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Estate Tax Reform: Issues and Options

By Lily L. Batchelder

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A. Introduction

The federal estate tax has been a fixture of the tax system since 1916. Together with the gift tax, it has been a relatively stable revenue source, generally raising between 1 percent and 2 percent of federal revenues. In 2007 the estate and gift taxes raised \$26 billion.¹ Nevertheless, in 2001 opponents of the estate tax succeeded in repealing it in a bizarre way. The estate tax is scheduled to disappear in 2010 and then return one year later. This situation is untenable, creating vast uncertainty and gruesome incentives for prospective heirs. Observers expect the Obama administration and Congress to act swiftly to prevent this sequence of events from taking place.

The immediate need for legislative action is unfortunate, but it has a silver lining in that it creates a window of opportunity to reconsider the taxation of wealth transfers. This article is intended to inform those efforts, and makes three main points:

- First, inheritances magnify economic disparities and are probably the largest barrier to achieving a different standard of living from one's parents. While inherited income is distributed fairly evenly across most of the income distribution, the amount inherited rises sharply at the very top. The amount

inherited is also highly correlated with one's parents' position on the economic ladder. Inheritances therefore limit intergenerational economic mobility by providing an important safety net and source of income that is unrelated to work efforts.

- Second, the estate tax is critical for the fairness of the tax system overall because it mainly burdens very high-income heirs, and partially offsets tax advantages accorded to them elsewhere. The income tax and payroll tax effectively apply zero or negative tax rates to inherited income because of the step-up in basis and exemptions for inherited income. Thus, absent the estate tax, all inherited income would be taxed at much lower rates than income from work and savings. The estate tax reduces those tax advantages, especially among high-income and high-inheritance heirs. In doing so, it mitigates the effect of inheritances on economic disparities and intergenerational mobility. It is also a relatively efficient source of revenue.
- Finally, the upcoming need for reform creates an opportunity to better focus the estate tax system on the otherwise untaxed — and potentially subsidized — income that inheritances represent. Policymakers should use this opportunity to strengthen the system so that it continues to tax inherited income, but in a more equitable manner. One option is to retain the estate tax, but enact a package of simplification reforms that would limit the extent to which heirs' tax burdens depends on their access to sophisticated tax advice. A second, more ambitious but workable option is to replace the estate tax system with an inheritance tax that would more effectively level the playing field between income that is personally earned and extraordinary amounts of inherited income.

Section B of this paper provides some background on the magnitude and effects of wealth transfers. Section C reviews the tax treatment of wealth transfers. Section D summarizes its distributional and efficiency effects. Section E discusses options to improve the equity and efficiency of the current system, and Section F concludes.

B. Magnitude and Effects of Wealth Transfers

In 2009 annual bequests will total about \$410 billion, excluding transfers to spouses and charitable organizations.² The expected flow of gifts is unclear, but it should be a small fraction of this amount.³ To give a sense of the

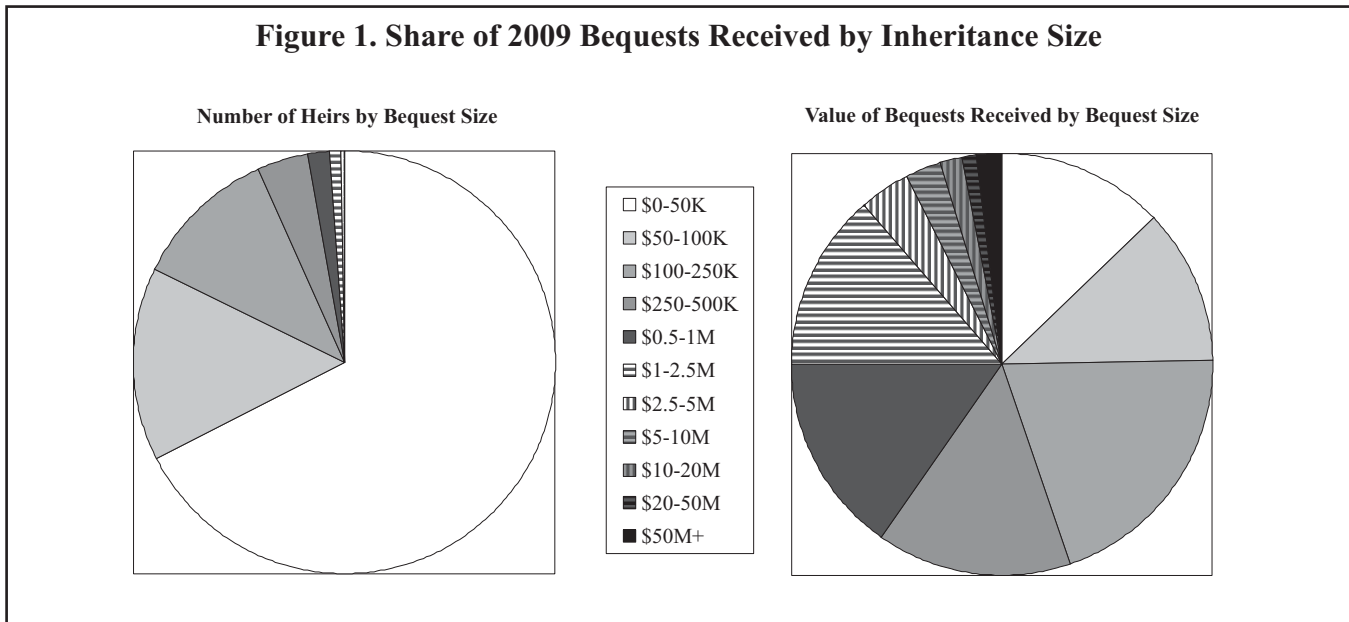
²Unless otherwise noted, all estimates in this article are based on 2009 law and data, and are derived from Lily L. Batchelder and Surachai Khitatrakun, "Dead or Alive: An Investigation of the Incidence of Estate Taxes Versus Inheritance Taxes" (work in progress), or Batchelder, "Reform Options for the Estate Tax System: Targeting Unearned Income," Testimony Before the United States Senate Committee on Finance (Mar. 12, 2008). The estimates are very rough because of data limitations that require multiple levels of imputation and because they rely in part on data from 1992.

³See, e.g., David Joulfaian and Kathleen McGarry, "Estate and Gift Tax Incentives and *Inter Vivos* Giving," 57 *Nat'l Tax J.* 429, 439, table 5 (June 2004); and Internal Revenue Service, Statistics

(Footnote continued on next page.)

¹Office of Management and Budget, Budget of the United States Government, FY2008.

Figure 1. Share of 2009 Bequests Received by Inheritance Size



relative size of wealth transfers, \$410 billion represents about 4 percent of all household income, and about half of the income of households that will receive a bequest in that year. Gifts and bequests are also an important determinant of household wealth, representing between 35 percent and 45 percent of household net worth.⁴

Gratuitous gifts and bequests (referred to as inheritances) tend to magnify disparities in economic opportunities and outcomes in several ways. Inheritances are distributed very unequally. Data on lifetime inheritances are limited, but existing evidence suggests that about 40 percent of individuals never receive a bequest,⁵ and about two-thirds never receive a substantial gift.⁶ Moreover, among those lucky enough to receive an inheritance, the amount inherited varies widely. As illustrated in Figure 1, about two-thirds of bequest recipients in 2009 will inherit less than \$50,000. However, the top 1 percent will inherit more than \$1 million (often much more), or about a quarter of the value of all bequests.⁷

Those disparities in inherited income tend to magnify economic disparities overall because the amount inher-

ited is highly correlated with the recipient's other income and underlying earning ability. As illustrated in Figure 2, lifetime inheritances are somewhat evenly distributed among the roughly 96 percent of households with economic incomes of less than \$200,000.⁸ But the average bequest increases rapidly with economic income thereafter. As a result, the average lifetime inheritance among households with economic income of more than \$200,000 is more than 10 times higher than it is for all others.⁹

Inheritances further exacerbate economic disparities because they are probably the most important barrier to

of Income Division, *Estate Tax Returns Filed in 2006 by Tax Status and Size of Gross Estate* (Oct. 2007).

⁴James B. Davies and Anthony F. Shorrocks, "The Distribution of Wealth," in *Handbook of Income Distribution* (Anthony B. Atkinson and Francois Bourguignon, eds.) (2001); and Wojciech Kopczuk and Joseph P. Lupton, "To Leave or Not to Leave: The Distribution of Bequest Motives," 74 *Rev. Econ.* 207, note 2 (2007).

⁵See, e.g., Michael D. Hurd and James P. Smith, "Expected Bequests and Their Distribution," 9 (Nat'l Bur. Econ. Research Working Paper 9142, 2002).

⁶See, e.g., Michael Hurd, James P. Smith, and Julie Zissimopoulos, "Inter-Vivos Giving Over the Life Cycle," 1-2 (RAND working paper, Oct. 2007).

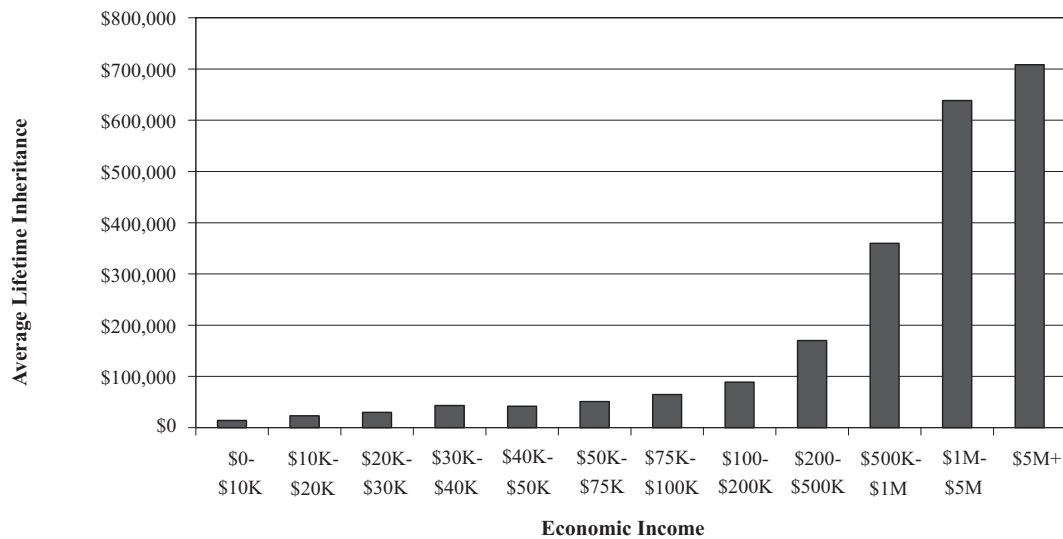
⁷This group will also probably inherit relatively more in the future because the more one has inherited in the past, the more likely one is to inherit in years to come. See, e.g., Hendrik Jürges,

(Footnote continued in next column.)

"Gifts, Inheritances and Bequest Expectations," in *The Survey of Health, Ageing and Retirement in Europe* 189 (Axel Börsch-Supan et al., eds., 2005).

⁸Economic income is defined as annual income from labor and savings plus the annuitized value of any bequest received over the recipient's remaining life expectancy.

⁹This discussion assumes that one is interested in disparities in the amount, not the share, of potential income. If instead one is interested in the share, it is unclear what effect inheritances have on economic disparities. The estimates underlying Figure 2 suggest that the percentage of income that is inherited tends to decline as income rises, and that inheritances tend to reduce disparities in the share of income received. However, those estimates systematically understate the inheritances of the most affluent heirs. For example, they do not include gifts, multiple bequests, or accrued gains, all of which are highly concentrated among those receiving the largest inheritances, and thus the most affluent. See, e.g., Joulfaian and McGarry, *supra* note 3, table 3. Heirs receiving unusually large inheritances also tend to work less or retire early in response. See, e.g., David Joulfaian, "Inheritance and Saving" (Nat'l Bur. of Econ. Research Working Paper No. 12569) (Oct. 2006); Jeffrey R. Brown et al., "The Effect of Inheritance Receipt on Retirement" (Nat'l Bur. of Econ. Research Working Paper No. 12386) (July 2006). Finally inheritances are a strong proxy for underlying earning ability of the recipient. Thus, under a more accurate measure of economic status, inheritances probably magnify disparities in the share of actual and imputed income received as well.

Figure 2. Rough Distribution of Average Lifetime Inheritance by Economic Income

intergenerational economic mobility. The United States has one of the lowest levels of economic mobility among developed countries, meaning that an individual living here is much less likely to achieve a different standard of living than that of his parents.¹⁰ Barriers to intergenerational mobility are especially high at the ends of the income distribution.¹¹ For example, individuals born into the top decile of the income distribution are, on average, 53 times more likely to end up in the top decile than those born in the bottom.¹²

Inheritances contribute to these economic rigidities because they provide an important source of income that is correlated with one's parents' position on the economic ladder, but unrelated to one's own efforts. Moreover, inheritances can have important effects on mobility even before the time of receipt. The mere knowledge of how much one is likely to inherit presumably restricts mobility because those anticipating large (or small) inheritances feel more (or less) comfortable taking risks, knowing that they do (or don't) have family members on whom they can rely financially if the risks they take do not pan out. These differences should in turn affect lifetime earnings — for example by influencing whether

individuals invest in higher education or become bankrupt at some point during their life.¹³

Recent evidence suggests that inheritances are indeed a crucial determinant of the relatively low levels of intergenerational economic mobility in the United States. The high correlation between parent and child income is partially attributable to many factors that are difficult to change, such as the correlation between parent and child IQ, personality, and schooling.¹⁴ But the evidence suggests that inheritances are the most important cause, outweighing all of those other factors combined.¹⁵

In short, if we could do only one thing to break down the remaining elements of a hereditary class structure in the United States, the most effective approach would be to reduce the role of inheritances in perpetuating it. Those unique effects, and the others described above, suggest that we shouldn't disregard extreme differences in inherited income through estate tax repeal. Instead, we should pay particular attention to extraordinarily large inheritances when allocating tax burdens.

¹⁰OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries 205*, figure 8.1 (2008).

¹¹Bhashkar 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).

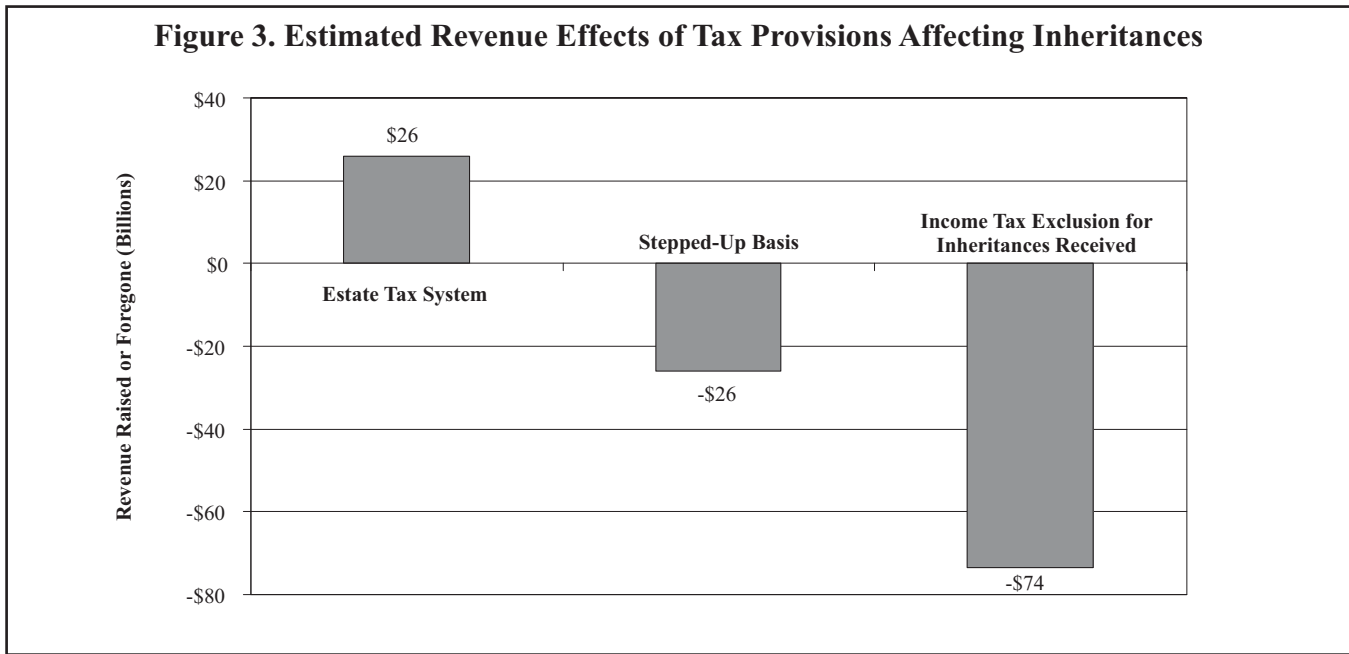
¹²Tom Hertz, "Rags, Riches and Race: The Intergenerational Economic Mobility of Black and White Families in the United States," in *Unequal Chances: Family Background and Economic Success* 165, 184.

¹³See Philip Oreopolous et al., "The Intergenerational Effects of Worker Displacement," 16 (Nat'l Bureau of Econ. Research, Working Paper No. 11,587, 2005) (finding in Canada that parental job loss results in children earning substantially less than similar children whose fathers did not experience an employment shock).

¹⁴Samuel Bowles et al., "Introduction" 1, 18-19, in *Unequal Chances: Family Background and Economic Success* 1, 20, note 11 *supra*.

¹⁵Thomas Piketty, "Theories of Persistent Inequality and Intergenerational Mobility," in *Handbook of Income Distribution* sections 2.1, 3 (A. Atkinson and F. Bourguignon, eds., 2001); Mazumder, *supra* note 11.

Figure 3. Estimated Revenue Effects of Tax Provisions Affecting Inheritances



C. Design of Taxes on Wealth Transfers

All societies necessarily shape the intergenerational transmission of wealth, whether through the law governing trusts and estates, or through the tax system. The federal tax system does so by taxing inheritances much more lightly than income from work and saving. There are three important ways in which the federal tax system treats inheritances differently than other kinds of income.

First, some inheritances are taxed under the estate tax system, which is composed of three interconnected taxes. The estate tax is the principal tax, and was enacted shortly after the income tax in 1916. As of 2009, it taxes lifetime gifts and bequests transferred in excess of \$3.5 million (\$7 million per couple) at a 45 percent rate. It is supplemented by the gift tax and the generation-skipping transfer tax, which limit estate tax avoidance through transfers made during life and transfers made directly to one’s grandchildren, respectively. Presently, the gift tax applies a rate of 41 percent to 45 percent to gifts exceeding \$1 million over the donor’s lifetime. Meanwhile, the GST tax imposes a second layer of tax on transfers exceeding \$1 million that are made to those two or more generations younger than the donor. All three taxes permit donors to disregard \$12,000 of gifts made to a given heir each year (\$24,000 for a married couple) so that those gifts do not count toward the lifetime exemptions. All three also partially exempt some transfers of family businesses, and fully exempt transfers to spouses and charities, gifts used for education and medical expenses, and basic support payments for dependent children.

The second way that inherited income is treated differently is that it is tax exempt under income and payroll taxes. Some view this exclusion of inherited income from the tax base of heirs as indirectly compensating donors for the fact that they do not receive a deduction for gifts and bequests they make. But the better view is that it is a tax preference. Generally the

income and payroll taxes do not provide deductions for personal expenses on the theory that tax burdens should be allocated based on the amount of money that one can choose how to spend.¹⁶ Extraordinarily large gifts and bequests to adult children represent such a choice, and thus are personal, not business, expenses.

Finally, inheritances consisting of appreciated property are effectively subsidized relative to other types of income under the income tax. Appreciated assets gifted during life receive a carryover basis and bequests receive a stepped-up basis. As a result, not only does the income tax exempt the inherited income of heirs, but it substantially reduces the accrued income tax owed by donors on appreciated assets that are gifted, and forgives this tax entirely in the case of appreciated assets that are bequeathed.

The net effect of those special provisions governing wealth transfers is that inherited income is subject to a zero effective tax rate, meaning that it is heavily subsidized relative to other kinds of income. As illustrated in Figure 3, in 2007 the estate tax system raised about \$26 billion.¹⁷ But recent estimates suggest that the step-up in

¹⁶Exceptions to this general rule are typically categorized as tax expenditures, and akin to a subsidy through a direct spending program.

¹⁷Office of Management and Budget, *Historical Tables, Budget of the United States Government*, FY2008, table 2.5 at 45 (2008). Repeal of the estate tax would likely lose significantly more revenue because the estate tax serves as an important backstop to the income and gift taxes. The Joint Committee on Taxation estimates that estate tax repeal would also lead to income and gift tax revenue losses. See Joint Committee on Taxation, “History, Present Law and Analysis of the Federal Wealth Transfer Tax System” (JCX 108-07) (Nov. 13, 2007), *Doc 2007-25286*, 2007

(Footnote continued on next page.)

Table 1. Studies of Share of Wealth Transfers Attributable to Different Wealth Accumulation Motives

Study	Accidental	Egoistic	Compensatory	Altruistic
Kotlikoff and Summers (1981)	19%		81%	
Hurd (1987)	Most Bequests		Minority of Bequests	
Modigliani (1988)		>80%		<20%
Hurd (1989)	Most		Small	
Bernheim (1991)		<70%-84%		>16%-30%
Altonji et al. (1992)		Most		Model Rejected
Wilhelm (1996)		Most		Little Evidence
Laitner and Juster (1996)		77%-82%		18%-23%
Laitner and Ohlsson (2001)		Most		Some Evidence
Dynan et al. (2002)		Most		<8%
Hendricks (2002)	>47%		<53%	
Page (2003)	Not All		Some	
Li Gan (2004)	Very Large Share			Small
Kopczuk and Lupton (2007)	47%	53%, Mostly Egoistic		

basis costs roughly \$26 billion in forgone revenue,¹⁸ and the income tax exemption for inherited income costs on the order of \$70 billion.¹⁹ Thus the cost of tax preferences accorded to inheritances in the income tax alone appears to swamp the revenue raised by the estate tax system. Those are overall effects. We now turn to understanding the effects of the estate tax system specifically.

D. Effects of the Estate Tax System

1. Advantages. The estate tax system has a number of important advantages, the first being that it is a relatively efficient source of revenue. All taxes generate efficiency losses to the extent that taxpayers alter their behavior in negative ways in response. In the case of wealth transfer taxes, any negative response is largely determined by the donor's motive for accumulating the funds that she transfers. Heirs may respond to such a tax by working or saving more but, if they do, that improves efficiency. Thus, the only potential negative behavioral response is if the donor reduces the amount she earns, saves, or gives. She will do so, however, only to the extent that she accumulated the wealth in order for her heirs to receive it. If she accumulated it for other reasons, she will not change her behavior and wealth transfer taxes will generate no efficiency losses (and might create efficiency gains).

Existing evidence suggests that most wealth transfers stem from this second category of wealth accumulation motives, and that wealth transfer taxes generate relatively few efficiency costs. As illustrated in Table 1, it appears that about 20 percent of wealth transfers are altruistically motivated, meaning that the donor saved the funds transferred because she wanted her beneficiaries to receive that portion of her savings. But the lion's

share appears to stem from the donor saving for reasons unrelated to how much her heirs will receive. Indeed, those studies suggest that about half of wealth transfers stem from the donor saving to insure against future risks, such as outliving one's savings or incurring uncovered healthcare costs in retirement (referred to as life cycle savings or accidental bequests). The remainder appears to result mostly from egoistic wealth accumulation, when the donor accumulated the funds simply because she enjoyed working or being known as wealthy. The surprisingly small role of altruism in generating wealth transfers is further confirmed by evidence that donors curtail wealth transfers only to a limited degree in response to wealth transfer taxes, and possibly not at all.²⁰ Thus, existing evidence implies that wealth transfer taxes are a relatively efficient source of revenue because they generate little or no negative behavioral responses.²¹

The second and perhaps more important advantage of the estate tax system is that it is critical to the fairness of the tax system as a whole. The estate tax system predominantly burdens very wealthy heirs, not donors. In doing so, it partially offsets the income and payroll tax advantages accorded to inherited income, especially among high-income and high-inheritance heirs. It also tends to mitigate the effect of inheritances on economic disparities and intergenerational mobility.

²⁰See, e.g., David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," 59 *Nat'l Tax J.* 253 (June, 2006); and 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).

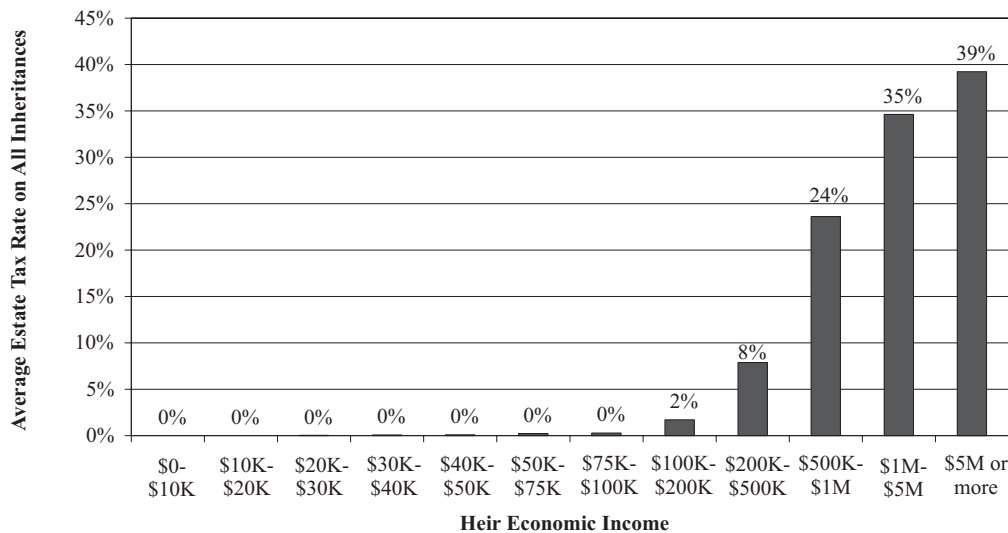
²¹Any positive behavioral response by heirs also appears to be small. See, e.g., Joulfaian, *supra* note 9; Jeffrey R. Brown et al., *supra* note 9; Jacob Mikow and Darien Berkowitz, "Beyond Andrew Carnegie: Using a Linked Sample of Federal Income and Estate Tax Returns to Examine the Effects of Bequests on Beneficiary Behavior" (Statistics of Income, Internal Revenue Service, 2000); and Douglas Holtz-Eakin et al., "The Carnegie Conjecture: Some Empirical Evidence," *Q. J. Econ.* 413 (May 1993).

TNT 220-13; and Nona A. Notto, "Estate and Gift Tax Revenues: Past and Projected," 13 (Congressional Research Service Report, Aug. 24, 2007).

¹⁸Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012" (Oct. 31, 2008).

¹⁹Batchelder and Khitatrakun, *supra* note 2.

Figure 4. Average 2009 Estate Tax Rate on All Inheritances by Heir Economic Income



The reasons why the estate tax predominantly burdens heirs relate to the reasons why it is a relatively efficient tax. Donors are burdened by wealth transfer taxes only to the extent that they care how much their beneficiaries receive. As discussed, this is not donors' primary or usual motive for saving most of the funds they transfer. Moreover, even when a donor does care how much her heirs receive, she is burdened by a wealth transfer tax only to the extent that she values transferring the wealth to her heirs more than she values spending it on herself. Heirs, by contrast, are typically burdened by the entire estate tax remitted on amounts they inherit, plus any reduction in the amount donors give them on a pretax basis in response to the tax.²²

Most distributional estimates of the estate tax system historically have found that it is highly progressive on the assumption that it burdens donors, not heirs. This assumption has been because of limited data on the financial circumstances of heirs, and not any deeply held conviction among economists that donors bear most of the tax burden. This article therefore summarizes the distributional effects of the estate tax system on the assumption that it predominantly burdens heirs instead.

²²As an example, suppose a mother would like to bequeath \$10 million to her only son. If a flat 33 percent estate tax is enacted, she has three options. She can transfer the same amount as planned, leaving her son with \$6.7 million after tax. She can consume less and save more, leaving her son with a smaller after-tax inheritance. Or she can consume more and save less, leaving him with a larger after-tax inheritance. In reality, she is most likely to adopt the first or second strategy, given that donors appear to transfer the same amount or slightly less in response to the estate tax. Thus, the burden her son bears will be at least \$3.3 million (the tax remitted) plus any reduction in his pretax inheritance.

On this assumption, the estate tax system is somewhat less progressive than if the burden falls entirely on donors, but it is still highly progressive. As illustrated in Figure 4, the effective estate tax rate on heirs with less than \$200,000 of economic income is close to zero, but it rises rapidly thereafter. The estate tax system reduces the extent to which inheritances widen economic disparities by taxing high-income heirs much more heavily.

The estate tax also reduces the negative effect of inheritances on intergenerational mobility. Figure 5 shows that heirs inheriting less than \$2.5 million bear little or no estate tax burden, but those inheriting even larger amounts often face substantial tax burdens. Given that intergenerational mobility is lowest at the ends of the economic distribution spectrum, the estate tax system appears to mitigate the most important contributor to the remaining elements of a hereditary class structure in the United States by reducing extremely large inheritances.

The effects of the estate tax system are especially important because otherwise inheritances that are extremely large would receive the largest subsidies under the income and payroll taxes. As illustrated in Figure 6, the income and payroll tax burden on households generally rises with economic income. Therefore, the income and payroll tax exemptions for inherited income are most valuable for the most affluent heirs. The benefits of stepped-up and carryover basis (which are not included in Figure 6) are also much more valuable for them.²³

The estate tax system steps in to partially offset these tax preferences among high-income heirs. Figure 6 shows

²³Untaxed appreciation represents about 35 percent of the value of all bequests and about 55 percent of the value bequests exceeding \$10 million. James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in *Rethinking Estate and Gift Taxation*, 439-440, William G. Gale, et al., eds., 2001).

Figure 5. Average 2009 Estate Tax Rate on All Inheritances by Inheritance Size

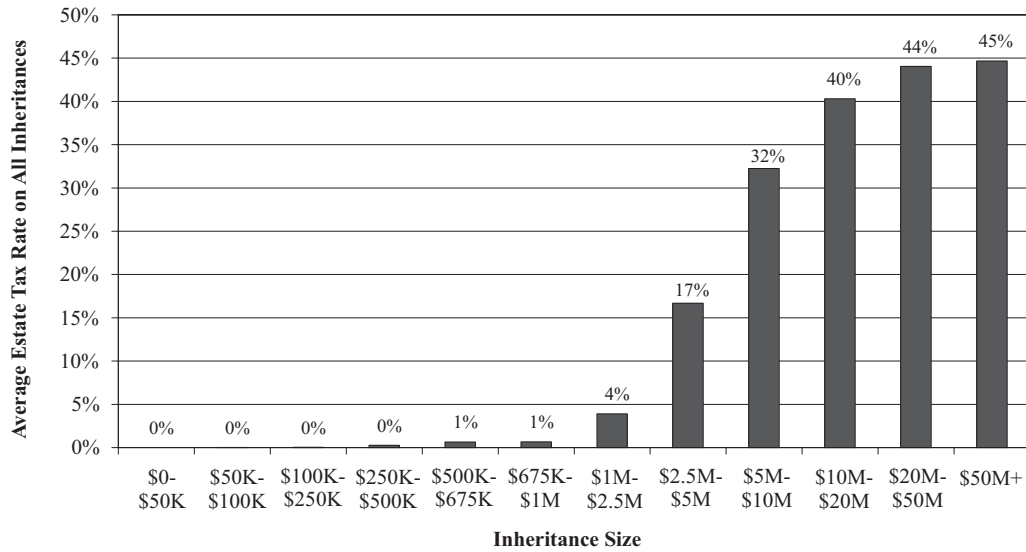
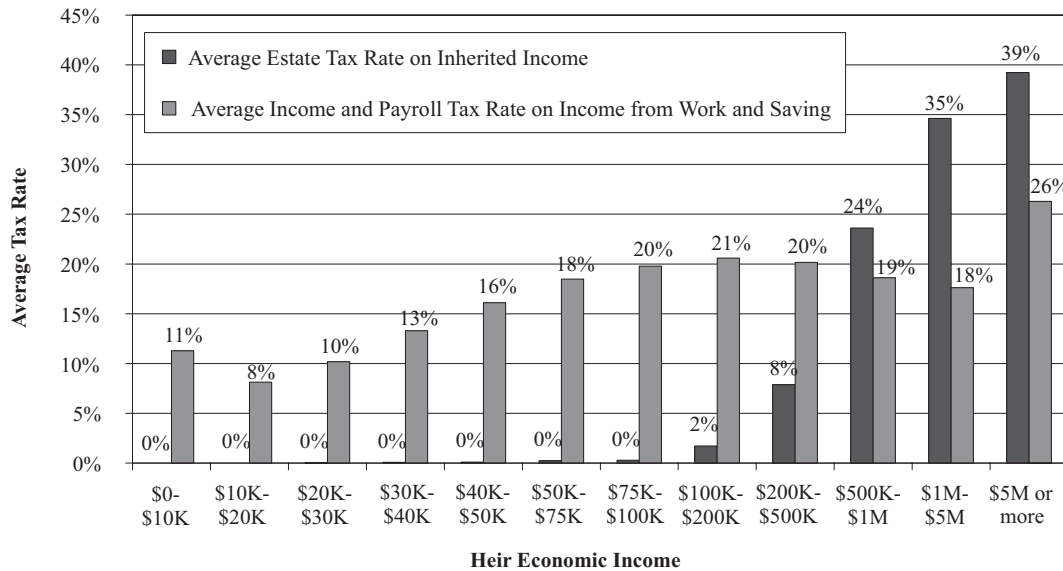


Figure 6. Average 2009 Estate Tax Rate on All Inherited Income and Income and Payroll Tax Rate on Income From Work and Saving by Economic Income



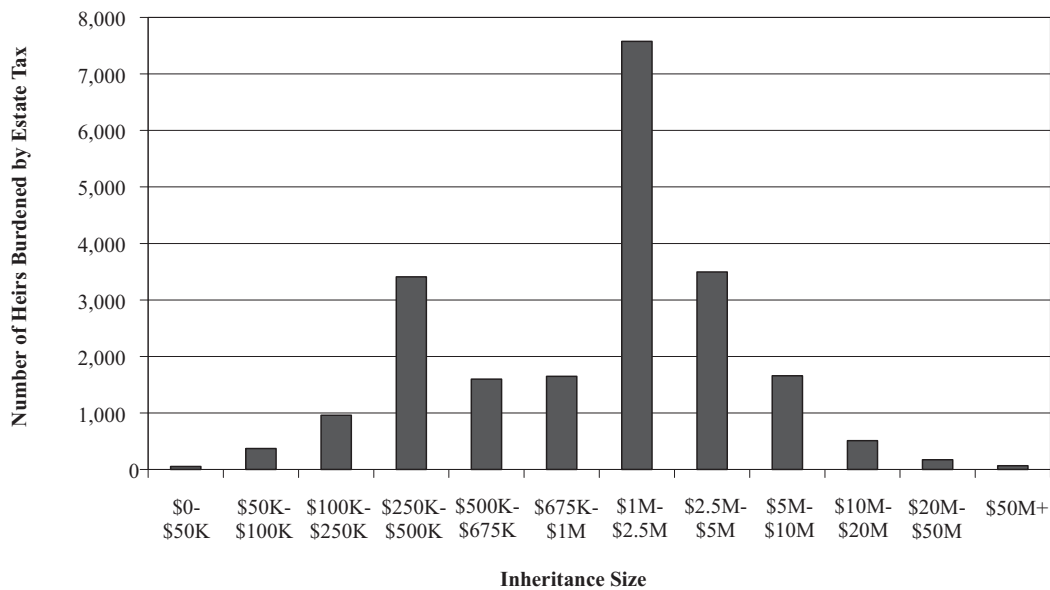
Note: Figure 6 somewhat overstates the income and payroll tax rates of low-income households because the income tax rate included is always non-negative.

that it more than fully offsets the income and payroll tax exclusions for inherited income among households with economic income in excess of \$500,000. This is the case because the estate tax rate on inherited income is higher than the income and payroll tax rate on earned income among those households. Once stepped-up basis and carryover basis are taken into account, however, the estate tax may only partially offset these tax preferences.

For example, if untaxed appreciation represents 55 percent of the value of the inheritances of high-income heirs (the average for large bequests),²⁴ then the average tax

²⁴*Id.*

Figure 7. Number of Heirs Burdened by 2009 Estate Tax by Inheritance Size



rate on inherited income should fall by roughly 8 percentage points if the appreciation represents long-term capital gains, and by 14 percent if it represents ordinary income. Households that are less affluent, meanwhile, effectively retain most or all of the value of the income tax and payroll tax preferences for their inheritances.

The estate tax system plays a critical role in leveling the playing field between inherited income and income that is personally earned among extremely high-income and high-inheritance heirs. Given that those are precisely the individuals whose economic status is most influenced by the family into which they are born, it also plays a key role in furthering the American dream that anyone can succeed — and that the rewards of society should not depend on where one is from.

2. Shortcomings. Despite those substantial advantages, the estate tax system is not a perfect tax and could be improved. First, as discussed below, it entails a fair amount of unnecessary complexity, and its effects are not transparent.

Second, it should be expanded to raise a larger share of revenue. As discussed above, inheritances generally are subsidized relative to earned income by the tax system as a whole. The estate tax system only reduces these subsidies for extraordinarily large inheritances and, even for those large inheritances, it may only partially offset them.

From an equity perspective, however, unusually large amounts of inherited income *should* be taxed more heavily than other types of income, given the indirect information they provide about how well-off an individual is. Doing so would also improve the efficiency of the tax system overall. The traditional tension between fairness and efficiency may not exist for taxing wealth transfers, and both objectives could be served by increas-

ing the share of revenue raised by wealth transfer taxes and reducing the share raised by taxes on income that is personally earned.

The final shortcoming of the estate tax system is that while it clearly enhances the fairness of the tax system in aggregate, it does so imprecisely at an individual level. Figures 7 and 8 illustrate this point. They show that about 37 percent of heirs who are burdened by the estate tax have inherited less than \$1 million, but about 70 percent inheriting more than \$1 million bear no estate tax burden. Admittedly, inheritances of less than \$1 million account for only 4 percent of estate tax revenue. Nevertheless, the point remains that many low-income and low-inheritance heirs are burdened by the estate tax to some degree, while many heirs who are much better off are not.

The source of those individual-level inequities is the fact that the estate tax applies to the amount transferred rather than the amount received. The relationship between the tax rate and the heir’s financial circumstances is therefore imprecise because the two are linked only indirectly. In fact, somewhat surprisingly, estate size is not a very good proxy for inheritance size, as shown in Figure 9.²⁵ This divergence does not appear to be driven by parents treating children differently. Instead, it is largely driven by the fact that donors have different numbers of children, and a substantial share have none. The net result of those varied giving patterns, is that the estate tax system provides a “rough justice” approach to

²⁵The correlation is only 0.66, which is relatively small. It remains surprisingly low at 0.83 if the data are weighted by inheritance size.

Figure 8. Percentage of Heirs Burdened by 2009 Estate Tax by Inheritance Size

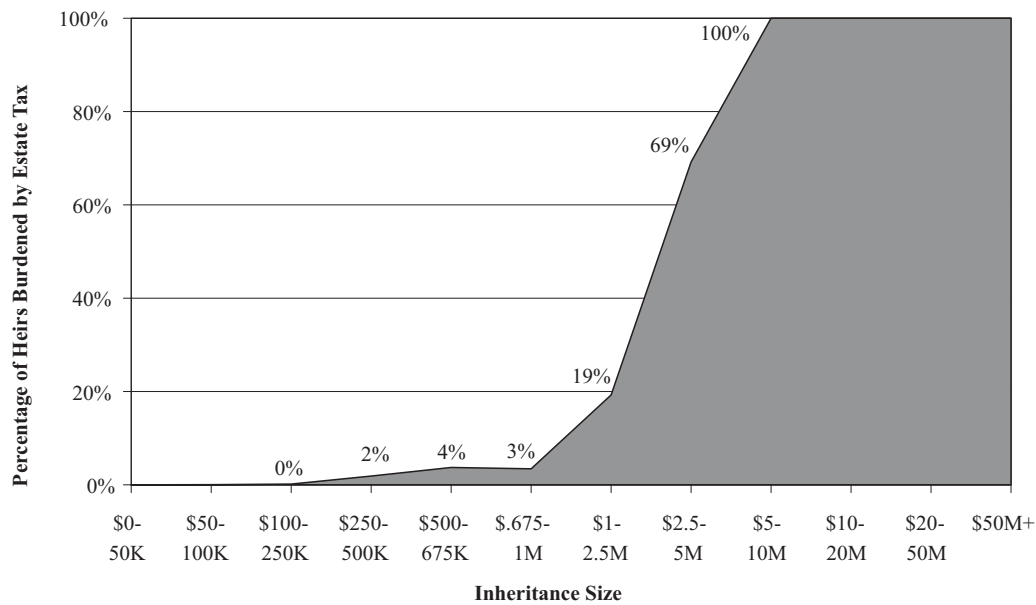
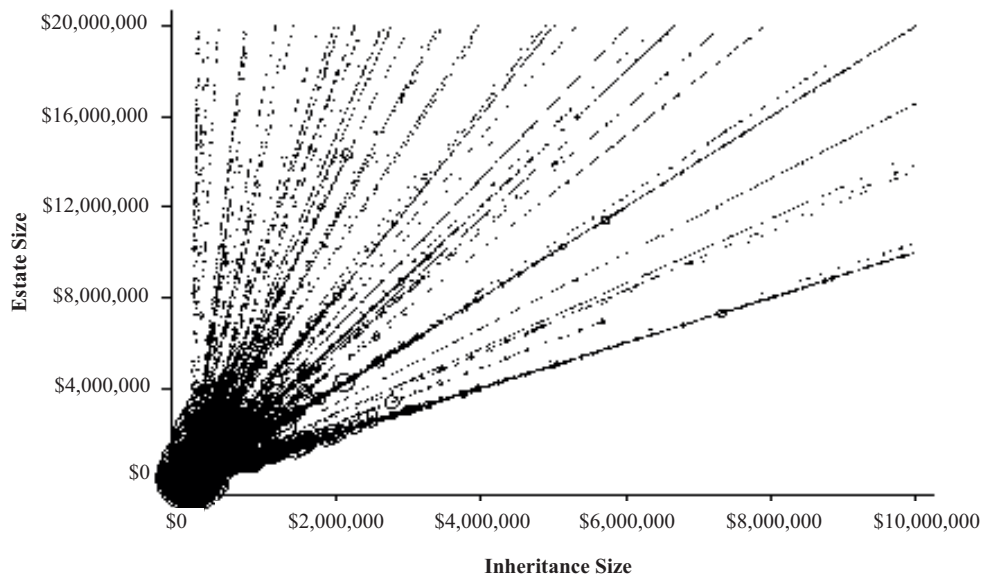


Figure 9. Inheritance Size Versus Donor's Taxable Estate Size



Note: To improve readability, current inheritance amounts exceeding \$10 million and taxable estates larger than \$20 million are excluded. The taxable estate is the gross estate before taxes but after spousal and charitable transfers and other expenses.

mitigating the tax subsidies for inheritances among high-income heirs receiving extremely large inheritances. But it systematically misallocates fiscal burdens in individual cases.

E. Options for Reform

The goal of any reform of the estate tax system should be to address those shortcomings, principally by more

effectively allocating tax burdens based on an individual's economic status, including whether he has received an extraordinarily large inheritance and the accompanying extraordinarily large tax subsidies. Doing so would ensure that the estate tax system is based on the ability to pay of the person who actually bears the tax: the heir. It would also improve the fairness of the tax system as a

	Tax Rate		Exclusions			Basis Provisions
	Estate & GSTT	Gift	Annual Gifts	Lifetime Estate & GSTT	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 \$4.3 million capital gains.
2011 onward	41-55%		\$12,000	\$1 million		Gifts: carryover bequests: stepped-up

*The annual gift tax exclusion is inflation-adjusted so it may rise above \$12,000 after 2008. In 2011 and beyond, for estates between \$1 million and \$3 million, the marginal tax rate will rise from 41 percent to 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. For larger estates, the marginal tax rate remains 55 percent.

whole by more effectively mitigating the barriers to intergenerational economic mobility that extremely large inheritances create.

As illustrated in Table 2, over the next several years, the estate tax is scheduled to decline in 2009, disappear in 2010, and then return to life with a much lower exemption and higher rate in 2011 and thereafter. Stepped-up basis is also scheduled to partially disappear in 2010 and then return in 2011. The net result is sharp changes in the law, vast uncertainty for taxpayers, and gruesome incentives for prospective heirs on the eve of 2011. This untenable situation does, however, create a window of opportunity for reform. This section discusses two general options for improving the current system.

1. Estate tax stabilization and simplification. The first option is to retain but rationalize the current estate tax system by resolving discontinuities in the law and adopting a package of simplification measures. Doing so would better focus the system on the amount transferred, and limit the extent to which tax burdens depend on access to sophisticated tax advice. This, in turn, should make the system better targeted on extremely large inheritances, because the amount a donor transfers is a proxy, albeit an imperfect one, for the amount an heir inherits.

Starting with the objective of smoothing the rate structure over time, ideally a larger share of federal revenue would be raised from wealth transfers than under 2009 estate tax law (the version of the estate tax modeled), as argued above. President Obama has proposed making the 2009 estate tax law permanent, which is expected to raise about \$17.5 billion next year. Doing so would, however, reduce revenues by about \$284 billion over 10 years relative to current law because a lower exemption and higher rate would otherwise apply over most of that period.²⁶

A better alternative is to make the 2008 law permanent. As illustrated in Table 3, this would raise about 50 percent more revenue. Another option, making the 2011 law permanent, would raise almost three times as much.

Estate Tax Law	Exemption (millions)	Rate	Revenue (billions)
2008	\$2.0	45%	\$26.2
2009	\$3.5	45%	\$17.5
2011	\$1.0	41%-55%*	\$50.2

*Phase-out of lower brackets disregarded.

Regardless of the revenue objective adopted, options that maintain or slightly increase the top marginal rate should be preferred to revenue-neutral options that apply lower exemptions and tax rates. A top marginal rate of 45 percent to 50 percent focuses the estate tax on the very wealthiest donors and heirs, limits compliance costs, mitigates barriers to intergenerational mobility more effectively, and ensures that a portion of extraordinarily large inheritances are taxed at rates comparable to those imposed on earned income.

Turning to simplifying the estate tax system, the following three measures are worth consideration. Each can be adopted on a revenue-neutral and distributionally neutral basis, with the rate structure adjusted so that there is no change in the aggregate distribution of estate tax burdens.

a. Spousal transfers. First, policymakers could eliminate the need for careful planning by married couples by permitting a surviving spouse to use any unused lifetime exemption of his or her deceased spouse. Currently spouses can reduce their joint tax liability by making sure that each transfers an amount equal to the lifetime exemption to their heirs, for example through a credit shelter trust. Some well-advised wealthy taxpayers take advantage of this opportunity; others do not. This reform would ensure that wealthy taxpayers pay the same rate on comparable wealth transfers, regardless of whether they are aware of this tax planning opportunity.

b. Harmonize tax treatment of gifts and bequests. Second, policymakers could reduce differences in the effective tax rates that apply to gifts versus bequests. Under current law, in some circumstances gifts are tax advantaged because of the annual gift exclusion, the lack of present value adjustments for gifts and lifetime exemptions, and the fact that gifts are taxed on a tax-exclusive basis, resulting in an effective top marginal rate

²⁶Len Burman et al., "An Updated Analysis of the 2008 Presidential Candidates' Tax Plans: Revised August 15, 2008," at 22 (Tax Policy Center, Sept. 12, 2008).

of 31 percent.²⁷ In other circumstances, however, bequests are tax preferred because of stepped-up basis and the higher lifetime exemption that applies to bequests. Those countervailing incentives create substantial tax planning costs, traps for the unwary, and inequities between similarly situated heirs. They could be mitigated through several changes.

To come close to eliminating differences in the effective tax rate applied to gifts and bequests, a significant set of reforms would be necessary. The annual gift exclusion would have to be lowered in order to limit incentives to set up tax planning vehicles that take advantage of each year's annual exemption, such as *Crummey* trusts. Through those trusts, donors can effectively increase the value of their estate tax exemption by an amount on the order of \$2.5 million.²⁸ The lifetime exemptions would also have to be harmonized, and either those exemptions or the value of gifts would have to be indexed to a market interest rate. Doing so would mitigate incentives to freeze the value of an estate by transferring assets earlier in time to avoid the estate tax (and higher income tax rates) on the assets' appreciation. Estate freezes permit donors to further increase their estate tax exemption by approximately \$11 million.²⁹ Finally, gifts would have to be taxed on a tax-inclusive basis, and carryover basis extended to bequests.³⁰

Weighing against this agenda are compliance costs and political economy concerns. Raising the annual exemption would increase record-keeping burdens for the small number of donors giving more than \$12,000 to an adult who is not using the funds for health or education. Carryover basis for bequests has long been viewed as unadministrable. This impression is somewhat unfair, however, given the peculiar features of the carryover basis regime enacted and repealed in the 1970s,³¹ technological advances in basis tracking, and the fact that Germany, Japan, and Australia have all successfully applied carryover basis to bequests.³² Also, harmonizing the lifetime exemptions and indexing them to a market interest rate carries hidden revenue and equity costs, by running the risk of resulting in much higher lifetime exemptions over time than would otherwise be the case.

A more modest set of reforms worth consideration in this area is to begin taxing gifts on a tax-inclusive basis, harmonize the lifetime exemptions on a nominal (not present value) basis, and index the value of gifts to a market interest rate when calculating estate tax liability.³³ This package would go a long way toward reducing the inequities and inefficiencies that result from the divergent tax treatment of gifts and bequests. Applying carryover basis to appreciated assets that are bequeathed would strengthen such a reform package. It would ensure that all capital income is taxed once, regardless of the donor's familiarity with tax planning techniques. Moreover, any associated increase in compliance costs could be minimized by providing an exception for assets for which the basis would be difficult to obtain.³⁴

c. Treatment of family businesses. Finally, current law could be simplified in the area of the complex relief provisions for family-owned businesses. The rules governing family businesses are both overly generous and overly restrictive. On the one hand, they frequently create an incentive to hold wealth in closely held businesses or transfer liquid assets before death. For example, the tax liability due on some bequests that include a family business can be deferred for 15 years at a below-market interest rate.³⁵ This tax preference is available for many estates that face no liquidity constraints, even absent the provision, because estates composed of up to 65 percent liquid assets can qualify, but the average effective tax rate on taxable estates exceeding \$20 million is only 22 percent.³⁶ On the other hand, the existing rules do not succeed in protecting all family businesses from ever being sold to pay the estate tax, at least at a theoretical level. For example, an heir whose sole inheritance is a closely held business may still not be able to pay the associated estate tax liability after 15 years if the business is unprofitable. (In practice, there is little evidence of family businesses ever being sold to pay the estate tax, but the issue remains important politically.³⁷)

To address those problems, one option is to repeal the existing tax advantages for family businesses and replace them with a single, new relief provision for all illiquid assets that permits unlimited deferral of wealth transfer tax liability at a market rate of interest to the extent that

²⁷For instance, under the gift tax, the tax due on a \$100 after-tax gift is \$45. The pretax gift is \$145, and thus the tax-inclusive rate is \$45 divided by \$145, or 31 percent.

²⁸Author's calculation assuming 5 percent interest rate and that donor transfers \$12,000 per year to her heir for 50 years.

²⁹Author's calculations assuming 5 percent interest rate and that donor transfers \$1 million 50 years earlier than she would otherwise.

³⁰Another option is to treat both gifts and bequests as a realization event. This could reduce inefficiencies associated with the realization requirement but would maintain differences in the tax treatment of gifts and bequests by creating incentives to receive wealth transfers later in time in order to avoid triggering accrued gains.

³¹For example, the legislation included a complicated (and unnecessary) amnesty provision that required taxpayers to value all of their assets on one day several years in the past in order to claim its benefits.

³²Canada treats bequests as a realization event, which also necessitates valuation at the same time.

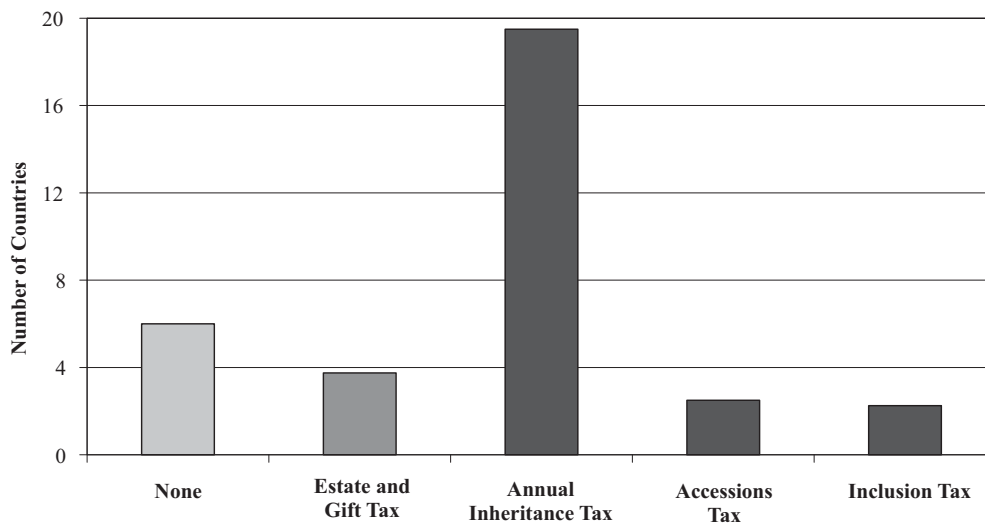
³³The principal drawback of this strategy is that taxpayers might still be able to avoid wealth transfer taxes by receiving inheritances earlier if the donor is not subject to the estate tax at the time of death. (Presumably no tax would apply to an estate that does not exist.) If this were a substantial problem, a third option would be to retain a lower lifetime exemption for gifts.

³⁴One possibility is to retain stepped-up basis for appreciated assets — such as jewelry, a baseball card collection, or a piece of furniture — that were not held for the production of income and are worth less than, for example, \$10,000.

³⁵Also, some business assets can be valued at less than their normal market value, and there is a special deduction for some qualified family-owned business interests that sunset in 2004 but is scheduled to return in 2011.

³⁶Urban-Brookings Tax Policy Center, *Table T08-0145: Current-Law Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2008* (June 27, 2008).

³⁷Michael J. Graetz and Ian Shapiro, *Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth* 126 (2005).

Figure 10. Form of Wealth Transfer Tax in OECD Countries

Sources: 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); and Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (2nd ed., 2004).

the tax liability exceeds the liquid assets transferred (minus a reasonable cushion).³⁸ Such a provision would eliminate both incentives and disincentives to hold wealth in illiquid forms. It would also eliminate even the theoretical possibility that an estate or heir would have to sell an inherited illiquid asset to pay the estate tax. It is only worth consideration, however, if a true market interest rate were applied. Otherwise, it could result in substantial gaming by sophisticated donors and heirs, and substantial revenue losses.

2. Replacing the estate tax with an inheritance tax. The simplification measures described above would substantially improve the equity and efficiency benefits of the estate tax system by limiting the extent to which relatively savvy taxpayers can avoid the tax. Many of them also appear to be achievable politically. Nevertheless, none of those measures would address the estate tax system's lack of transparency or the individual-level inequities that are intrinsically part of it. To do so, a more sweeping reform is necessary: replacing the estate tax system with an inheritance tax system.

Currently jurisdictions apply five general approaches to taxing wealth transfers, but inheritance taxes are by far the most common, as illustrated in Figure 10. An inher-

itance tax differs from an estate tax in that it is based on the amount received, rather than the amount transferred. Theoretically this would not make a difference if the rate structure of both taxes were flat. But in practice all wealth transfer taxes have rising marginal tax rates because of annual or lifetime exemptions.

Among inheritance taxes, there are three types. An annual inheritance tax applies to the heir based on the amount received in the current year. An accessions tax is the same except that it applies to the amount inherited over a longer period of time, typically the heir's lifetime. Finally, an inclusion tax requires inclusion of inheritances in the heir's income tax base.

All three of those inheritance taxes have been proposed by a number of commentators,³⁹ and have their advantages and drawbacks. An inclusion tax would link the tax rate to the heir's ability to pay, but would permit extensive gaming by applying a much lower rate if inheritances were spread out over time. Depending on

³⁸This deferred tax liability could be allocated pro rata to all illiquid assets of the estate and could become a liability of the recipients of such assets. Thus, to the extent that an heir withdrew funds from an inherited, closely held business through distributions or partial sales, he could be required to use those funds to satisfy the deferred tax liability and interest. Also, illiquid assets could be defined fairly broadly as long as a market interest rate was applied, but it should not include property used in part for personal consumption because the value of that property will tend to decline as it is consumed.

³⁹See, e.g., Anne L. Alstott, "Equal Opportunity and Inheritance Taxation," 121 *Harv. L. Rev.* (2007); Maya MacGuineas and Ian Davidoff, "Tax Inheritance, Not 'Death'," *The Washington Post* (July 4, 2006); Gary Becker, "Should the Estate Tax Go?" (May 15, 2005), available at http://www.becker-posner-blog.com/archives/2005/05/should_the_esta.html; David G. Duff, "Taxing Inherited Wealth: A Philosophical Argument," 6 *Can. J. L. and 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. Simons, "Personal Income Taxation" (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.* (1938); and Edwin R. A. Seligman, "A National Inheritance Tax," *The New Republic* (Mar. 25, 1916).

Table 4: Estimated Revenue Effects of Estate Tax System and Comprehensive Inheritance Tax Under Different Revenue Baselines

Estate Tax		Bush Income Tax Cuts	Revenue-Neutral Inheritance Tax		Revenue (billions)	
Law	Exemption (millions)		Rate	Exemption (millions)		Surtax
2009	\$3.5	45%	Yes	\$1.9	15%	\$17.5
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

*Phase-out of lower brackets disregarded.
 **Tax cuts to top two income tax brackets eliminated.

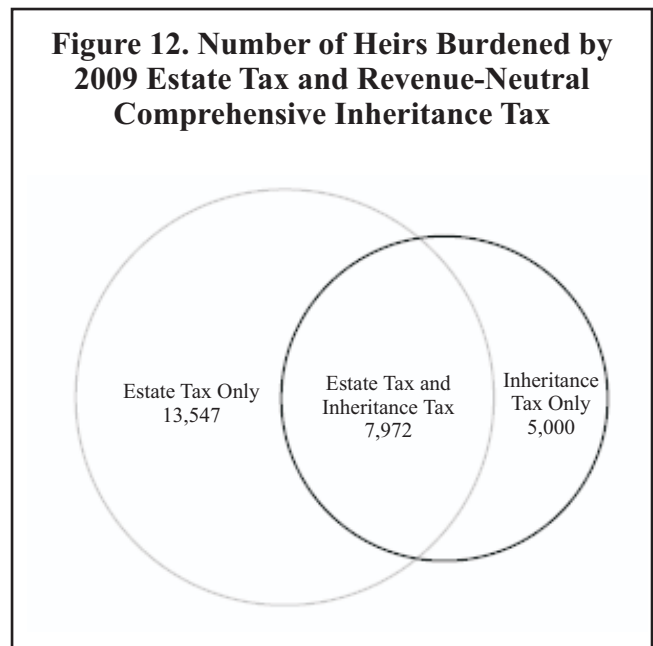
the year, it could also result in a 10 percentage point to 15 percentage point rate cut, resulting in labor income being taxed at a much higher rate than extremely large amounts of inherited income. This rate cut would in turn necessitate a lower exemption and more extensive record-keeping and filing burdens. By contrast, an annual inheritance tax could maintain the top marginal rate on the largest inheritances. But it would permit similar gaming, and would ignore the overall ability to pay of the heir, who might have very little earning potential because of a disability or other condition. Meanwhile, an accessions tax also would not link the tax rate to the heir's ability to pay. But it would limit gaming and permit higher exemptions through higher marginal tax rates on the largest inheritances than is possible under a pure inclusion system.

In light of those trade-offs, the type of inheritance tax most worthy of consideration is a hybrid accessions-inclusion tax that combines the best features of all three approaches. Surachai Khitatrakun and I have estimated the revenue and distributional effects of one such tax (referred to as a comprehensive inheritance tax), under which an heir would pay income tax and an additional surtax on any portion of his inheritance that exceeded a large lifetime exemption. Such a tax would be revenue neutral relative to the 2009 estate tax law (a \$3.5 million lifetime exemption per donor) if roughly the first \$1.9 million in lifetime inheritances were tax exempt, and inheritances thereafter were included in income and subject to a flat 15 percent tax.

To state the obvious, \$1.9 million is a lot of money. An individual who inherits \$1.9 million at age 18 can live off his inheritance for the rest of his life without either he or his spouse ever working, and his annual household income will still be higher than that of 9 out of 10 American families.⁴⁰ A lower exemption would therefore be even more desirable and would raise more revenue. Table 4 summarizes some alternate possibilities that are revenue neutral relative to different baselines.

⁴⁰ Author's calculations based on a 7 percent interest rate and U.S. Census Bureau, "Current Population Survey 1968 to 2006 Annual Social and Economic Supplements," table A-3.

Figure 12. Number of Heirs Burdened by 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax



The principal advantage of a comprehensive inheritance tax is that it would more equitably allocate fiscal burdens based on individual taxpayers' economic status. As illustrated in Figure 11, the distribution of tax burdens under the comprehensive inheritance tax described here would be quite similar at an aggregate level to the distribution under the estate tax system. However, Figure 12 shows that the inheritance tax would allocate tax burdens very differently at an individual level. Of all the heirs who would be burdened by either tax in 2009, only 30 percent would be burdened by both. The essential reason why these differences arise is that all large inheritances do not come from the largest estates, and all smaller inheritances do not come from smaller ones.

In addition to burdening different heirs, this inheritance tax would apply very different tax rates to those heirs who are burdened by both taxes. Figure 13 illustrates this point by plotting the average estate tax rate and inheritance tax rate that each heir would face among those heirs who are burdened by either tax (that is, in one of the circles in Figure 12). Each point represents an heir

Figure 11. Estimated Average Tax Rate on All Inheritances Under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax by Heir Economic Income

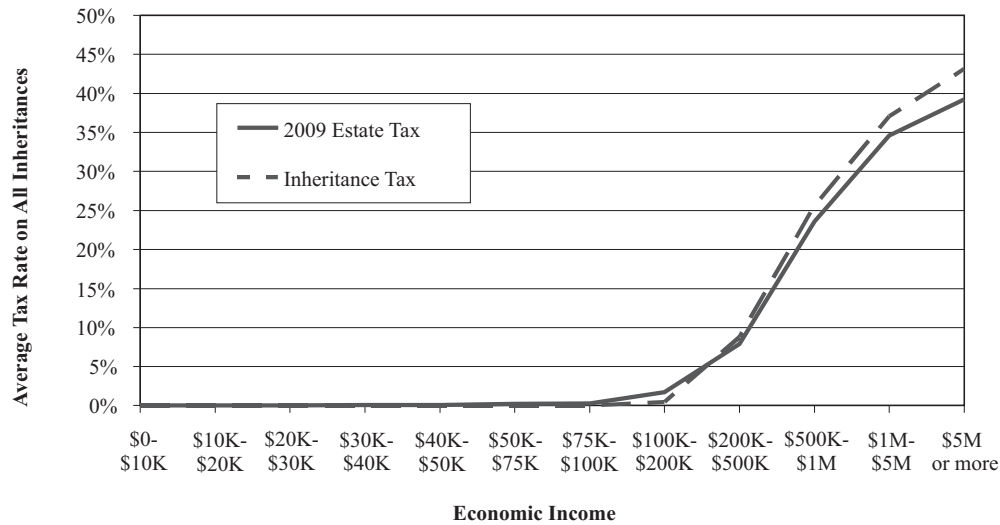
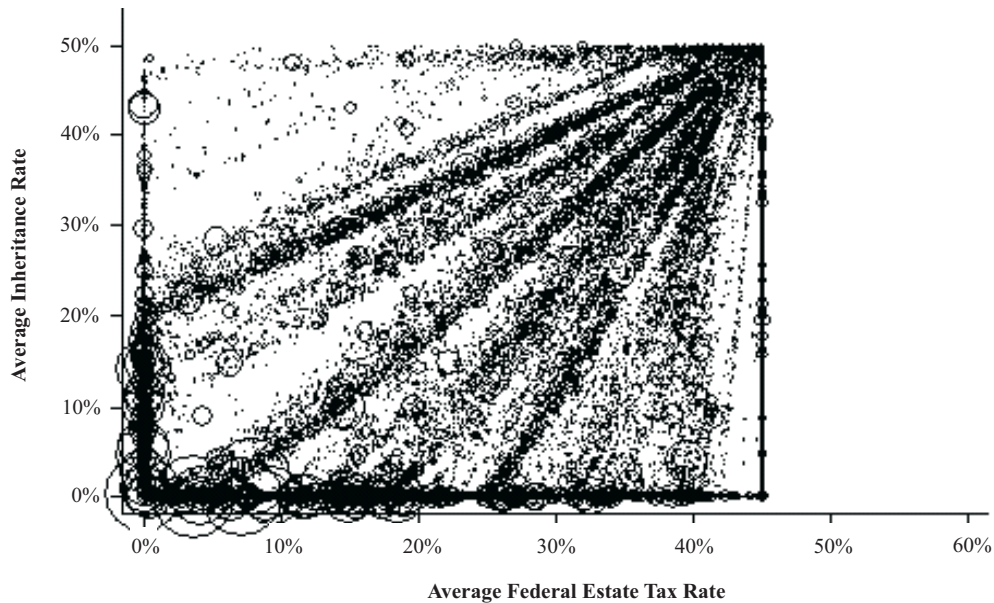


Figure 13. Average Tax Rate on Inheritance of Individual Heirs Under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax (Weighted by Inheritance Size)



and a circle represents multiple heirs. On average, the estate tax rate rises with the inheritance tax rate, and vice versa. But individual heirs who are burdened by both tax systems often face dramatically different rates under one tax versus the other. Indeed, overall about 30 percent of the burden of the inheritance tax in dollar terms would fall on different heirs than under the 2009 estate tax system.

Beyond those equity advantages, a comprehensive inheritance tax would improve the transparency and incentive structure of the estate tax system, while reducing its complexity.

An inheritance tax would be more transparent than the estate tax system because, both by design and in practice, it falls on heirs and offsets tax preferences for

inherited income. As a result, it could correct the understandable public misperceptions that the income tax applies to inherited income, and the estate tax system predominantly burdens donors. Estate tax opponents have exploited those misconceptions by framing the estate tax as a double tax on frugal, hardworking, generous donors. An inheritance tax would make such mischaracterizations more difficult, instead highlighting the fact that the estate tax is a single tax (and the only tax) imposed on the fortunate few in our society who inherit extremely large amounts of money.

A comprehensive inheritance tax would also improve the incentives that donors face. Under current law, a wealthy donor can give to 100 heirs or one, to Paris Hilton or a foster child, and her tax rate is unaffected. By contrast, a comprehensive inheritance tax would create incentives to give to low-income or low-inheritance individuals because the tax rate would turn on the amount inherited and the heir's other income.

Finally, a comprehensive inheritance tax would be simpler. Many of the estate tax simplification measures described above are intrinsic elements of an inheritance tax or could be replicated within it. For example, under an inheritance tax, it makes no difference whether an heir receives a portion of his inheritance from both parents or from just one. Moreover, an inheritance tax would permit further simplification that is not possible within an estate tax system. In particular, current law contains a wide swath of rules intended to limit the extent to which donors can reduce their estate tax liability through valuation games involving split and contingent transfers. Those rules could be eliminated under an inheritance tax by waiting to see which beneficiaries receive what before applying the tax. An estate tax system, by contrast, cannot adopt this wait-and-see approach because its tax rate is based on the amount transferred, and it therefore has to be levied at the time of transfer.

There are some potential drawbacks to replacing the estate tax system with an inheritance tax. Theoretically it could reduce the level of charitable giving, although in practice it is unclear whether it would have any such effect. Also, it could increase direct compliance costs. For example, the comprehensive inheritance tax described would result in about twice as many taxable returns because there are more heirs than estates, and the tax filer would be the heir. It also would entail transition costs in crafting the system and accounting for prior inheritances that an heir has received. Many of those costs could be eliminated by maintaining the current infrastructure of legal rules and administrative practices. But policymakers would have to draw on the experience of other jurisdictions with inheritance taxes when maintaining current rules was not possible.

Nonetheless, the benefits of shifting to an inheritance tax appear to merit these costs. It would substantially improve the equity, simplicity, and transparency of the tax treatment of wealth transfers. And, in doing so, an inheritance tax might increase awareness of the critical role that wealth transfer taxes play in our fiscal system.

F. Conclusion

Inherited income tends to exacerbate existing economic disparities and is probably the most important

barrier to intergenerational economic mobility. As a result, any equitable tax system should account for whether an individual has inherited an extraordinarily large amount when allocating tax burdens. Failing to do so privileges heirs over those who are self-made, and perpetuates the remnants of a class structure based on the circumstances of one's birth. As Franklin D. Roosevelt declared: "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."⁴¹

The estate tax system is the most important mechanism by which our fiscal system mitigates the effect of inheritances on economic disparities and intergenerational mobility. It is borne largely by a small number of heirs inheriting extraordinarily large amounts of wealth. Moreover, it actually serves only to partially offset the tax advantages accorded to inherited income elsewhere in the tax system.

Nevertheless, the estate tax system could be improved. It is not terribly transparent and entails needless complexity. Also, the relationship between an heir's financial circumstances and his estate tax burden is relatively imprecise. The scheduled repeal of the estate tax in 2010 and reinstatement at higher levels in 2011 creates an opportunity to better focus the system on the unearned income that inheritances represent. One option is to stabilize the rate structure and simplify the estate tax system so that it better targets the amount transferred as a proxy for the amount inherited. An even better and more ambitious option would be to replace it with an inheritance tax that directly taxes extraordinary amounts of inherited income at the same or higher rates as income that is personally earned.

Either way, we should use this opportunity for change. Rather than increasing inherited economic power by expanding the preferential tax treatment of inherited income through estate tax repeal, we should *reform* it so as to tax inherited income more equitably.

⁴¹Roosevelt, *supra* note 39.