. to move in this direction. We should seize this moment to replace the estate tax system with the inheritance tax proposed, instead of moving further down the road to repeal of wealth transfer taxation.

This article's proposal would strengthen the ability of our tax system to achieve its underlying goals. By basing tax burdens on the economic

²⁶⁹ See, e.g., Esther Duflo et al, *Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block*, 121:4 Q. J. ECON. 1311 (Nov., 2006).

status of the person who bears the tax—the heir—it would better account for the direct and indirect information that inheritances provide about an heir’s economic status. By creating incentives to give to those outside of the inner circle of the extraordinary wealthy, it could result in a broader pre-tax distribution of inherited advantage and income. It should also simplify the law. And ultimately, because its form more transparently embodies its function, it could reinvigorate public support for taxing inheritances. As a result, we could address the current undertaxation of inherited income relative to income and wealth that is self-made, and begin to expect from heirs a fairer share of what they have been given.

VII. APPENDICES

Appendix A: Methodology

The revenue and distributional estimates in this paper are based initially on the Urban-Brookings Tax Policy Center Estate Tax Microsimulation Model (ETMM).²⁷⁰ The ETMM was constructed by imputing wealth on to micro data of individual income tax returns. It then assigns a probability of death and imputes the amounts of charitable and spousal deductions in order to create a dataset 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, we imputed the amount of spousal transfers. Spousal deductions in the ETMM database may not be equivalent to the amount transferred. For example, suppose the estate tax exemption is \$3.5 million and there are two \$4 million estates. If one donor left the entire estate to the surviving spouse while the other left only \$500,000 to the surviving spouse (with the remainder going to the children), both would claim a \$500,000 spousal deduction even though their spousal transfers vary widely. To address this issue, we imputed spousal transfers below the exemption amount²⁷¹ based on tabulations of the restricted 1992 IRS Collation Study that the Statistics on Income division generously prepared for us.

Next, we imputed the number of beneficiaries in each relationship group (children and other beneficiaries) based on Collation Study tabulations by the decedent's marital status and estate size.²⁷² The number of beneficiaries was classified as 0, 1, 2, 3, 4 or greater than 4 (in which case an average value was used). The Collation Study has quite good information on the identity of estate beneficiaries, including when all or part

²⁷⁰ For further details, see Jeffrey Rohaly, Adam Carasso & Mohammed Adeel Saleem, *The Urban-Brookings Tax Policy Center Microsimulation Model: Documentation and Methodology for Version 0304* (Jan. 10, 2005), available at http://www.urban.org/UploadedPDF/411136_documentation.pdf.

²⁷¹ The differences between the estimates in this paper and Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*, BROOKINGS INST. HAMILTON PROJECT DISCUSSION PAPER 2007-07 (June, 2007) arise from this refinement and use of an updated income tax calculator.

²⁷² Estates were grouped in the following categories: (1) up to \$600,000, (2) \$600,000 up to \$1 million, (3) \$1 million up to \$2.5 million, (4) \$2.5 million up to \$5 million, (5) \$5 million up to \$10 million, and (6) \$10 million and above.

of the estate is left in trust, because it examines probate records when the beneficiary is unclear. It is able to categorize the beneficiaries of credit shelter trusts, QTIP trusts and generation-skipping trusts fairly reliably. Where a trust does not fit into one of these categories and provides an income interest to one beneficiary with a remainder to others, the Collation Study assigns all the trust assets to the individual with the income interest. The net effect is probably to attribute some transfers ultimately received by the grandchildren of a donor to the donor's children instead. However, given current tax incentives to make generation-skipping transfers through trusts limited to the third generation or beyond, these errors should not be substantial.

Once the number of beneficiaries in each relationship group was imputed, the share of the estate allocated to each relationship group was then imputed based on decedent's marital status, the estate size and the number of beneficiaries, again using tabulations of Collation Study data. This was necessary because if an estate has, for example, two child beneficiaries and one other beneficiary, it is necessary to determine what share goes to the children.

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. This seemed reasonable given that the vast majority of bequests to children are bequeathed pro rata.²⁷³ 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, a ratio between the beneficiary's prior and current inheritance size was then imputed. These imputed ratios were derived from combined 2001 and 2004 Survey of Consumer Finance (SCF) data. For each current inheritance group,²⁷⁴ the imputed ratio was randomly assigned as the middle percentile of one of the following four groups: 0th-40th percentile, 40th-60th percentile, 60th-90th percentile, and 90th-100th percentile. Prior inheritances were then

²⁷³ See *supra* note 44.

²⁷⁴ Current inheritances were classified into the following groups: (1) \$10,000 or less, (2) more than \$10,000 to \$50,000, (3) more than \$50,000 to \$100,000, (4) more than \$100,000 to \$500,000, (5) more than \$500,000 to \$1 million, and (6) more than \$1 million.

calculated as the product of the imputed ratio and the beneficiary's current inheritance.

Next, each individual beneficiary was assigned a marital status and income group. Both were based on Collation Study tabulations by the decedent's marital status, the estate size, and the beneficiary's relationship to the decedent. The tabulations for the income group assignment were also based on the beneficiary's marital status.²⁷⁵ The measure of income in the Collation Study generally tracks adjusted gross income (AGI), but with some adjustments.²⁷⁶

Then, conditional on marital status, income group and relationship to the decedent, each beneficiary was assigned an age group.²⁷⁷ The assignment targets the average differences between the decedent's and the beneficiary's ages so that the resulting differences are consistent with the average age gaps reported in the Collation Study.

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 income group, marital status, and age group of the heir. All income data was inflated to 2009.²⁷⁸ The heir's income and inheritance tax liability was then calculated based on this tax information and his or her current and prior inheritance. In particular, we account for payroll taxes, child tax credits, and earned income credits when calculating tax liability on non-inherited income. In the current version, only earned income credits are affected by the presence of inheritances in the inheritance tax calculation.

²⁷⁵ Beneficiary income was grouped in the following categories: (1) \$10,000 or less, (2) more than \$10,000 to \$25,000, (3) more than \$25,000 to \$50,000, (4) more than \$50,000 to \$100,000, (5) more than \$100,000 to \$200,000, and (6) more than \$200,000, in 1992 dollars. Income growth rates were based on a CBO data. See tbl.1C at <http://www.cbo.gov/ftpdocs/70xx/doc7000/Spreadsheets.xls>.

²⁷⁶ Specifically, it 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 and trust income. When positive, it also includes schedule C gross profit/loss (from the first three schedules), schedule F profit/loss (from first two schedules) supplemental gains/losses, other income, farm/rent income/loss, taxable interest income, net short-term gain/loss, and net long-term gain/loss.

²⁷⁷ The age groups were 0-18, 19-26, 27-34, 35-42, 43-50, 51-58, 59-65, 66-72, 73-79, and 80 or older.

²⁷⁸ Again, income growth rates were based on a CBO data. See tbl.1C at <http://www.cbo.gov/ftpdocs/70xx/doc7000/Spreadsheets.xls>.

Earned income credits of beneficiaries with some inheritances subject to the inheritance tax (i.e. above the lifetime exemption) are reduced pro rata by the amount of the inheritances subject to tax divided by five until this amount reaches \$3,000 at which point all earned income credits become zero. The \$3,000 threshold reflects the amount of investment income that disqualifies tax units from receiving earned income credit in 2009.

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 the tax burdens if they are assumed to fall on heirs, the tax liability of estates was assigned to individual heirs in the same manner as inheritances were assigned to them. That is, any estate tax due was assumed to be borne by an heir in the same proportion as his inheritance bore to the inheritances of all other non-spousal heirs of the estate.

We examine the distribution of wealth transfer tax burdens based on three measures of income. The first measure is the decedent's "cash income," which we also refer to as "non-inherited income" and is a more comprehensive measure of income frequently employed by the TPC and defined at Tax Policy Center (2004). In addition to AGI, it includes a variety of forms of tax-exempt income, such as tax-exempt interest, the employer's share of payroll tax liability, and deductible or excludable contributions to tax-preferred retirement savings plans. It does not, however, include inheritances received.

In order to account for the effect of inheritances on heirs' economic status, we employ two alternate measures for tax units that receive inheritances. The first is the heir's cash income plus one-fifth of his current inheritance, which we refer to as his "averaged economic income." This measure is consistent with the way inheritances are treated in the inheritance tax calculation. The second is the heir's cash income plus the annuitized value of his current inheritance, which is referred to as "annuitized economic income." In particular, we assume that the current inheritance is used to buy a fair life annuity that guarantees a constant nominal payment every year until the beneficiary dies. In order to calculate the annual annuity payment, we assume a constant nominal interest rate of

6% annually and life expectancies based on the Social Security Administration 2010 life table.²⁷⁹

Two assumptions underlying the microsimulation model should be noted. First, the estimates of both estate tax and inheritance tax liabilities assume no state wealth transfer tax liability. Second, the estimates importantly assume no behavioral response and thus no deadweight loss. That is, the model assumes no change in the magnitude of wealth transfers or their allocation on a pre-tax basis in response to the wealth transfer tax.

Both of these assumptions are very strong, and it is implausible that wealth transfer taxes generate no excess burden whatsoever. However, they are probably the least misleading in light of the very limited information available to study the issue. The assumption of no behavioral response is common in distributional analysis and less troubling where, as here, revenue-neutral alternatives are compared.

As should be clear, the following estimates should be treated with a high degree of caution. They are derived from a model that is based in part on data from 1992 and involves multiple layers of imputation. This is necessary due to the fact that there is no publicly-available micro data linking tax information on decedents and their estates to heirs' income tax returns and the amount heirs inherit. As a result, the estimates could change substantially in response to new information. Nevertheless, they begin to paint a picture of who benefits from wealth transfers, which heirs are burdened by wealth transfer taxes, and how their burdens vary by the type of tax.

²⁷⁹ For more detail, see Social Security Administration, Office of the Chief Actuary, *Table 6 - Period Life Tables for U. S. Social Security Area by Calendar Year and Sex*, available at http://www.ssa.gov/OACT/NOTES/as116/as116_Tbl_6_2010.html#wp1085673.

Appendix B: Data Underlying Graphs

Table A1: 2009 Bequests Received by Inheritance Size

Inheritance Size	Number of Tax Units Receiving Inheritances	Share	Value (\$) of All Inheritances Before Tax	Share
\$0+-50K	3,199,899	67.4%	53,112,039,792	12.9%
\$50-100K	699,071	14.7%	49,231,899,495	12.0%
\$100-250K	532,391	11.2%	81,877,544,619	19.9%
\$250-500K	179,450	3.8%	62,044,933,370	15.1%
\$500K-1M	90,693	1.9%	62,638,606,905	15.2%
\$1-2.5M	39,328	0.8%	55,763,085,425	13.5%
\$2.5-5M	5,049	0.1%	16,652,820,416	4.0%
\$5-10M	1,660	0.0%	11,137,022,099	2.7%
\$10-20M	511	0.0%	6,811,015,905	1.7%
\$20-50M	172	0.0%	5,139,014,788	1.2%
\$50M or more	67	0.0%	7,474,189,991	1.8%
Total	4,748,291	100.0%	411,882,172,803	100.0%

Table A2: Rough Distribution of Average Lifetime Inheritance by Earned Income

Earned Income	Average Lifetime Inheritance (\$) of All
\$0+-10K	41,939
\$10-20K	45,840
\$20-30K	50,985
\$30-40K	44,069
\$40-50K	49,932
\$50-75K	53,042
\$75-100K	50,882
\$100-200K	57,531
\$200-500K	103,129
\$0.5-1M	185,203
\$1-5M	204,064
\$5M+	128,423
All	52,046

Table A3: Rough Distribution of Average Lifetime Inheritance (\$) by Economic Income

Economic Income	Average Lifetime Inheritance (\$) of All
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\$0+-10K	14,222
\$10-20K	23,128
\$20-30K	30,015
\$30-40K	43,228
\$40-50K	41,845
\$50-75K	50,816
\$75-100K	64,719
\$100-200K	89,035
\$200-500K	170,144
\$0.5-1M	359,838
\$1-5M	638,299
\$5M+	708,164
All	52,046

Table A4: Rough Share of Economic Income Derived from Annuitized Inheritances

Economic Income	Share of Economic Income Derived from Annuitized Inheritances
\$0+-10K	15.9%
\$10-20K	10.1%
\$20-30K	8.1%
\$30-40K	8.6%
\$40-50K	6.2%
\$50-75K	5.8%
\$75-100K	5.4%
\$100-200K	4.7%
\$200-500K	4.4%
\$0.5-1M	3.8%
\$1-5M	2.4%
\$5M+	0.4%
All	4.4%

Table A6: Share of Revenue Raised from Wealth Transfer Taxes and Recurrent Wealth Taxes

Country	Share of Revenue Raised
Luxembourg	5.6%
Switzerland	4.9%
Iceland	2.5%
Japan	1.7%
France	1.6%
Norway	1.6%
Netherlands	1.2%

Korea	1.2%
U.S.	1.1%
Canada	1.1%
Spain	1.0%
Ireland	0.9%
Germany	0.9%
Belgium	0.8%
Greece	0.8%
Sweden	0.8%
Finland	0.6%
U.K.	0.6%
Italy	0.5%
Denmark	0.4%
Portugal	0.2%
Austria	0.1%
Hungary	0.1%
Czech Rep.	0.1%
Poland	0.1%
Turkey	0.0%
New Zealand	0.0%
Mexico	0.0%
Australia	0.0%
Average	1.1%

Table A8: Average Tax Rate on Earned Income and Economic Income of 2009 Heirs

Economic Income	Income Tax Rate on Earned Income	Income Tax Rate on Economic Income	Income and Estate Tax Rate on Economic Income
\$0+-10K	11.3%	8.3%	8.3%
\$10-20K	8.1%	6.7%	6.7%
\$20-30K	10.2%	8.8%	8.9%
\$30-40K	13.3%	11.5%	11.6%
\$40-50K	16.1%	14.5%	14.6%
\$50-75K	18.5%	16.8%	17.1%
\$75-100K	19.8%	18.0%	18.4%
\$100-200K	20.6%	18.9%	20.8%
\$200-500K	20.2%	18.7%	26.5%
\$0.5-1M	18.6%	17.4%	39.5%
\$1-5M	17.6%	17.0%	32.5%
\$5M+	26.3%	26.2%	28.7%
All	20.4%	19.1%	23.1%

Table A9: Number and Percentage of Heirs Burdened by the 2009 Estate Tax by Inheritance Size

Inheritance Size	All Heirs	Heirs Burdened by Estate Tax	Percentage of Heirs Burdened	Revenue Derived from Heirs	Percentage of Revenue Derived
\$0+-50K	3,199,899	51	0.0%	600,451	0%
\$50-100K	699,071	370	0.1%	6,908,429	0%
\$100-250K	532,391	961	0.2%	28,711,776	0%
\$250-500K	179,450	3,408	1.9%	166,443,206	1%
\$500-675K		1,599	3.7%	159,654,252	1%
\$675K-1M	42,837	1,647	3.4%	251,947,906	1%
\$1-2.5M	47,856	7,578	19.3%	2,172,261,487	12%
\$2.5-5M	39,328	3,495	69.2%	2,779,965,150	16%
\$5-10M	5,049	1,660	100.0%	3,592,328,575	21%
\$10-20M	1,660	511	100.0%	2,745,700,478	16%
\$20-50M	511	172	100.0%	2,264,003,122	13%
\$50M or more	172	67	100.0%	3,339,304,571	19%
All	4,748,291	21,519	0.5%	17,507,829,402	100%

Table A10: Number and Percentage of Heirs Burdened by the 2009 Estate Tax by Economic Income

Economic Income	All Heirs	Heirs Burdened by Estate Tax	Percentage of Heirs Burdened	Revenue Derived from Heirs	Percentage of Revenue Derived
\$0+-10K	593,947	38	0.0%	812,709	0.0%
\$10-20K	694,455	153	0.0%	2,310,147	0.0%
\$20-30K	598,801	252	0.0%	13,429,174	0.1%
\$30-40K	529,999	449	0.1%	25,257,976	0.1%
\$40-50K	404,967	717	0.2%	23,559,675	0.1%
\$50-75K	712,258	1,591	0.2%	130,038,623	0.7%
\$75-100K	417,796	1,047	0.3%	130,758,665	0.7%
\$100-200K	573,723	6,867	1.2%	1,481,191,540	8.5%
\$200-500K	173,066	6,694	3.9%	3,834,727,177	21.9%
\$0.5-1M	21,934	2,240	10.2%	3,347,913,220	19.1%
\$1-5M	17,452	1,365	7.8%	5,597,926,205	32.0%
\$5M+	9,895	104	1.1%	2,919,904,290	16.7%
All	4,748,291	21,519	0.5%	17,507,829,402	100.0%

Table A11: Correlation between Inheritance Size and Donor's Taxable Estate Size

Unweighted	0.66
Weighted by Inheritance Size	0.83

Table A12: Inheritance Flows (\$) by Number of Estate's Child and Non-Child Beneficiaries

		Number Non-Child Beneficiaries					
		0	1	2	3	4	5+
Number Child Beneficiaries	0	0	33,433,507,761	28,323,891,263	13,801,777,233	8,062,832,383	45,661,124,369
	1	91,189,377,817	6,182,879,711	2,620,496,748	4,656,131,230	2,479,385,885	3,789,954,895
	2	69,664,543,695	3,884,623,282	8,603,100,484	1,079,607,665	4,126,778,097	3,105,798,767
	3	33,809,972,377	3,042,906,129	4,297,964,958	1,926,162,056	66,245,753	6,872,198,650
	4	18,477,882,758	15,019,540	41,662,919	53,007,308	0	3,047,225,989
	5+	9,288,568,831	124,891	81,743,812	31,653,291	27,981,089	136,041,165

Table A13: Average Tax Rate on All Inheritances by Heir Economic Income

Economic Income	Estate Tax	Proposed Inheritance Tax
\$0+-10K	0.0%	0.0%
\$10-20K	0.0%	0.0%
\$20-30K	0.0%	0.0%
\$30-40K	0.1%	0.0%
\$40-50K	0.1%	0.0%
\$50-75K	0.2%	0.0%
\$75-100K	0.3%	0.0%
\$100-200K	1.7%	0.5%
\$200-500K	7.9%	8.8%
\$0.5-1M	23.6%	25.6%
\$1-5M	34.6%	37.1%
\$5M+	39.2%	43.2%
All	4.3%	4.3%

Table A14: Average Tax Rate on All Inheritances by Inheritance Size

Inheritance Size	Estate Tax	Proposed Inheritance Tax
\$0+-50K	0.0%	0.0%
\$50-100K	0.0%	0.0%
\$100-250K	0.0%	0.0%
\$250-500K	0.3%	0.0%
\$500-675K	0.7%	0.0%
\$675K-1M	0.7%	0.0%
\$1-2.5M	3.9%	1.3%
\$2.5-5M	16.7%	21.6%
\$5-10M	32.3%	36.6%
\$10-20M	40.3%	43.6%
\$20-50M	44.1%	47.5%

\$50M or more	44.7%	49.4%
All	4.3%	4.3%

Table A15: Number of 2009 Heirs and Donors Burdened by Estate Tax and Proposal

	Total	Burdened by Estate Tax	Percent Burdened by Estate Tax	Burdened by Proposal	Percent Burdened by Proposal	Burdened by Both
Heirs	4,748,291	21,519	0.45%	12,972	0.27%	7,972
Estates	2,685,636	6,795	0.25%	9,399	0.35%	n/a

Table A16: Correlation between Average Tax Rate on Inheritances of Individual Heirs under Estate Tax and Proposal

Unweighted	0.33
Weighted by Inheritance Size	0.71

Table A17: Average Change in After-Tax Income of Winners and Losers by Economic Income

Economic Income	Number of Winners (Less Liability Under Proposal)	Number of Losers (More Liability Under Proposal)	Average Change for Winners	Average Change for Losers
\$0+-10K	38	0	21,161	-
\$10-20K	153	0	15,081	-
\$20-30K	252	0	53,269	-
\$30-40K	449	0	56,248	-
\$40-50K	717	0	32,843	-
\$50-75K	1,591	0	81,668	-
\$75-100K	1,047	0	124,603	(38,082)
\$100-200K	6,816	1,622	192,057	(141,002)
\$200-500K	5,094	4,513	266,825	(397,056)
\$0.5-1M	1,425	1,215	293,572	(578,976)
\$1-5M	733	741	294,709	(826,066)
\$5M+	43	68	445,300	(4,556,747)
Total	18,359	8,160		

Table A18: Average Change in After-Tax Income of Winners and Losers by Inheritance Size

Inheritance Size	Number of Winners	Number of Losers	Average	Average
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	(Less Liability Under Proposal)	(More Liability Under Proposal)	Change for Winners	Change for Losers
\$0+-50K	51	0	11,669	-
\$50-100K	370	0	18,664	-
\$100-250K	961	0	29,867	-
\$250-500K	3,408	0	48,838	-
\$500-675K	1,599	0	99,854	-
\$675K-1M	1,647	0	152,997	-
\$1-2.5M	7,455	3,568	261,123	-140,354
\$2.5-5M	2,075	2,975	373,464	-537,034
\$5-10M	593	1,067	414,349	-681,659
\$10-20M	197	314	331,414	-917,584
\$20-50M	3	169	165,443	-1,049,493
\$50M or more	0	67	-	-5,310,693
Total	18,359	8,160		

Appendix C: Wealth Transfer Taxes Cross-Nationally

Country	Donor Pays from After-Tax Income	Other Tax on Donor or Donee	Inclusion Tax		Accessions Tax		Estate and Gift Tax		Rate Varies by Relationship	Aggregation Period & Unit	Treatment of Accrued Gains	
			Gifts	Bequests	Gifts	Bequests	Gifts	Bequests			Gifts	Bequests
Australia	Y	N	N	N	N	N	N	N	N		Realization	Carryover
Austria	Y	Y	N	N	Y	Y	N	N	Y	Over 10 years by Donor		
Belgium	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
Bulgaria	Y	Y	N	N	Y	Y	N	N	Y			
Canada	Y	N	N	N	N	N	N	N	N		Realization	Realization
Czech Rep.	Y	Y	N	N	Y	Y	N	N	Y	Annually by Relationship		
Denmark*	Y	Y	Y	N	Y	Y	N	Y	Y	Annually by Donor if Gift, Relationship if Bequest		
Estonia	Y	N	N	N	N	N	N	N	N			Realization
Finland	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
France	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		Step-Up
Germany	Y	Y	N	N	Y	Y	N	N	Y	Over 10 years by Donor		Carryover
Greece	Y	Y	N	N	Y	Y	N	N	Y			
Hungary	Y	Y	N	N	Y	Y	N	N				
Iceland	Y	Y	Y	N	N	Y	N	N	N	Annually by Donor		
Italy	Y	N	N	N	N	N	N	N	N			
Ireland	Y	Y	N	N	Y	Y	N	N	Y	Over Life by Relationship	Realization	Step-Up
Japan*	Y	Y	N	N	Y	Y	N	N	N	Annually from All for Gifts, Relationship for Bequests	Carryover	Carryover
Korea	Y	Y	N	N	Y	Y	N	N	N	Annually by Donor		
Lithuania	Y	Y		N	N	Y	N	N	N	Annually from All		
Luxembourg	Y	Y	N	N	Y	Y	N	N	Y			
Mexico	Y	N	N	N	N	N	N	N	N			
Netherlands	Y	Y	N	N	Y	Y	N	N	Y		Carryover	Carryover
New Zealand	Y	N	N	N	N	N	N	N	N			
Norway	Y	Y	N	N	Y	Y	N	N	Y	Over Life by Donor		
Poland	Y	Y	N	N	Y	Y	N	N	Y	Over 5 Years by Donor		
Portugal*	Y	Y	N	N	Y	Y	Y	Y	Y	Over Life from All		
Russia*	Y	Y		N	N	N	N	N	N			
Serbia	Y	Y	N	N	Y	Y	N	N	Y			
Slovak Rep.	Y	N	N	N	N	N	N	N	N			
Slovenia	Y	Y	N	N	Y	Y	N	N	Y			
Spain*	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
Sweden	Y	N	N	N	N	N	N	N	N		Carryover	Carryover
Switzerland*	Y	Y	N	N	Y	Y			Y	Annually		
Turkey	Y	Y	N	N	Y	Y	N	N	Y			
U.K.	Y	Y	N	N	N	N	N	Y	N	Annually from All	Realization	Step-Up

U.S.	Y	Y	N	N	N	N	Y	Y	N	Over Life from All	Carryover	Step-Up
<p>* Denmark has an inclusion tax for gifts from relatives and requires income inclusion for gifts from non-relatives. It applies a hybrid estate / inheritance tax bequests, where the estate is taxed and there is an additional tax on bequests to heirs who are not lineal relatives or children-in-law. Japan provides exemption per estate and per statutory (not actual) heir, making it a hybrid estate/inheritance tax. Portugal does not tax gifts and bequests to lineal relatives. All others are subject to a flat wealth transfer tax, which is simultaneously an inheritance and an estate tax. Russia requires inclusion only for gifts to non-relatives. Spain also imposes a progressive surtax based on the wealth of the donee. In Switzerland, it varies by canton whether the wealth transfer tax is an estate or inheritance tax.</p>												