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ALTERNATIVES TO THE CURRENT FEDERAL ESTATE TAX SYSTEM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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SECOND SESSION

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ALTERNATIVES TO THE CURRENT FEDERAL ESTATE TAX SYSTEM

WEDNESDAY, MARCH 12, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Lincoln, Salazar, Grassley, Kyl, and Bunning.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Edmund Burke once criticized his opponents by saying, "They defend their errors as if they were defending their inheritance." We are here today to examine the estate tax. We are here today to consider whether taxing estates is an error, and we are here today to examine whether there are other ways to address inheritance.

This is a second hearing in a series of hearings focusing on estate tax reform. We hold a third when we return in April. Now usually, when people talk about estate tax, they focus on the current system. They talk about a little change here, a little change there. They talk about turning one dial a quarter to the left, turning another dial a quarter to the right. They work on the issue as though they were tuning a radio.

In this hearing, we put the old radio aside. Today we are going to take a look at other concepts, other ways to deal with inheritance outside of the box. Under current law, the estate tax changes every year through 2011. Every year, the law changes. The law phases out completely and then it springs back to its original high rate and low exemption level.

Our estate tax law is complicated. It is intimidating to small businesses, ranchers, and farmers. The law lacks certainty for the American people. We seriously need estate tax reform.

I know that accomplishing an estate tax mark-up this year will not be easy, but let us work toward that goal. I am committed to getting estate tax reform done, and I am ready to roll up my sleeves and work with Senators to get a reform proposal that will benefit Montana, and the rest of the country.

These Finance Committee hearings will give us a review of some reform possibilities. These Finance Committee hearings will begin a good policy debate, and I hope that the debate will lead to a bipartisan estate tax compromise.

Today we will hear about taxing the beneficiary rather than the estate. We will hear about an income exclusion system, and we will hear about how other countries deal with this issue and the results. Now, I do not endorse any of these proposals, certainly not at this time. They are very interesting, but they are not ones that I yet endorse.

What I do want is the committee to have thought widely about the possibilities for replacing the estate tax, so today we are not going to defend the tax law's errors. Today we are going to talk about fundamental change to the estate tax, and in so doing see if we can leave a better inheritance for everyone.*

The first witness is Professor Lily Batchelder, professor at New York University Law School. I am very proud to note that in her earlier career Professor Batchelder served as a law clerk for the Finance Committee. In fact, I was just talking with Jon Selib in my office, and how he and Lily were here at the same time as interns, and he has a very high regard for you, Professor. I know you have been talking with him since you have come back, but again, he has very high regard for you.

The second witness is Professor Joseph Dodge, professor at Florida State University College of Law. Also, we have with us Professor David Duff, who is professor from the University of Toronto in Canada. Thank you all for coming.

It is our practice here that every witness speaks 5 minutes, and your statements will automatically be included in the record.

Why don't you go ahead, Professor Batchelder?

STATEMENT OF LILY BATCHELDER, PROFESSOR, NEW YORK UNIVERSITY, SCHOOL OF LAW, NEW YORK, NY

Prof. BATCHELDER. Thank you. Mr. Chairman, members of the committee, my name is Lily Batchelder. I am an associate professor of law and public policy at NYU's School of Law. Thank you for the opportunity to testify before you today.

I would like to briefly discuss the distribution of inherited income and estate tax burdens under current law, and then discuss two reform options. Both of these could be implemented on a revenue-neutral basis and I think would make the estate tax system better targeted on the unearned income that extraordinary inheritances represent.

As I have outlined in my written testimony, wealth transfers tend to significantly exacerbate existing economic disparities. Surachai Khitatrakun and I have estimated that, in 2009, heirs will inherit about $400 billion. While people of all income levels often receive relatively small inheritances associated with the family bonds that I think we do, and should, value, a very small number of people at the top receive extraordinarily large inheritances.

For example, Figure 2 in my written testimony shows that, on average, inherited income of those in the top 1 percent of the inheritance distribution is about 34 times larger than the average inheritance of all others receiving a bequest in a given year.

*For more information, *see also,* "Description and Analysis of Alternative Wealth Transfer Tax Systems," Joint Committee on Taxation staff report, March 10, 2008 (JCX–22–08), *http://www.jct.gov/publications.html?func=startdown&id=1318.*

And I think this concentration of inheritances is important because it means that they are exacerbating existing economic disparities. About 40 percent of all household wealth is inherited. I think it is also important because disparities in inherited income appear to be the single largest barrier to intergenerational economic mobility.

The current estate tax system is the most important mechanism by which the fiscal system mitigates the effects of inheritances on economic mobility. This is the case because, under the estate tax system, the burden actually generally falls on heirs and not donors. As Figure 4 in my written testimony shows, on average, the estate tax only burdens heirs who receive really extraordinarily large inheritances.

To me, this means that it is not really a double tax on the decedent, who may have worked very hard to accumulate this wealth, but instead it is a tax on a major source of unearned income of those who are fortunate enough to be born into a family that leaves them a really extraordinarily large inheritance.

The estate tax system is a blunt instrument, though. In my view, its biggest weakness is that this relationship between, on one hand, the heir's financial circumstances, and on the other hand, the estate tax burden, is relatively imprecise. Some people receiving relatively modest bequests may bear a substantial tax burden if they are inheriting from an extremely large estate, and some people receiving really extraordinarily large inheritances may bear no estate tax burden if they are receiving from one or more estates that are just below the lifetime exemption. This basically happens because, under the current system, the tax rate depends on the amount transferred and not the amount inherited.

There is an opportunity for reform in 2009 because of the unthinkable, in my view, incentives created by a 1-year repeal of the estate tax. I think we should use this opportunity not to repeal the estate tax, but to reform it so that it is really better targeted on extraordinary amounts of inherited income.

The option I would like to discuss first, which in my view is the best alternative, would be to replace the current system with a comprehensive inheritance tax. Under this alternative, an individual inheriting an extraordinary amount over their lifetime would pay income tax and a flat 15-percent tax on a portion, and only a portion, of that inheritance. So in effect, extraordinary inheritances would then be taxed at the same rate that earned income is now taxed under the income and payroll tax.

We have estimated that this reform could be implemented on a revenue-neutral basis relative to 2009 law if about the first $2 million in inheritances were tax-exempt. To state the obvious, $2 million is a big inheritance. If an heir inherits this amount at age 18, he and his spouse can live off the inheritance for the rest of their lives without ever working and their annual household income will be higher than that of 9 out of 10 American families.

If this proposal were adopted, it would have important effects. The distribution of burdens among heirs under the estate tax would stay relatively similar on average, but Figure 8 of my written testimony shows that the burdens would be allocated very differently at an individual level. It shows that about 60 percent of heirs burdened by the estate tax would bear no tax burden under this inheritance tax, and, among those who are burdened by both taxes, their rate would often be very different.

I think these differences illustrate how this reform would improve the equity of the wealth transfer tax system because it would base the tax rate on the person that actually bears the burden of the tax, the heir, and it would make it better targeted on the unfair advantages that exceptionally large inheritances create. It would also have some other advantages. It could simplify current law. It would only burden about 3 heirs in 1,000.

But I do want to mention a second alternative because this is very ambitious, which would be to simplify current law.

The CHAIRMAN. If you could, very briefly.

Prof. BATCHELDER. Sure. There are a bunch of simplification options that one could apply to current law. For example, allowing carry-overs of the lifetime exemption for spouses, narrowing the differences between the tax rates on gifts and bequests, reforming the treatment of illiquid assets, including family businesses. I think all of these options are worth considering as well and could be implemented on a revenue-neutral and distributionally neutral basis.

Thank you.

The CHAIRMAN. Thank you, Professor, very much. That is very interesting.

[The prepared statement of Professor Batchelder appears in the appendix.]

The CHAIRMAN. Professor Dodge?

STATEMENT OF JOSEPH DODGE, PROFESSOR, FLORIDA STATE UNIVERSITY, COLLEGE OF LAW, TALLAHASSEE, FL

Prof. DODGE. Thank you, Chairman Baucus, Senator Grassley, committee members.

Well, I think the existing system is seriously flawed. It is quite easy to plan around. It does not really serve directly a purpose, as Professor Batchelder explained. It sort of creates incentives for wealth to either be destroyed or to be hidden. So now you have a great opportunity, since the estate tax is scheduled to expire soon, to in a sense start over again and come up with a better system.

But there are basically two different tracks that can be followed here, as I see it. One is reforming the income tax system, which sort of has a gap with respect to gifts and bequests. The other has to do with a better wealth transfer tax system which serves a different purpose. I would say the purpose is to mitigate undue disparities of unearned wealth, to further the dispersal of wealth. As a general matter, I do not think the income tax and the transfer taxes should be blended. I do not think features of a transfer tax should be imported into the income tax.

So in general, I do favor transferee-oriented taxes. I really do not have anything significant to add to that, except taxes on transferee directly tie in to goals of preventing undue accumulation of unearned wealth, furthering equality of opportunity, and encouraging the dispersion of wealth.

So apart from the accessions tax, the other transferee-oriented system that I want to talk about is what I call the income inclusion approach, which involves treating gifts and bequests as income to the transferee without a deduction to the transferor. If this system were adopted, then another income tax alternative, which would be to tax gains and losses at death or gift, would not be necessary.

Of course, that system of taxing gains and losses at transfer is a system that Canada now has. That is fine standing alone, but it should not be combined with including gifts and bequests as income. Basically, receipts of gratuitous transfers are income. If the statutory exclusions were repealed, they would be included as income.

Well, I see time is flying. So I want to mention, briefly, some of the features of the income inclusion proposal as I see it. There would be no lifetime exemption, as such. However, support received would be excluded, as under present law. Third party payment of bills would be excluded. That is like tuition and health care. Gifts of consumable items should be excluded, the general idea being that things that look like support would be excluded from the tax base. Even bequests could be excluded under certain circumstances, like bequests received by persons under 25. They could be annuitized and treated as support. There could also be an exclusion, within reason, for tangible personal property because that basically represents a consumption decision by somebody else.

Next, the income tax has a realization principle so that gifts and bequests received in kind would not necessarily have to be taxed upon receipt, but instead they could be taxed later on. Now, probably marketable, publicly traded, highly liquid assets should be included, but hard-to-value assets, which would include, of course, closely held business interests and some real estate, would not be income upon receipt, but instead the income would be deferred through a zero-basis mechanism. So either you would have a stepped-up basis if an item were included, or you would have zero basis, but historical basis would be erased.

Well, there are other features. I see my time is up. But basically the system would be integrated with the existing income tax system, including subchapter J dealing with the taxation of trusts and beneficiaries.

Thank you.

The CHAIRMAN. Thank you, Professor, very much.

[The prepared statement of Professor Dodge appears in the appendix.]

The CHAIRMAN. Professor Duff?

STATEMENT OF DAVID DUFF, PROFESSOR, UNIVERSITY OF TORONTO, FACULTY OF LAW, TORONTO, ONTARIO, CANADA

Prof. DUFF. Thank you, Mr. Chairman. And thanks to the committee for giving me the opportunity to speak with you today.

My name is David Duff, and I am a professor of tax law and policy at the University of Toronto, Faculty of Law, where I have taught since 1996.

My testimony today is based on two articles that I have written on wealth transfer taxation, and they are appended to my written testimony.

The first argues for a wealth transfer tax in the form of an accessions tax, which would apply to the cumulative amount of gifts and inheritances that are received by individuals over the course of their lifetimes rather than aggregate amounts given by donors over the course of their lifetimes, as is the case with the current Federal wealth transfer tax system in the U.S.

The second article attempts to explain the apparent political unpopularity of wealth transfer taxes and the abolition of these taxes in Canada, Australia, and New Zealand, which repealed their estate and gift taxes in the 1970s, 1980s, and 1990s.

Beginning with the first article, let me briefly explain why I think that a society should tax transfers of wealth and why an accessions tax is a better tax for this purpose than the current Federal wealth transfer tax system in the United States.

As a philosophical matter, I believe that it is both legitimate and desirable for a society to moderate extreme inequalities in the distribution of wealth and in the opportunities that wealth provides by taxing substantial gifts and inheritances above a generous exemption.

While I believe that a society should value and encourage the family bonds that are associated with the transfer of assets from one generation to another—and I think that is particularly the case with family heirlooms, family enterprises, family farms—I believe that this value needs to be balanced against the negative social and political consequences for a democratic society that can result from the transfer of large dynastic fortunes from one generation to the next.

In addition, to the extent that recipients have not earned the gifts and inheritances that they receive largely because of the luck of their birth, I do not believe that they can legitimately complain about a tax that requires them to share some of their good fortune with others who have not been so lucky. From this perspective, it is clear why an accessions tax would be a better tax than the current Federal wealth transfer tax system in the United States.

While the current gift and estate tax applies to aggregate amounts transferred by donors over the course of their lifetimes and at death—regardless of how this wealth is distributed among recipients—an accessions tax would apply to the cumulative value of gifts and inheritances that are received by beneficiaries over the course of their lifetimes, which are, after all, the amounts that actually contribute toward inequalities in wealth and opportunities.

As well, the current gift and estate tax sends exactly the wrong message about a wealth transfer tax by taxing successful, hard-working and generous donors who have accumulated wealth out of income on which they have often already paid tax.

In contrast, an accessions tax sends a very different—and I believe justifiable—message, by taxing the beneficiaries of substantial gifts and inheritances on amounts that they themselves have not earned and on which they themselves have not paid any tax. Why then do wealth transfer taxes seem to be so politically unpopular, and why were they abolished in Canada, Australia, and New Zealand?

Although I do not have time to go into all the details here, it is important to note that the wealth transfer taxes in each of these countries were estate and gift taxes, much like the current wealth transfer taxes in the United States. For this reason they were vulnerable to the same kinds of criticisms that have been rightly directed at the Federal estate and gift taxes in the United States: that they impose a second tax on donors who have accumulated wealth out of income on which they have already paid tax, and that they punish their success, hard work, and generosity.

As well, since affluent retirees can avoid donor-based wealth transfer taxes by moving to jurisdictions without these taxes, estate and gift taxes like those that existed in Canada, Australia, and New Zealand are also vulnerable to competition from jurisdictions that do not collect these taxes. This is probably not as big a concern in a large country like the United States, but was a significant concern in Australia, New Zealand, and Canada.

In contrast, since recipient-based wealth transfer taxes, like an accessions tax, apply to gifts and inheritances that are received by younger and less geographically mobile recipients, they are much, much less vulnerable to this kind of tax competition. As a result, when one surveys wealth transfer taxes around the world, it is not surprising that it is recipient-based taxes that have been far more resilient than donor-based taxes, and in fact in several countries account for a larger share of total tax revenue and Gross Domestic Product today than they did 30 years ago.

In conclusion, therefore, I believe that questions of principle, as well as practical politics, support replacing the current Federal wealth transfer tax system in the United States with an accessions tax that would apply to the amount of gifts and inheritances received by individuals over the course of their lifetimes.

The CHAIRMAN. Thank you, Professor. That was very interesting.

[The prepared statement of Professor Duff appears in the appendix.]

The CHAIRMAN. Senator Grassley, do you have a statement?

Senator GRASSLEY. Yes, if I could, please.

The CHAIRMAN. Sure.

Senator GRASSLEY. Just a short one.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. I apologize for being a little bit late. First of all, it is very important that we deal with this issue, because 2010 and 2011 are just around the corner and it is something we should have dealt with if we wanted to make estate planning easier for everybody. I bear some responsibility for that because I was chairman of this committee for a while as well. Because of these dates, it has become imminently necessary to discuss, and hopefully to determine, the fate of the estate tax.

As I have stated before, I believe that the death tax is fundamentally unfair from both a philosophical and technical perspective. I do not believe that it is appropriate for government to come in following the death of an individual and tax the money that a person has legally earned and saved during his lifetime.

Additionally, since the estate tax has to be paid 9 months after the death of an individual, many small business people and farmers have had to sell off their business assets simply to pay the death tax arising solely because of the death of a prior owner. To me, this situation is fundamentally wrong because death should not be a taxable event and government should not be profiting from death.

While my personal view of repeal is firm, I understand that other alternatives need to be explored in order to come to a fiscally appropriate compromise prior to the sunset of the 2001 reforms and the return of exorbitant rate schedules for 2011, with a 1-year repeal in 2010. I am going to be working towards that compromise.

Many of my colleagues have discussed changes to the current rate and exemption schedules, and their suggestions are well received. However, beyond these suggestions, both the chairman and I believe that it would be helpful and informative, as we are hearing today from academics and experts who have written extensively in this area, for the committee to have another hearing to address other issues in the current estate tax system if it remains unchanged following the expiration of the 2001 reforms.

Finally, the chairman and I believe that it is important to draw on the experiences of other countries, and we have heard about that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

A question comes to my mind. These are all very interesting ideas. That is, transition rules. Say we were to move toward an accession type of system, inheritance rather than tax to the transferor. What kind of transition rules do you contemplate? Professor Batchelder?

Prof. BATCHELDER. Yes. I think there are a couple of alternatives. I would actually suggest——

The CHAIRMAN. And I would say, because people plan. They plan their estates.

Prof. BATCHELDER. Yes.

The CHAIRMAN. A lot goes into planning by a lot of people, and then, lo and behold, it becomes a totally different system. Just your thoughts on transition.

Prof. BATCHELDER. Yes. Yes. Well, there is one country that, to my knowledge, has transferred from an estate tax to an inheritance tax, which was Ireland. What they did was have the transition occur prior to enactment. One of the issues is, if you enact an inheritance tax and have it go into effect right after the bill passes, many people, knowing that the bill will pass, will max out their lifetime gift tax exemption.

So in order to prevent that kind of gaming, I would recommend having the transition occur maybe back to the date of introduction or some prior date.

You could give credit for prior taxes paid, but I actually think that would give relatively small benefits, because most people who receive a substantial inheritance just receive one. In some of the data that I have looked at with my co-author, we find that, of people who inherit $1.7 million or more, that tends to represent, if they inherit that in 1 year, 94 percent of their lifetime inheritances. So giving them credit for prior taxes paid may not be necessary, but it certainly is an option.

The CHAIRMAN. Again, in Ireland, why the change? Do you know much about what happened in Ireland?

Prof. BATCHELDER. As far as I know, it has been very successful. It has been in place for about 30 years, and it is sort of similar to the accessions tax that Professor Duff was describing in terms of aggregating your inheritances over time and applying a tax rate to the amount received.

The CHAIRMAN. But is the amount of income taxes or the revenue gain saved by the government about the same, or not?

Prof. BATCHELDER. Yes. I do not have this in my written testimony, but the percentage of tax revenues raised from most transfer taxes cross-nationally is generally around 1 or 2 percent, and actually, inheritance taxes are much, much more common than estate taxes.

The CHAIRMAN. But even those countries that have inheritance tax, it is about 1 percent?

Prof. BATCHELDER. One to 2 percent. Some go up to 6 percent. It varies to some degree.

The CHAIRMAN. All right.

Mr. Duff, transition?

Prof. DUFF. Well, it is not an area I have actually done work in because, of course, in my context we abolished these things, so the transition would be starting from scratch.

The CHAIRMAN. Right. Right.

Prof. DUFF. And that poses much more significant issues than in the U.S., where the incentives obviously would not be as significant to game the system as if you are starting from scratch. I think, actually, Professor Batchelder has written about some of this. I think the transition issues where you already have an estate tax are not so serious because you already have something in place.

I think one thing that could be considered is a credit for prior estate taxes paid, but I think, as Professor Batchelder points out, it is not a huge issue because, for the most part, you get an inheritance once and you do not receive these small amounts over a period of time.

The CHAIRMAN. So what is wrong with this idea? I mean, there is always the other side of the coin. What are the down sides of an inheritance as opposed to estate tax?

Prof. DUFF. I actually find it difficult to see what the down side is. I am surprised that the world has not moved in this direction. I think if the U.S. were to do this, it would be a leader in this and a lot of other countries would follow.

The CHAIRMAN. If you had to think of a down side, what would it be?

Prof. BATCHELDER. I can offer a down side.

The CHAIRMAN. All right.

Prof. BATCHELDER. It sort of depends on your perspective. It does change incentives for giving. I tend to see this as a bit of an up side, that it creates an incentive for very wealthy households to distribute their wealth more broadly. But people may not like that.

It also would shift, to some degree, the incentives regarding charitable contributions, so in general, because charities are tax-exempt, they would not be subject to an inheritance tax, because when they receive inherited income that is not income. It might change the charities eligible for that exemption. Right now, my understanding is that certain charities, including 501(c)(4)s, are not eligible for the estate and gift tax exemption. They presumably would be for an inheritance tax exemption.

The CHAIRMAN. Professor Dodge?

Prof. DODGE. Well, the charitable community might not like it because they might actually prefer that wealth be highly concentrated so that the tax incentives for giving to charity would be maximized.

The CHAIRMAN. What about the countries you mentioned, Professor Duff? I am now addressing charitable giving. Is there as much, less, say in those countries compared with the U.S., and does it have any effect? Does the form of wealth transfer in those countries have an effect?

Prof. DUFF. I think there have been studies that suggest there is less charitable giving in Canada than in the U.S., but of course we do not have any kind of wealth transfer tax system that creates those incentive at all. So, if you get rid of the taxes altogether, I think the evidence is that there is actually less of an incentive for charitable giving. But that is an argument for some kind of wealth transfer tax system, not an argument for a particular kind, necessarily.

The CHAIRMAN. Senator Grassley? Thank you very much. Very interesting.

Senator GRASSLEY. Yes. I am going to start with Ms. Batchelder. One of our concerns with your program is the potential that a family farm or small business, whose assets by their nature are illiquid, will have to sell the assets of their business in order to pay off the inheritance tax. I know you address this issue in your paper by suggesting that an heir can defer payment of the inheritance tax based on illiquidity, while requiring the heir to pay a market rate of interest on the amount that was deferred.

What argument could you make that this market rate of interest requirement would not ultimately be more punitive in nature to the small business owner/farmer who may not even have the cash on hand to pay this amount of interest on the business or farm that they have inherited?

Prof. BATCHELDER. Thank you. Well, I guess one response I would have is, I think you could defer the interest as well. So the general idea was that, if you inherit a business and you do not inherit liquid assets sufficient to pay the associated tax liability, that you would be able to defer those taxes due with interest. I would be fine with deferring the interest payments until you actually sell that business. Frequently, with family businesses, heirs do choose to sell them just because they do not wish to continue operating them.

There are a number of provisions within current law to address family businesses. To my knowledge—but you may very well know of people who have been forced to sell their business—there has not been a family farm that has been forced to be sold under the current provisions, but I do think it is worth trying to establish the rules that make that not even a theoretical possibility, which is, I think, what this proposal could do.

Senator GRASSLEY. Mr. Duff, was it the experience of Canada, New Zealand, and Australia that the estate tax was replaced by a less divisive tax, like sales tax or value added tax, to replace the revenue which was lost based on the estate tax repeal, or was the revenue simply lost? The reason I ask this is because it would be instructional to know what tax had to ultimately rise in order to replace the revenue lost from the repeal of the estate tax or whether it simply went away with nothing to take its place.

Prof. DUFF. Right. Well, to answer that, one has to understand the nature of taxes that are based on the English model. Historically, neither Canada, nor Australia, nor New Zealand taxed capital gains at all, so capital gains in Canada were not taxable until 1972, in Australia, not until sometime in the 1980s, and New Zealand, not until the 1990s. So, in fact, what ended up happening in all of these countries is the wealth transfer taxes were repealed and capital gains taxes were introduced.

In Canada, actually the way it fell out politically is, it happened at the very same time in 1972, and partly it was because, in Canada, a decision was made to tax capital gains at death and there was a sense that the Federal Government had that, well, they should reduce the level of combined taxes on death from a deemed realization at death and the wealth transfer taxes. Their policy was not to eliminate wealth transfer taxes completely because provinces had collected wealth transfer taxes.

The Federal Government in Canada said, we will get out of the area and leave it to provinces to collect their share, but, of course, then what ended up happening is inter-jurisdictional tax competition took over. Once one province was out of the game, others also got out of the game and it all unraveled.

A similar phenomenon happened in Australia. In Australia and New Zealand, the wealth transfer taxes were repealed before capital gains tax was introduced, but once the transfer taxes were repealed it became a stronger argument for having capital gains tax.

In Australia, there is a carry-over basis at death, not a deemed realization at death. So, if one were to say what replaced them, it certainly was not value added tax. In Canada, that did not come until much, much later. It would be capital gains tax, which of course the U.S. has had right from the outset of its income tax.

Senator GRASSLEY. Do you want to comment, Mr. Dodge?

Prof. DODGE. I wanted to comment on Professor Batchelder's comment. I actually disagree with her on this point. I do not think an interest charge would need to be imposed on deferral because the tax base would grow, because the future tax base would include income and appreciation; therefore, there is no real revenue loss from deferral. In fact, there would be possibly a revenue gain if the greater amount were taxed in higher brackets. So, therefore, I do not think you need an interest charge on deferral.

Senator GRASSLEY. All right.

Do you want to react to that?

Prof. BATCHELDER. Yes. I actually do think it would be important. I think the general philosophy should be to try to not create incentives or disincentives to hold illiquid assets, so not to penalize family-owned businesses, also not to make them especially preferred.

In that case, it would be important to have the tax liability be assessed at the time of the transfer with interest, because otherwise you could have people withdraw a lot of the cash from the family business, sort of depreciate the value, and then when they ultimately pay tax, pay a much smaller tax burden, but they effectively would have received a huge amount of inheritance just by spending the cash of the business.

Senator GRASSLEY. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus and Ranking Member Grassley, for holding this hearing on this important issue.

I think, at least for me as I approach this issue, one of the big concerns we have had as we look at reform is, how do we deal with the reality of paying the bills of the government? The pay-go rules that we have adopted in this Congress are very important to me, and at least to some members of this committee.

So to you, Ms. Batchelder, I would ask this question. On your reform option one, you say you would impose a 15-percent tax on extraordinary bequests that would be beyond the inheritance and you would create some kind of a $2-million exemption. Can you elaborate on your proposal and what the consequence of that would be in terms of the fiscal consequence sent to the government?

Prof. BATCHELDER. Sure. So the roughly $2-million exemption would be revenue-neutral relative to 2009 estate tax law, which is a $7-million per-couple exemption, $3.5 million per donor. The idea would be that you would include amounts above that $2 million in income and there would be a 15-percent flat tax, so that means that I could inherit $2 million tax-free. If I inherit $3 million, I would include $1 million in income, so it would be subject to the income tax and it would be subject to a 15-percent flat tax, so the marginal tax rate would start off at 15 percent.

Senator SALAZAR. So the $2 million, we are taxing the heir. We are taxing the inheritance, we are not taxing the estate, under your concept. That $2-million exemption is a lifetime exemption. It would be similar to, say, a household's primary residence, the lifetime exemption that we have under tax law. Is that the kind of concept that you would be pushing here under that proposal?

Prof. BATCHELDER. It would be lifetime inheritances received. And one thing I should note is, the $2-million revenue-neutral threshold is sort of arbitrary relative to 2009 law. In my written testimony I did include our estimates of what the revenue-neutral threshold would be relative to 2008 law, to 2011 law, a few different permutations. So it would depend on what revenue baseline Congress would like to set in order to achieve the targeted level of deficit reduction.

Senator SALAZAR. Mr. Duff, I will ask you as well. You talk about the importance of—I think you said, if we do the accessions tax, philosophically where you approach this issue from, I think your words were that it is all right, a good thing for society to moderate extreme inequalities in wealth. Then you continued on and you said that it is also important to protect certain heirlooms, family farms, family businesses, and the like.

How, under your concept of the accessions tax or your reform package number one, would you deal with that issue of those special properties? I think Senator Baucus, myself, and others on this committee are very concerned about ranchers and farmers, and the fact that we have many estates out there that have a high value but very low cash. One of the things we want to make sure we do is to prevent having farmers and ranchers from having basically to give up the family farm or ranch to pay some kind of an estate tax. That is one of my key interests in dealing with this issue. So how would you deal with that issue under your concepts?

Prof. DUFF. Well, I think there are two responses. One, with a significant-enough exemption, it is generally not a problem. The statistics I have seen in the U.S. suggest that, as the exemption in the U.S., the estate tax has gotten high enough. Most of the estates that have these illiquid assets generally have very liquid assets as well. I think the evidence is pretty clear on that.

But I agree with Professor Batchelder that, even if in theory there is a problem with illiquid assets, then it should be addressed. As I said, my arguments suggest that there should be a balance between the values of transferring these kinds of family assets and the tax.

Senator SALAZAR. So would you create an exemption then for those illiquid assets under your proposal?

Prof. DUFF. I think my preference would be not an exemption, because of course that creates strong incentives for people to transfer assets like that and then, of course, liquidate them. So I think a deferral approach, as Professor Batchelder suggests, is probably the best kind of approach to deal with those concerns.

Senator SALAZAR. All right.

Yes, go ahead.

Prof. DODGE. Yes. I guess I also think that deferral is a solution, but I think I might differ from the others. I would defer the taxable event until either sale or cessation of qualified use, as opposed to imposing a tax and then deferring the tax with interest. So I would defer the taxable event and that would also avoid valuation issues. You just wait and see what happens.

Senator SALAZAR. Thank you very much. My time is up.

The CHAIRMAN. Thank you, Senator.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Professor Batchelder, in your testimony you referred to inheritance income as unearned. But that term is more than a little misleading. It is not only earned income, it is earned and previously taxed. If a donor earns $100 of ordinary income and pays 40 percent in Federal and State income tax, he or she is left with $60. If the donor dies the next day and decides to leave it to his grown child or children, under your proposal it would be taxed at 54.6 percent in 2011, that is 39.6 plus your 15-percent flat tax. That leaves $27.24 before State death tax, sales tax, and other tax imposed on the child.

I understand you are proposing a $2-million exemption, but that may not be enough if the donor is trying to transfer a farm or a small business. What possible incentive would donors have to build a nest egg to provide for the safety and security of their children and grandchildren if more than 73 percent will be taxed away? I understand your zeal to level our income, but what will you do to the incentive structure that for centuries has motivated Americans to build businesses and create jobs?

Prof. BATCHELDER. Well, I would like to make two points. First, with respect to it being a tax on unearned income, I agree that the donor, when we work and we save, we are taxed on that income. They then have a choice about how to spend it. When an heir receives a windfall, which I would view extraordinarily large inheritances to be, that is another person getting to choose how to spend that income.

Senator BUNNING. What if the first person spent everything?

Prof. BATCHELDER. Then they would be taxed on it.

Senator BUNNING. Yes. Then they would not be able to provide that second, or first, or fifth, or ninth child with one cent of inheritance.

Prof. BATCHELDER. Well, I sometimes find double taxes to be a bit of a misnomer, because I think we should have one tax on each person. So if the donor spends it on some jewelry, then the jeweler will pay tax.

Senator BUNNING. Why does the government have a right to that money? That is what I want to get at.

Prof. BATCHELDER. I do not think it is about a right so much as how we should allocate tax burdens. If someone has inherited more than $2 million over their lifetime, I think they do have a better ability to pay taxes than someone who has not inherited anything and has worked to earn $2 million over their lifetime. So in terms of figuring out——

Senator BUNNING. Well, the same thing would go with that second person then that went out and earned that $2 million, or $4 million, or whatever it might be. You are going to confiscate their inheritance for their children the same way. So what is the incentive?

Prof. BATCHELDER. The burden, as I mentioned in my testimony, will be borne by the heir. So I think that, in allocating the tax burdens between people who inherit extraordinary amounts in society and those who do not, we should be taking into account extraordinary amounts of inheritances. For normal inheritances, I fully agree that we should be supporting and encouraging those kinds of family bonds. But once we get above $2 million, that to me becomes——

Senator BUNNING. I have an example. Somebody said that you do not lose family farms. I am going to give you a perfect example how a $12-million estate, in 4 years, disappeared to the tax collector. A $12-million estate. No will by the owner, no will by the spouse. The owner dies, spouse is due for the estate tax. The spouse dies. Now the children inherit the $12 million. Now they have to pay $4 million in estate tax. This is just as recently as 10 years ago. They cannot pay it. They do not have the liquid assets.

So they hock the farm to a bank, and the farm is a horse farm that has to produce so much income to pay off the principal and the interest that they borrowed. Well, the horse business went south and it did not produce the principal and interest enough to pay off that liability. The bank, 4 years later, took the whole estate, $12 million. This man worked 60 years to build this estate of $12 million, and in 4 years the Federal Government leveled it, totally and completely. It is my daughter-in-law and son, if you really want to know about it. So the Federal Government has a tax event—I am sorry, Mr. Chairman, but this gets a little personal because my family was involved.

The CHAIRMAN. You go right ahead.

Senator BUNNING. And so the tax consequences of dying should not be accompanied with the transfer of that money to the Federal Government.

Prof. BATCHELDER. If I could, I am very sorry about that.

Senator BUNNING. So am I.

Prof. BATCHELDER. Under the proposal I would be advocating for treating family farms and other illiquid assets, there would be no tax due when the transfer occurred. So long as your daughter and son-in-law were operating the farm, that tax liability would just be deferred indefinitely. It would be due only if they decided, we do not want to run it any more, we want the cash, then the tax would be paid and due. But prior to that, there would be no tax due.

Senator BUNNING. And what happens if they run it and transfer it to their children?

Prof. BATCHELDER. The tax liability would continue to accrue and it would be deferred indefinitely.

Senator BUNNING. Deferred as long as a member of the family ran the farm?

Prof. BATCHELDER. As long as it is not sold, it stays within the family and is being run by the family, it would not. It would just defer with interest.

Senator BUNNING. All right.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Are you ready, Senator Lincoln? All right. Fine. Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman. And thanks for pulling us together here to have another discussion.

Professor Batchelder, Professor Dodge, and Professor Duff, we thank you for taking time to be here today to discuss an issue that is of tremendous importance to me particularly on behalf of my constituency, to reform the estate tax system.

I have been working with my colleagues here on the Senate Finance Committee for more than 5 years, at a minimum, I guess, since 2003, to really try to address the uncertainty that is created. The unknown for any of us is dangerous and creates a tremendous amount of fear, but here in the estate tax system we created that uncertainty with the 2001 law in terms of the cliff that we are going to hit after 2009, people not understanding or being able to plan ahead, and particularly with something that is as precious to them as something that they have spent their life creating, whether it is a business or their family's inheritance or a family farm that has been in the family for generations, or a business that has been in the family for generations.

So it is something very tangible and certainly something that I think represents a tremendous amount of who we are as Americans, that you could work hard all your life to be able to build something, to pass it on to your children, and then unfortunately find yourself in a situation where, because of the tax system we have created, you would have to sell all of that in order to be able to pay those taxes.

But for 5 years, Senator Kyl, Senator Grassley, Chairman Baucus, and I, and others have been studying this issue. We have been meeting with experts at the Joint Committee on Taxation. We have been discussing the possible solutions that would bring about relief for our family-owned farms and businesses. Here we are again today, continuing that discussion about this very issue, with another discussion expected sometime, I think, in the next work period. We are going to continue to do that.

And certainly I do appreciate the chairman's dedication to this issue, because he truly has been dedicated to it, and the committee's continuing desire to study the issue—and no one can deny that today's hearing, with three professors on our witness panel, is a good way to examine the topic from an academic perspective.

But I think, particularly from the perspective of my constituency, it is time for less talk and less study and more in terms of action, in terms of what we can do to provide more predictability and more assurances to families who are working hard every day to build that family business, the opportunity to be able to hand it off to their children, which is what they want more than anything.

We have heard from our professors here today who say we should think about other alternative systems. I have to say, with all due respect, I am sorry, but my family-owned businesses in Arkansas could really care less whether it is called an estate tax, an inheritance tax, or take-the-money-and-run tax, or whatever we are going to call it. Whatever name we want to put on it and whatever system that you use to collect it, it is all the same for our family-owned businesses and farms that have to pay it.

Maybe you have a difference of opinion, and I would certainly be glad to hear that. But whether it is a farmer or a farmer's son that will inherit the business and keep it running, whether it is a meatpacking business, whether it is a small equipment business, whatever, one of them has to pay the tax and neither of them has the liquidity to be able to deal with that, the liquid capital that they need in order to be able to do that. So changing the method of collection is not, in my opinion, going to make that problem go away for a family-owned business.

Maybe there are tweaks or bells or whistles that you all have come up with, or ideas—I apologize for being late—that you may have expressed, and we are certainly glad to listen to those. But I do strongly believe that now is the time for action. Two thousand nine is our last year under the 2001 changes before we eliminate the estate tax, and certainly in 2011, we go right back to where we started.

I believe that we have the capacity and the capability to reflect our American values in our tax system in a way that is going to be balanced, fair, and is going to help us continue these kind of businesses that are the generators of the good jobs that exist out there in America, not to mention the investment that it makes in this country. So I look forward to working with my colleagues who care about this issue in the weeks and the months ahead to take some real action to address the issue, and I look forward to, again, your perspectives and suggestions.

Maybe, Professor Dodge, you would like to start. You were shaking your head "no," that somebody is not going to have to pay that tax if it is an inheritance.

Prof. DODGE. Well, it is a fundamentally different tax. It is not the same tax with a different name. Under the current system, the taxable event is the time of the gift or the date of death, and you just have to have that be the taxable event and you have to value the property at that time.

But under either the accessions tax or the income inclusion proposal, or even under the deemed realization system, the taxable event can be whenever you decide, because they are transferee-oriented systems.

So in the case of family farms and closely held business interests, I would propose an inherent or integral part of the transferee-oriented tax—which, by the way, is similar to the realization principle of the income tax, that the receipt of an interest in a trust or a family business or an illiquid asset is just not a taxable event.

Senator LINCOLN. Well, if revenue is coming in, somebody is paying it.

Prof. DODGE. What?

Senator LINCOLN. If revenue is coming in, someone is paying it.

Prof. DODGE. Well, there are other aspects of the tax. This would only be a part of it. Deferral, if these businesses are successful, the tax base will be larger at such time later on that it is taxed. If they are unsuccessful—as in Senator Bunning's case, you will not have a tax liability that is greater than the value of the business.

Senator LINCOLN. So you are suggesting that it be deferred to see if the business is going to be successful?

Prof. DODGE. No. It has nothing to do with—that is just random. But it would be deferred until such time as the business is either sold or it ceases its qualified use.

Senator LINCOLN. What about prepayment?

Prof. DODGE. Well, people could elect to prepay, possibly.

Senator LINCOLN. For a lower rate.

Prof. DODGE. You could build an election. Sometimes people would find it advantageous to accelerate the taxable event. I see no reason not to have that option built into the system.

Senator LINCOLN. Professor Batchelder?

Prof. BATCHELDER. Yes. First, in terms of the difference between an inheritance tax and an estate tax, I would be happy to sort of explain why I think it actually would matter, practically, at the level of who is burdened by the tax. But in terms of illiquid assets in family farms and family-owned businesses, it seems like there are several different approaches we could take. One would be to stick with the sort of patchwork of rules that we have.

There was a quote in a book on estate tax repeal that found that both the American Farm Bureau and the *New York Times* had never identified a single family farm that had been sold to pay the estate tax. We just heard a story of one that had been, so I think it certainly may exist and is a theoretical possibility under the existing rules.

And two other possibilities have been discussed. Professor Dodge has discussed the possibility of just not imposing the tax at all until the business is sold, and then imposing it on the value of the business at that time.

I would actually prefer an approach where you would determine the tax liability at the time of the transfer, but then defer it indefinitely with interest until it was sold. So as long as it is not sold, there would be no tax liability.

Senator LINCOLN. But there would be tax liability eventually, with interest, which puts the pressure on the business that is moving from one entity to another in terms of management. I mean, if we use the example of Wall Street and publicly traded companies, when the CEO dies, there is no shift there. The liquidity is there in order for those businesses to continue.

When you take a shift here from one generation to the next in a family-owned business, a farming operation, or a ranching operation, I mean, all of a sudden you have to come up with the liquidity to pay a tax, as well as assuming the management risk and other things like that. How can they be competitive in that scenario?

Prof. BATCHELDER. Well, the concept would be that they would not owe any tax at that time, so there would be no need for liquidity because you would owe no tax. It would be deferred until, if the heirs eventually decide they want to cash out, they do not want to run the family business. Then they would be taxed on their inheritance to the extent that it exceeds a really high exemption, but if they do not take the cash out they would not be taxed.

Senator LINCOLN. Does it make a difference who they sell it to?

Prof. BATCHELDER. No, I do not think it necessarily should.

Senator LINCOLN. No. We have lost tremendous family-owned businesses, which people here in Washington love to talk about how important family-owned businesses are. We have seen tremendous sales of family-owned businesses to major corporations because they cannot survive under the kind of pressures that both these types of tax systems and regulations have on them as small businesses without the capital to be able to survive.

I mean, I do not know. If our objective here in this country is to not only create, but perpetuate the American dream that you can build a family-owned business, how are we providing the fertile environment in order for that to continue? If we continue to put the kind of restrictive, both tax laws, but also the same kind of regulatory burdens that exist for small businesses, I do not know.

I am truly an advocate for family-owned businesses because I see the productivity in them and I see the job creation that they provide this country. So, I do not know. I do not see where you are doing anything but putting off the pain.

Prof. BATCHELDER. Well, I think it means that there is no liquidity crunch. I guess the other point I would make is, I would hate for us to lose sight of the potentially valuable role that making wealth transfer taxes part of the tax system can create in terms of ensuring that economic mobility is distributed more evenly. I would hate for us to be distracted from that by this problem.

Just to cite one statistic, the Tax Policy Center has estimated that business and farm assets compose more than half of the estate value for only 2.8 percent of taxable returns, so 97 percent of taxable returns really do not have a problem right now.

I think it is important to remember those 97 percent and think about, do we want this kind of tax within our fiscal system, do we think it is important to recognize the extent to which inheritances can affect someone's ability to pay, just like earning income from work or savings can affect their ability to pay?

Senator LINCOLN. So are you saying that 97 percent are not affected because they do not reach the amount or is it because they have planned for it?

Prof. BATCHELDER. It is because——

Senator LINCOLN. There are a lot of resources that, unfortunately, family businesses have to spend and devote to mitigating their risk in terms of estate taxes and what their families and their future generations will have to deal with.

Prof. BATCHELDER. Yes. So this statistic was that over half of taxable estate values are liquid assets. Ninety-seven percent of them have over half of their estate as liquid assets. So I do not know what those liquid assets are, but generally one would think then liquidity is not the issue, that one should be able to pay any associated tax liability and continue the family business, if you so choose, without the tax system preventing you from doing so.

The CHAIRMAN. Professor Dodge, you look like you want to get in here.

Prof. DODGE. Well, it is hard to tell just from the statistics about liquidity. As Senator Lincoln suggests, there might be pressure to sell to large corporations or there may be purchases of life insurance. I do not think the tax law should distort economic decisions such as the purchase of life insurance just to fund the liquidity for the tax. So it is hard to tell. I would not be able to, I submit.

Besides, this is obviously an issue of intense interest to the committee. I do not think we need to be absolute purists. So again, I would say that, given the big picture, I think the accessions tax or the income inclusion system is better than the existing system, partly because it is a transferee tax. Again, I would say in the case of illiquid property, that the answer is deferral of the taxable event.

That would have two ancillary benefits. First, there would not be any interest charge involved. Second, you would not have to value a closely held business interest. Under present law, valuing closely held business interest is where all kind of estate planning gimmicks are, family-limited partnerships and all that sort of thing.

Senator LINCOLN. But would that mean that you would not have a step up in basis when they pass down within the family? You would have to, would you not?

Prof. DODGE. Well, if you were going to defer the—no, that is an income tax issue. So the accessions tax is a separate tax. Income tax issues are separate.

The CHAIRMAN. Let me just ask a question here. Why not, just as these three countries, just abolish the wealth transfer tax and the government just gets the revenue it wants with income tax, or capital gains, or whatnot, as I suppose Australia, Canada, and New Zealand do. I do not know what their taxation system is that realizes the income.

Before I ask you two that question, let me ask Professor Duff. So how do these countries make up for lost revenue?

Prof. DUFF. Well, as I said, in these countries capital gains tax did not exist beforehand, so they introduced capital gains tax and that really was the——

The CHAIRMAN. Is it higher or lower than the U.S.?

Prof. DUFF. It is slightly different. In Canada, we include half the gain in income and then subject it to the ordinary rate, so it is effectively half the ordinary rate. Probably comparable to the U.S., our capital gains tax rate. Maybe a little bit higher.

The CHAIRMAN. All right.

Prof. DUFF. Our tax rates are a bit higher.

The CHAIRMAN. But again, why not——

Prof. DUFF. Can I actually address that? Because I do not think those taxes address the key issue, the philosophical issue, about why I think it is legitimate and desirable to tax these transfers of wealth. As I said before Senator Lincoln was here, I think there needs to be balance in a tax system, I think balance in the values that a society has. One value is the value of building up an enterprise, transferring it to your children, and I think that value is an incredibly important value that should be respected and encouraged. But it has to be balanced against the concerns about moderating significant disparities in wealth and opportunity.

The CHAIRMAN. Would you advise those countries to redress that balance? Is there imbalance in those three countries?

Prof. DUFF. I think in terms of the transfer of wealth from one generation to the next, there is.

The CHAIRMAN. In those three countries. Yes. Well, that might answer your question then, your answer—both your answers—as to why not abolish and address it the way these three countries do, that is, lost revenue.

Prof. BATCHELDER. I would just add that, currently, that income tax taxes all the receipts that we have, from work, from saving, from lottery winnings, if you find a fancy painting on the street. That is all income.

The one major thing that is included is income from gifts and bequests. I think that, if we are going to do that within income tax, we should be thinking about how to make sure that that kind of income is still counted in allocating tax burdens, and either an estate tax or an inheritance tax is one way to do that.

I am less concerned about sort of ordinary inheritances. So most people receive inheritances well below, actually, $100,000. Once you get up to, say, $2 million, that is the top 1 percent of the inheritance distribution and they are receiving these really extraordinarily large inheritances that are not considered at all in allocating income tax burdens.

So, if we were to repeal the estate tax and not replace it with anything else that looked at inheritances, we would really be giving a free ride to people who, in my view, are very fortunate to receive such a large inheritance and be born into a family that can afford to give it to them. I am not saying we should tax it all away, but when it really exceeds some extraordinary threshold, we should have them share their good fortune, as Professor Duff said, with everyone else.

The CHAIRMAN. So both Professors Dodge and Duff would agree with that general concept? That is, extraordinary wealth should be taxed, that the transferee should pay some tax on extraordinary bequests.

Prof. DODGE. Yes. But it is ultimately a political question, because the idea of an accessions tax is, in a way, kind of different from fixing holes in the income tax. You could do both simultaneously. Like, you could have a system that, under the income tax, taxed gains and losses at gift or death, and on top of that have an accessions tax with a large exemption. They are just two different taxes.

The CHAIRMAN. What do European countries do?

Prof. DUFF. Most European countries levy inheritance type taxes. I am not as familiar with what they do with capital gains at death, whether they have carry-over basis, whether they have deemed realizations. I think some have one, some have the other.

I think the U.S. is pretty unique in having stepped-up basis around the world, but most continental European countries have a recipient-based tax. The donor-based taxes tend to be something that the English-speaking world has adopted, so England, as I said, Australia, Canada, New Zealand, had them. The U.S. has that approach. It was probably related somehow to common law systems versus civil law systems.

The CHAIRMAN. I understand.

Senator LINCOLN. Could I ask just a couple?

The CHAIRMAN. Yes, go ahead.

Senator LINCOLN. So, Professor Dodge and Professor Duff—I'm assuming, I guess, Professor Batchelder, too—you really think government then should play the role of determining how personal income should be divided? I mean, if you are saying that it is redistribution and those who are fortunate enough to have worked hard all their life to build something, I mean, the incentive was there that if we build this business we will be able to hand it off to our heirs, our children. But then at that point the government decides whether or not you are going to be able to do that because we are going to redistribute your personal income, your personal wealth in a way that we see fit?

Prof. DUFF. As I said, I think there needs to be balance, right? These values are very important, and so, as we have talked about this, I think all of us have said that, for closely held enterprises—farms, certain kinds of family heirlooms—that kind of value is really important and needs to be respected. The best way to, I think, address that is through either deferring the moment of the tax or deferring the tax itself. But it has to be balanced against other values that I think democratic societies hold, which are that when there are extreme inequalities of wealth and opportunities, that is not a healthy thing for a society.

Senator LINCOLN. Can you not do that by limits?

Prof. DUFF. What do you mean by limits? I think that is what——

Senator LINCOLN. Amounts.

Prof. DUFF. That is what exemptions are about. A basic exemption that says only taxing above very large, substantial gifts and inheritances is, I think, exactly that: a limit. It does not say, well, you cannot do beyond that. It is just, there is a price to be paid beyond that, and the price is to share with the rest of society. You might even say, well, all right, so government requires that sharing. Then, of course, people always say, well, it disappears into government, right? So then make the sharing explicit. Take the revenues and dedicate them to education for people from disadvantaged backgrounds, things that will give people a leg up who do not have that leg up otherwise.

Senator LINCOLN. Right. I do not disagree with you, necessarily. I certainly believe that, as Americans, we all have a huge responsibility to give back to this great country that has given us so much in terms of opportunities, and those very opportunities to build a business from nothing or from scratch. But then comes the big question that we always fall over ourselves about here, and that is, where are those limits? How do you determine?

I visited with a man who has spent his life building a small business, investing in infrastructure and machinery. He has four sons. To say he is limited to an exemption of $1.5 million or $3.5 million does not get him to where he needs to be. He is still going to have to dissolve. Better yet, he will be bought out by some big major, huge corporation because he cannot pass it down to his sons without coming up with the liquidity that he needs to do that.

Prof. DUFF. This is one of the advantages, of course, of the inheritance type or accessions approach: four sons, four exemptions, as opposed to four sons, one exemption under the estate tax. You distribute to your four sons, each of them gets, under Professor Batchelder's proposal, a $2-million exemption. That is $8 million of exemption rather than, the current system is what next year? Three or something?

Prof. BATCHELDER. Next year would be $3.5 million. Right now, it is $2 million.

Senator LINCOLN. And then back to $1.5 million in 2011, which would be one.

You mentioned the deferral, Professor Dodge, that you thought that might be something that would be very helpful. Of course, we want to create something that not only is going to be, I think, advantageous to making sure that family businesses can continue, but we also want to simplify as we go. I know the chairman has worked tirelessly, working on simplification of the tax code.

We do not want to make it any more complicated. But with deferral, I am not aware of all of the administrative burdens, but I do understand there are some in terms of the IRS reporting requirements and other things like that. Is there any issue there? Have you done the research in terms of how that can be simplified?

Prof. DODGE. Well, under the accessions tax, that is completely separate from issues like whether there is a carry-over basis or a stepped-up basis. So whatever the basis is for income tax purposes, under accessions tax deferral there would be no valuation at the time of gift or death.

There would just not be a taxable event until it is basically converted away from the qualified use; that is what you are trying to protect, keeping the business in the family. So, if they sold it, then the proceeds of sale would be subject to accessions tax. If it were a farm and they ceased operating it as a farm and decided to subdivide it and sell off the lots, well, that would be the triggering event.

Senator LINCOLN. What about if it went into conservation?

Prof. DODGE. I do not see any administrative problem. All you would have to do is identify property out there that is subject to this system.

Senator LINCOLN. Right. So you do not see any worries about additional reporting or IRS complications or greater need for oversight.

Prof. DODGE. No, that is the problem under the carry-over basis system, because you have an event that supposedly fixes basis, but it does not bear fruit for many years later. But I do not see that as a problem under the accessions tax.

The CHAIRMAN. As I understand it though, with the other systems, with inheritance systems, there could well be a lot of complexity there, too. You do have issues of step-up or carry-over, a number of exemptions. A lot of people do not like the current system because they do not like paying taxes.

But, second, they do not like paying taxes on something they build up, as has been discussed here. The third, it is extremely complex. Estate planning is very, very complex. The question is, if we were to have a system where wealth was transferred on the basis of inheritance, would we necessarily have a much less complex system or not? I am just only on complexity at this point.

Prof. DUFF. Professor Batchelder has actually talked about this. I think there are lots of advantages to a recipient-based tax over an estate-based tax in terms of simplicity, particularly when you come to dealing with trusts and the generation-skipping tax that exists in the U.S. All that complexity comes from trying to tax on the donor side rather than the recipient side. Actually, I will hand it over to Professor Batchelder because she has written about this.

Prof. BATCHELDER. Yes. I actually think there are a number of simplification advantages to an inheritance tax, and also a number of ways that we could simplify current law. Some of the advantages of an inheritance tax you can only get within an inheritance tax.

The big issue, I think, is that, whenever you have a tax that is applied to extraordinarily wealthy people with very sophisticated tax advisors, you are going to need some complicated rules because their tax advisors are going to spend a lot of time trying to figure out how to game them.

The way to prevent that is to treat economically similar transactions alike, so that, even if you restructure a transfer, it is all going to be taxed the same way and then there is really no way around it.

An inheritance tax, I think, would allow more of that. A particular area that it would is, there are some very complicated rules under current law about split and contingent interests—this is when sort of the ultimate beneficiary is unclear. You create a trust and maybe a portion of it is going to go to the spouse and be exempt, or a portion will go to a charity and be exempt, and then a portion is going to go to a taxable beneficiary. We have these very complicated rules to figure out, all right, we think 53 percent is going to go to the tax-exempt beneficiary. An inheritance tax would let you just wait and see, and ultimately whatever goes to the spouse or charity, that is subject to the exemption. Whatever goes to the taxable heir——

The CHAIRMAN. I am going to have to conclude this hearing, unless——

Senator LINCOLN. Can I just ask one last question, please?

The CHAIRMAN. Senator Lincoln has one question.

Senator LINCOLN. Thank you, Mr. Chairman.

There are not many times that I wish I was a tax attorney, but with this issue, I do. Fortunately I am surrounded by some very, very thoughtful tax attorneys, and grateful for their counsel. But you are right, they are very smart people and they do figure out an awful lot on that chessboard in terms of ways to deal with it.

The last thing I would just like to ask is, you all talked consistently about deferral in terms of the payment. One of the issues we deal with—I mean, family businesses can defer, I think, already in many instances. But the way we work around here are in 10-year budgets, so we have to understand what something is going to cost. The repeal of the estate tax is very costly, in the sense that it is a lost revenue to the Treasury. If this inheritance tax continues to be deferred, does this proposal or idea that you are advocating not score as costly as repeal if all we are doing is deferring that tax?

Prof. BATCHELDER. Well, again, the deferral option that I was describing would only apply if you do not have the liquid assets to pay the tax. So as I mentioned, 97 percent, at least, of estates do. Presumably about that many would under an inheritance tax.

Senator LINCOLN. Of course, the nitty-gritty detail there is what you are describing as liquid. I mean, you can always sell land. It becomes liquid if it has to.

Prof. BATCHELDER. Right. Right.

Senator LINCOLN. Yes. So I know that certainly the chairman has been an incredible tutor in terms of figuring out, when there is a cost with something, it has to be dealt with. Obviously, the cost of full repeal is tremendous. We realize that that is problematic. But if we are continually deferring the inheritance tax, then I think it probably scores enormously costly as well and is something we have to deal with in terms of figuring out how we change things and make them better.

So, Mr. Chairman, thank you very much. I do hope that we can come to a resolution, because the unknown has become enormously frightening to many of my small businesses, farmers, and ranchers. I know if we all put our heads together we can come up with something that gives them more certainty in terms of what they can expect, and certainly greater simplification. So I appreciate the chairman's leadership.

Thank you all.

The CHAIRMAN. I thank you all. This has been a very provocative hearing. It is kind of mind-bending, in some respects. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

REFORM OPTIONS FOR THE ESTATE TAX SYSTEM: TARGETING UNEARNED INCOME

Lily L. Batchelder[1]
Associate Professor of Law & Public Policy, NYU School of Law

Testimony Before the United States Senate Committee on Finance
March 12, 2008

Good morning, Mr. Chairman, Ranking Member Grassley, and Members of the Committee. My name is Lily Batchelder and I am an associate professor at NYU School of Law. Thank you for the opportunity to testify before you today on alternatives to the current federal estate tax system. My testimony makes three main points:

- First, inheritances tend to exacerbate existing economic disparities and may be the most important barrier to intergenerational economic mobility. These tendencies are most pronounced at the top of the income distribution. Inheritances are a significant component of household income. They are also the source of about 40 percent of all household wealth. While inherited income is distributed fairly evenly across most of the population, it rises sharply at the very top. Among households receiving a bequest in a given year, the average inheritance of those in the top 1 percent of the inheritance distribution is 34 times larger than the average inherited income of everyone else.

- Second, the estate tax system is the most important mechanism by which the current fiscal system mitigates the effect of inheritances on economic disparities and intergenerational mobility. The burden of the estate and gift taxes falls largely on heirs, not donors. On average, it also rises rapidly with the amount the heir inherits and his economic income.[2] Nevertheless, the relationship between the heir's financial circumstances and his or her estate tax burden is relatively imprecise. Some individuals who receive extraordinarily large inheritances bear little or no tax burden, while a small number who inherit relatively small amounts bear substantial tax burdens.

- Finally, the scheduled repeal of the estate tax in 2010 and reinstatement at higher levels in 2011 create an opportunity to better focus the estate tax

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[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of NYU School of Law. Portions of this testimony draw upon 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), Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes versus Inheritance Taxes* (work-in-progress), 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). My co-author also should not be held responsible for the views expressed in this testimony.

[2] This is the case regardless of whether economic income is defined as income from work and saving plus the amount inherited, one-fifth of the amount inherited, or the annuitized value of the amount inherited.

system on unearned income that inheritances represent. We should use that opportunity to reform, not repeal, the estate tax system so that we continue to tax inherited income, but in a more equitable manner. I will discuss two potential reform options.

- The first would replace the estate tax system with a comprehensive inheritance tax, under which an individual inheriting an extraordinary amount over his lifetime would pay income tax and a flat 15 percent tax on a portion of his inheritance. Relative to the 2009 law, this reform could be implemented on a revenue-neutral basis if approximately the first $2 million in lifetime inheritances were tax-exempt. In effect, extraordinary amounts of inherited income would be taxed at about the same rate that families pay on earned income under the income and payroll taxes. This reform would substantially alter tax burdens, and improve the fairness of the current system by more accurately targeting the unfair advantages that exceptionally large inheritances create.

- If this reform is considered too ambitious, a second alternative would be to retain and improve the estate tax system by better focusing it on the amount transferred as a proxy for the amount inherited. Specifically, I will discuss a package of simplification reforms that would limit the extent to which the tax burden on heirs depends on their access to sophisticated tax advice.

I. Background on Wealth Transfers

Gifts and bequests affect economic opportunities and outcomes in important ways. They tend to magnify income and wealth disparities. They also create barriers to intergenerational economic mobility.

In 2009, annual bequest flows in the U.S. will total about $400 billion, excluding transfers to spouses and charitable organizations.[3] Bequests will represent about 4 percent of all household income and, among households receiving a bequest that year, about half of their receipts from labor, saving and bequests. In addition, gifts and bequests (which I will refer to as inheritances or wealth transfers) are a tremendously important determinant

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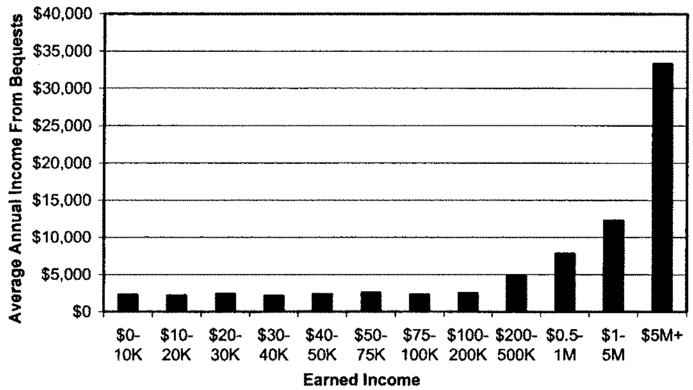
[3] Unless otherwise noted, all estimates in this testimony are based on 2009 law and data, and are derived from Batchelder and Khitatrakun, *supra* note 1, or Batchelder (2008), *supra* note 1. These estimates are very rough because of data limitations that require multiple levels of imputation and because they rely in part on data from 1992.

Including taxable gifts made by the donor during life would increase the $400 billion figure by an unclear amount. Taxable gifts exclude gifts to spouses and charities, support expenses for minor children, payments for education or health care, and, currently, the first $12,000 in otherwise taxable gifts to a given beneficiary each year ($24,000 per couple). Taxable gifts comprise about 15 percent of the lifetime wealth transfers of donors taxed under the estate tax system. However, the likelihood that a donor will make a taxable gift rises dramatically if the donor is exceptionally wealthy. David Joulfaian & Kathleen McGarry *Estate and Gift Tax Incentives and Inter Vivos Giving*, 57 NAT'L TAX J. 429, 439 tbl.5 (June, 2004).

of household wealth. According to the best estimates, between 35 and 45 percent of all household wealth is inherited.[4]

Inheritances are distributed fairly evenly across most of the income distribution, but rise sharply at the very top. As illustrated in Figure 1, tax units in roughly the top 1 percent of the earned income distribution (earning more than $500,000) receive about four times as much income from bequests as other households do on average. Moreover, some individuals—whether highly-compensated workers or not—inherit extraordinarily large amounts. For example, Figure 2 shows that among tax units receiving a bequest in a given year, the average inherited income of those in the top 1 percent of the inheritance distribution is 34 times larger than the averaged inherited income of everyone else. Inheritances thus tend to magnify economic inequality.

Figure 1: Estimated Average Annual Income from Bequests by Earned Income of All Tax Units in 2009



In addition, inheritances are perhaps the most important barrier to intergenerational economic mobility, or the ability of a child to achieve a different standard of living than that of his parents. The income that a child earns over his lifetime continues to be heavily influenced by the income of his parents, and this correlation is even higher at the ends of the income distribution.[5] For example, on average, children

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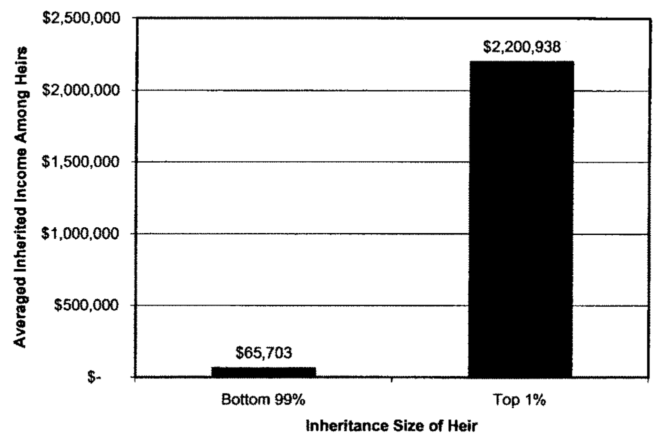
[4] James B Davies & Anthony F. Shorrocks, *The Distribution of Wealth*, *in* HANDBOOK OF INCOME DISTRIBUTION (Anthony B. Atkinson and Francois Bourguignon, eds.) (2001); Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207, note 2 (2007).

[5] Thomas Piketty, *Theories of Persistent Inequality and Intergenerational Mobility*, *in* HANDBOOK OF INCOME DISTRIBUTION §§ 2.1, 3 (A. Atkinson and F. Bourguignon, eds., 1998). For example, half of sons of fathers in the bottom income decile have earnings below the 30th percentile, while half of sons of fathers in the top decile have earnings above the 80th percentile. 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).

born to the top decile of the income distribution are 53 times more likely to end up in the top decile than children born to the bottom.[6]

Figure 2: Average Annual Income from Bequests by Inheritance Size among Tax Units Receiving a Bequest in 2009



There are many sources of these barriers to economic mobility. Most are factors society would find difficult to mitigate. For example, existing evidence suggests that about 18 percent of the intergenerational correlation of income is explained by the correlation between parent and child IQ, personality and schooling.[7] However, inheritances can be adjusted in a relatively straightforward manner through fiscal policy. Moreover, disparities in inheritances appear to be the most significant barrier to mobility—accounting for about 30 percent of the correlation between parent and child economic outcomes.[8]

II. Magnitude and Distribution of Estate Tax Burdens

Currently the estate tax system adjusts the amount individuals inherit through three interconnected taxes: the estate tax, the gift tax, and the generation-skipping transfer (GST) tax. This estate tax system is effective at narrowing the distribution of inheritances by imposing higher tax burdens on those who inherit more over their lifetime. But it does so in a relatively rough manner.

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[6] 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).

[7] Samuel Bowles, et al, *Introduction* 1, 18-19, *in* UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS 1, 20 (Samuel Bowles et al, eds., 2005).

[8] *Id.*; Piketty, *supra* note 5; Mazumder, *supra* note 5 at 94.

Background on the Estate Tax System

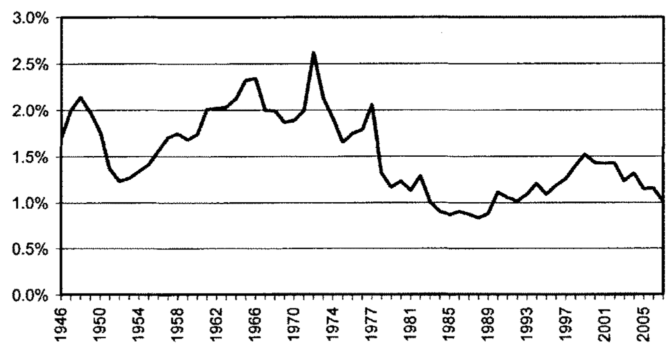
In 2008, the estate tax system operates as follows. An individual can transfer $2 million in gifts and bequests ($4 million in the case of a couple) tax-free. Any portion of a bequest above this threshold is taxed at a 45 percent rate under the estate tax.

In order to prevent donors from avoiding the estate tax by making transfers during their life, the estate tax is coupled with a gift tax. Under the gift tax, gifts transferred prior to death that exceed $1 million over the donor's lifetime ($2 million in the case of a couple) are taxed at a 41 to 45 percent rate. A third tax, the GST tax, prevents donors from achieving lower tax rates by transferring wealth directly to their grandchildren instead of through their children.

In addition to the lifetime exemptions of the estate tax system, a number of other wealth transfers are tax-free. Each year a donor can completely disregard $12,000 of gifts to each of his or her beneficiaries ($24,000 in the case of a couple). All transfers to spouses and charities are disregarded. And all payments for education and health care are also tax-exempt.

The estate tax system only applies to the amount of gifts and bequests that a donor transfers. There is no separate tax on the amount of gifts and bequests that an heir receives. Importantly, under the income tax, gifts and bequests are not considered income of the heir, and are thus tax-free.

Figure 3: Estate and Gift Taxes as a Share of Federal Revenues, 1946-2007[9]



The estate tax system has been a small but stable source of revenue ever since the estate tax was enacted in 1916, generally raising between 1 and 2.5 percent of federal revenues as illustrated in Figure 3. Most revenue comes from the estate tax itself.[10] In

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[9] *Id.* tbls. 2.1 & 2.5 at 31, 45 (2008). Federal revenues include on-budget and off-budget receipts.

[10] In 2006, the estate tax raised $24.653 billion, the gift tax $1.628 billion and the generation-skipping transfer tax $0.126 billion. Internal Revenue Service, Statistics on Income, *Estate Tax Returns By Tax Status and Size of Gross Estate, 2006*, *available at* http://www.irs.gov/pub/irs-soi/06es01fy.xls; Internal Revenue Service, Statistics on Income, *Total Gifts of Donor, Total Gifts, Deductions, Credits, and Net Gift Tax, 2006*, *available at* http://www.irs.gov/pub/irs-soi/06gf01gr.xls.

2007, the estate tax system raised about $26 billion.[11] Repeal of the estate tax would likely lose significantly more revenue.[12]

The Distribution of Estate Tax Burdens

On average, the estate tax system is effective at mitigating the effect of inheritances on economic disparities and intergenerational mobility. This is the result of two factors. First, the economic burden of the estate tax system falls predominantly on heirs, not donors. Second, the tax burden rises steeply with the amount the heir inherits and his or her economic income.

The reason the burdens of the estate tax fall predominantly on heirs is that the tax typically reduces the amount that an heir receives. For example, suppose a mother would like to bequeath $10 million to her only son. If an estate tax is enacted that would tax such a transfer at 33 percent, she has three options. She can transfer $10 million as planned, leaving her son with $6.7 million after-tax. She can consume more and save less, leaving her son with an after-tax inheritance of less than $6.7 million. Or she can consume less and save more; for example, she could increase her saving to $15 million, leaving her son with $10 million after-tax. So long as she does not save more in response to the tax, her son will bear the tax burden in the form of a smaller inheritance.[13] In practice, wealthy donors appear to transfer the same amount or slightly less in response to the estate tax system (implying that it has a small effect or no effect on private savings).[14] As a result, heirs generally bear most of the tax burden.

Most analyses of the distribution of estate tax burdens historically have assumed that it burdens donors, not heirs. This has been due to limited data on the financial

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[11] OFFICE OF MANAGEMENT AND BUDGET, HISTORICAL TABLES, BUDGET OF THE UNITED STATES GOVERNMENT, FY2008, tbl. 2.5 at 45 (2008).

[12] This is 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); NONA A. NOTTO, ESTATE AND GIFT TAX REVENUES: PAST AND PROJECTED 13 (Congressional Research Service Report for Congress, Aug. 24, 2007).

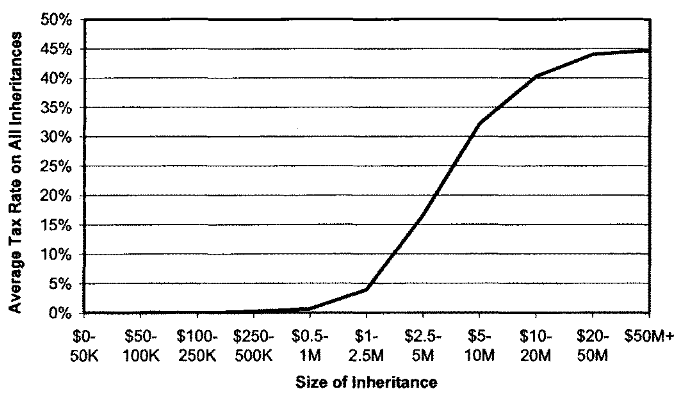
[13] Even if all donors respond to wealth transfer taxes by increasing their consumption, they may still bear some burden to the extent they value the after-tax amount their heirs receive. However, a surprisingly large share of wealth transfers appear to stem from the donor saving for reasons unrelated to their heirs. Recent studies estimate that these other motives for accumulating wealth that is bequeathed (e.g., precautionary saving for retirement expenses) account for the vast majority of bequests. *See e.g.*, Wojciech Kipczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007); John Laitner & F. Thomas Juster, *New Evidence of Altruism: A Study of TIAA-CREF Retirees*, 86 AM. ECON. REV. 893 (Sept., 2006). In a review of the empirical literature, Douglas Holtz-Eakin concluded that there is no single "smoking gun" explanation for why donors accumulate wealth that is bequeathed, including the explanation that the donor values how much his or her heirs receives. Douglas Holtz-Eakin, *The Uneasy Empirical Case for Abolishing the Estate Tax*, 51 TAX L. REV. 495, 511 (1996).

[14] *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 & Joel Slemrod, *The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior*, *in* RETHINKING ESTATE AND GIFT TAXATION 299 (William G. Gale, James R. Hines Jr., and Joel Slemrod, eds, 2001) . Kopczuk and Slemrod note any negative relationship between the size of reported estates and the estate tax rate may reflect evasion activity, rather than a change in the amount transferred.

circumstances of heirs inheriting from large estates, not to a belief among economists that donors truly bear the tax burden. Indeed, the President's former chairman of the Council of Economic Advisors, Gregory Mankiw, has stated that he believes that the burden of the estate tax system falls on heirs and not donors and decedents.[15]

The fact that heirs appear to bear most of the burden of taxes on gifts and bequests has important implications for how such taxes should be conceptualized and designed. To the extent that the burden of wealth transfer taxes is borne by heirs, they are not double "death" taxes on the decedent, who may have worked hard to accumulate his or her wealth. They are taxes on the unearned windfalls that children who are fortunate enough to be born into wealthy households receive. As such, we may wish to tax inheritances in the same way that we tax other unearned windfalls, like lottery winnings or sunken treasure—by including them in taxable income. Moreover, because wealth transfer taxes tend to be borne largely by heirs, we may want the tax rate to depend on, and rise with, the financial circumstances of the heir, not the donor.

Figure 4: Estimated Average 2009 Estate Tax Burden on All Inheritances, by Inheritance Size



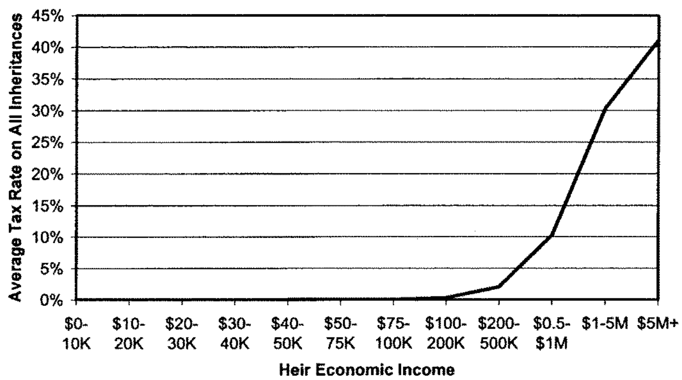
Under the current estate tax system, the tax rate does not directly turn on, or rise with, the amount the heir receives, but rather with the amount the donor transfers. In practice, estate tax burdens do, on average, rise steeply with the amount the heir inherits and his economic income, as illustrated in Figures 4 and 5.[16] Overall, 98 percent of estate tax revenue comes from heirs with economic income above $200,000, while 96 percent of estate tax revenue comes from taxes on inheritances of more than $1 million. This is the case because, on average, the size of an inheritance rises with the wealth transfers of

[15] Gregory N. Mankiw, *Remarks by Dr. N. Gregory Mankiw, Chairman, Council of Economic Advisers at the National Bureau of Economic Research Tax Policy and the Economy Meeting* (Washington DC: National Press Club) (Nov. 4, 2003), *available at* http://www.whitehouse.gov/cea/NPressClub20031104.html.

[16] In Figure 4, economic income includes the heir's income from work and saving, and the amount the heir inherits which is spread over five years in order to account for the fact that inheritances typically are not received in equal amounts every year. The figure looks directionally similar if the inheritance is spread over the heir's remaining life expectancy instead.

the donor and, on average, children born into high-income households are higher-income. But the relationship between the tax rate and the heir's financial circumstances is necessarily imprecise because the two are only linked indirectly.

Figure 5: Estimated Average 2009 Estate Tax Burden on All Inheritances, by Heir Economic Income



Indeed, under the current estate tax system, some heirs inheriting extraordinarily large amounts bear little or no tax burden, while others inheriting relatively small amounts bear large tax burdens. As Table 1 shows, in 2009 only about 5 in 1,000 people who receive an inheritance will bear any estate tax burden. In part, this is because more than 30 percent of heirs inheriting between $2.5 and $5 million are not burdened by the estate tax at all. Generally these heirs have inherited all or part of an estate just below the exemption threshold. Meanwhile about 4 percent of those inheriting between $500,000 and $1 million are burdened by the estate tax, often at quite high rates. Typically these heirs have inherited a much smaller amount from an even larger estate.

In short, the strength of the current estate tax system from a fairness perspective is its ability to effectively narrow disparities in inherited income on average. Its weakness is that it is inconsistent in doing so in individual cases.

Table 1: Estimated Number of Heirs Burdened by 2009 Estate Tax in 2009

Size of Inheritance	Number of Heirs	Subject to Estate Tax Under 2009 Law	Percentage
$0+-100K	3,898,970	422	0%
$100-250K	532,391	961	0%
$250-500K	179,450	3,408	2%
$0.5-1M	90,693	3,246	4%
$1-2.5M	39,328	7,578	19%
$2.5-5M	5,049	3,495	69%
$5M+	2,410	2,410	100%

III. Reforms Worth Consideration

The goal of any reform of the estate tax system should be to more effectively target the tax on the unearned income that inheritances represent. Doing so will ensure that it is based on the ability to pay of the person who actually bears the tax: the heir. It will also ensure that the tax more effectively mitigates the income and wealth disparities and barriers to intergenerational economic mobility that extraordinarily large inheritances exacerbate. If a reform can further this objective while reducing administrative and compliance costs, or strengthening the efficiency of the tax system in other ways, all the better.

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. The 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. I will discuss two promising approaches to improving the current system.

Table 2: Scheduled Changes to the Estate Tax System

	Tax Rate		Exclusions			Basis Provisions
	Estate & GST	Gift	Annual Gift[17]	Lifetime Estate & GST	Lifetime Gift	
2008	45%	41-45%	$12,000	$2 million	$1 million	Gifts: Carryover Bequests: Stepped-up
2009	45%	41-45%	$12,000	$3.5 million	$1 million	Same
2010	0%	35%	$12,000	N/A	$1 million	Gifts & Bequests: Carryover. Up to $4.3M capital gains tax-exempt.
2011 & on	41-55%[18]		$12,000	$1 million	$1 million	Gifts: Carryover Bequests: Stepped-up

A Comprehensive Inheritance Tax

The first option, which would be the most ambitious and effective, would be to replace the estate tax system with what I refer to as a "comprehensive inheritance tax." Under a comprehensive inheritance tax, any individual inheriting an extraordinary amount over his lifetime must pay income tax and an additional "surtax" on the portion of his inheritance that exceeds a large lifetime exemption. This reform could be implemented on a revenue-neutral basis by adjusting the exemption amount and surtax level.

Surachai Khitatrakun and I have estimated that a comprehensive inheritance tax would be revenue-neutral relative to 2009 estate tax law (a $3.5 million lifetime exemption) if the first $1.9 million in lifetime inheritances were tax-exempt, and

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[17] The exclusion is inflation-adjusted so it may rise above $12,000 after 2008.

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

inheritances thereafter were included in income and subject to a flat 15 percent tax. In effect, extraordinary amounts of inherited income would then be taxed at the same rate that families pay on earned income under the income and payroll taxes.

To state the obvious, $1.9 million is a lot of money. An individual who inherits $1.9 million at age eighteen 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 nine out of ten American families.[19] Accordingly, a lower exemption amount could be adopted to raise more revenue, or to maintain revenue-neutrality relative to a different baseline. Table 3 summarizes some alternate possibilities. These estimates assume that any portion of a bequest that is included in income can be spread out over the current year and the previous four years. They also assume that each year $12,000 in gifts and $60,000 in bequests can be disregarded entirely, and do not count toward the lifetime exemption. All of these estimates are very rough and would differ from an actual revenue estimate because they assume no behavioral response.[20] For example, the Joint Committee on Taxation estimates that 2009 estate tax law will raise $21.8 billion and 2011 law will raise $50.7 billion.[21]

Table 3: 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.

To understand how this tax would work, imagine a person receives a bequest of $3 million above the annual exemption and has not received inheritances exceeding the annual exemption in any prior year. If the lifetime exemption is $1.9 million and the surtax is 15 percent, this person would only have to include $1.1 million of the bequest in his taxable income. This portion of his inheritance 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.

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[19] 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* tbl. A-3, *available at* www.census.gov/hhes/www/income/histinc/p60no231_tablea3.pdf.

[20] The estimates are very rough due to data limitations, outdated data, and the assumption of no behavioral response to the tax. To the extent that donors respond to the different incentives created by the tax, it is likely that the revenue-neutral exemption would be lower and, as discussed below, that disparities in inherited income on a pre-tax basis would be narrower.

[21] Joint Committee on Taxation, *supra* note 12, tbl.5 at 29.

To limit this effect, he could elect to file as if he received $220,000 of taxable inheritance in the current year and the same amount in the previous four years.[22]

From an administrative perspective, the heir should 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 should 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 paying any excess tax due if his lifetime reportable inheritances exceeded the lifetime exemption.

Advantages and Estimated Effects

A comprehensive inheritance tax would be substantially more targeted on inherited income than the current estate tax system because the tax rate would turn directly on the amount received. It would also be better attuned to the ability to pay of the individual who bears most of the burden of either tax—the heir.

Theoretically, if an estate and inheritance tax both had the same flat tax rate, there would be no difference in their distributional effects. Because all inheritances come from estates, the aggregate amount subject to tax would be the same, and any differences in how estates were distributed would be irrelevant because of the flat tax rate. Similarly, if all estates were distributed to only one taxable beneficiary and the inheritance tax rate depended solely on the amount inherited, there would be no distributional difference between the two approaches. In practice, however, the estate tax system has a progressive rate structure (due to the lifetime exemption) and estates frequently have more than one taxable beneficiary. As a result, a comprehensive inheritance tax should burden people differently.

Figures 6 through 9 illustrate that a comprehensive inheritance tax would indeed result in different tax burdens, and to a surprisingly large degree. If the 2009 estate tax was replaced with the revenue-neutral comprehensive inheritance tax outlined (with a $1.9 million exemption and 15 percent surtax), the distribution of tax burdens under the new tax would be similar in aggregate. This is true regardless of whether one considers the distribution of burdens by the amount inherited, the heir's economic income, or even the estate size or decedent's income (Figures 6 and 7).

But at an individual level, the new tax would allocate burdens very differently. For example, Figure 8 shows that of all 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 not bear any tax burden whatsoever under the comprehensive inheritance tax. The essential reason why these differences arise is that all

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[22] Inherited income should be spread over prior years in order to limit incentives for the heir to work less in order to obtain a lower tax rate.

large inheritances do not come from the largest estates, and all smaller inheritances do not come from smaller ones.[23]

Figure 6: Estimated Average Tax Burden on All Inheritances under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax by Inheritance and Estate Size

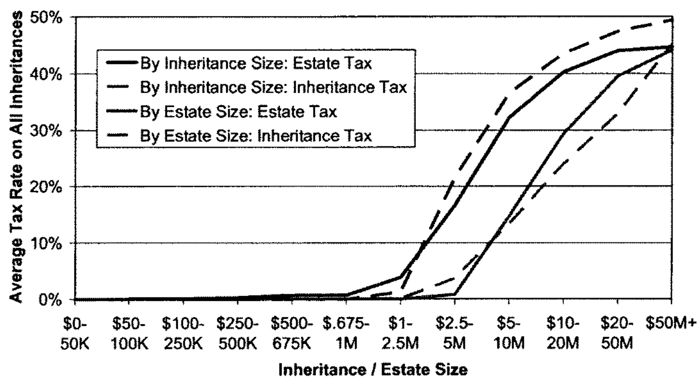
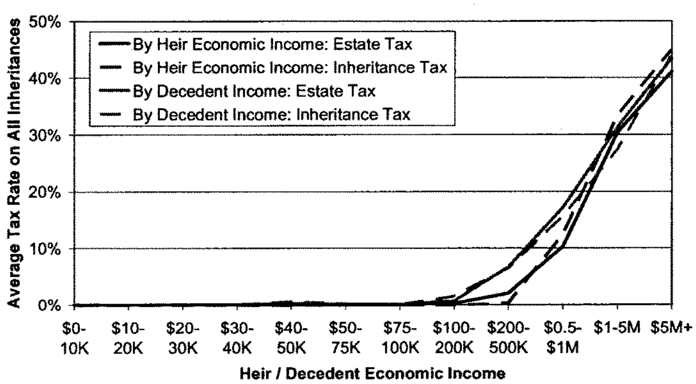
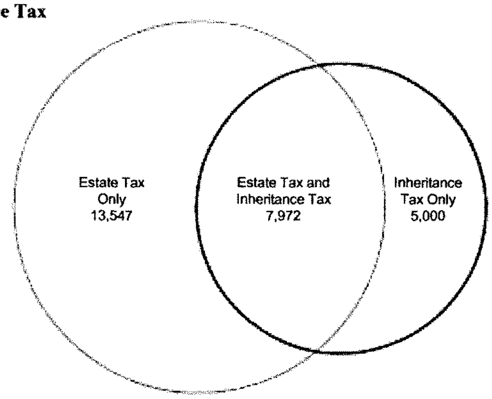


Figure 7: Estimated Average Tax Burden on All Inheritances under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax by Heir and Decedent Economic Income



[23] 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 could be left entirely to one heir who is in the top income tax bracket and 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%, but in the latter it would be zero. As a further example taking the opposite perspective, 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 estate tax rate on the former 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.

Figure 8: Number of Heirs Burdened by 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax

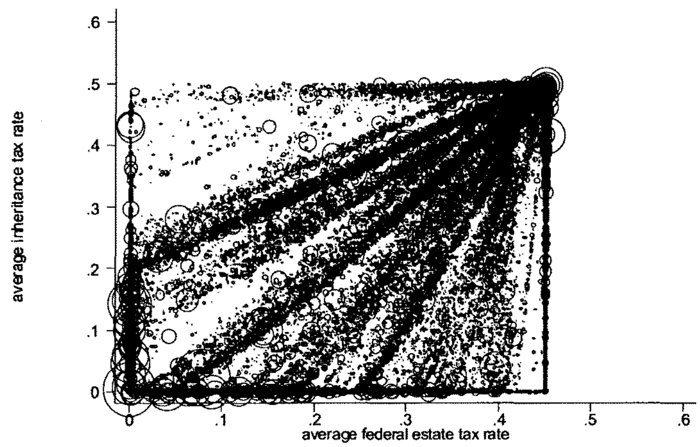


The differences between the estate tax system and this new tax can be understood still further by considering heirs who would be burdened by both taxes. These heirs do account for the lion's share of revenue raised under either tax (about 90 percent). However, many would be subject to a very different tax rate under the comprehensive inheritance tax. 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 9, which focuses on those heirs who would be burdened by either tax (i.e., in one of the circles in Figure 8) and plots the average estate tax rate and comprehensive inheritance tax rate that each heir would face.[24] On average, the estate tax rate rises with the inheritance tax rate, and vice versa. But Figure 9 illustrates that individual heirs who are burdened by both tax systems often face dramatically different rates under one versus the other.

These substantial distributional differences in the burdens of a comprehensive inheritance tax essentially quantify its fairness benefits relative to the estate tax system. Each time the comprehensive inheritance tax applies a higher or lower tax rate to an heir, it is more accurately measuring inherited income and, in doing so, more effectively narrowing the disparities in economic opportunities and outcomes that stem from extraordinary large inheritances.

[24] Each point represents an heir and each circle represents multiple heirs. Along the y-axis are heirs who are burdened only the inheritance tax, and along the x-axis are heirs who are burdened only by the estate tax. Every point in between represents the 30 percent of burdened heirs, who account for 90 percent of the revenue, and are burdened by both taxes. The correlation statistic for Figure 9 is 0.71. If the figure is not weighted by inheritance size, the correlation statistic is 0.33.

Figure 9: Average Tax Rate on Inheritance of Individual Heirs under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax (Weighted by Inheritance Size)



A comprehensive inheritance tax is only one of several alternatives to an estate tax system. As illustrated in Figure 10, jurisdictions currently apply five general approaches to taxing wealth transfers. Some, like the United States, have an estate and gift tax. Others have no wealth transfer tax and therefore disregard inherited income entirely in allocating tax burdens. Most, however, have an inheritance tax of which there are three types. The rate schedule of an "accessions tax" turns solely on the amount the heir inherits over a long period of time, typically his lifetime. The rate schedule of an "annual inheritance tax" instead turns on the amount inherited each year. Finally, an inclusion tax requires the heir to include inheritances in his income tax base, and the rate schedule therefore turns on both the amount inherited and the heir's other income.

All three traditional types of inheritance taxes have their advantages and have been proposed by a number of commentators.[25] Nevertheless, a comprehensive inheritance tax would be the best approach. Under the current income tax rate schedule, an inclusion tax would result in lower tax burdens on the largest inheritances and thus would be less effective at mitigating the effects of extraordinary large inheritances. Both an inclusion tax and an annual inheritance tax would permit extensive gaming by applying much lower rates if inheritances are spread out over an heir's lifetime. Finally,

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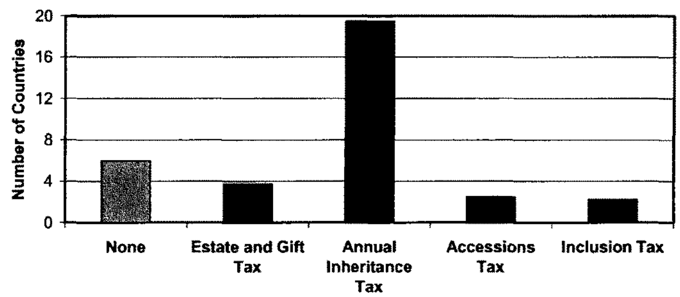
[25] *See e.g.*, Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. (2007); Maya MacGuineas & Ian Davidoff, *Tax Inheritance, Not "Death"*, WASH. POST (July 4, 2006); Gary Becker, *Should the Estate Tax Go?*, (May 15, 2005), *available at* www.becker-posner-blog.com/archives/2005/05/should_the_esta.html; 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); Edwin R. A. Seligman, "A National Inheritance Tax," *The New Republic* (March 25, 1916).

an annual inheritance tax and accessions tax would not link the tax rate to the ability to pay of the heir, who might have very little earning potential due to a disability or other condition. A comprehensive inheritance tax essentially combines the best features of all three.

Figure 10: Type of Wealth Transfer Tax in 34 Countries[26]



Potential Concerns and Responses

Replacing the estate tax system with a different tax system should raise a number of concerns. While the estate tax system is a rough tool for mitigating disparities in inherited income, it is reasonably effective nonetheless. The fairness advantages of a comprehensive inheritance tax should be weighed against the costs of enacting such far-reaching reform. On balance, my view is that these costs are worth the benefits of a more equitable system. Moreover, a comprehensive inheritance tax has advantages along other dimensions by reducing incentives in the current system to engage in costly and complicated tax planning.

Family Farms and Other Illiquid Assets. One concern that may arise is the effect of a comprehensive inheritance tax on family-owned businesses and other illiquid assets. All of the current relief provisions for such property, and others, could be part of a comprehensive inheritance tax.

Given the tendency of this issue to dominate discussion of wealth transfer taxes, one idea worth consideration is replacing the current relief provisions with a single one that would completely eliminate the possibility that an heir would need to sell an inherited family business immediately in order to pay the associated tax liability. This could be accomplished by providing that, to the extent that the tax due on inherited assets exceeded the liquid assets an heir inherited, the heir could defer the tax due on his

[26] International Bureau of Fiscal Documentation, *Asia-Pacific Tax Surveys* (2006); International Bureau of Fiscal Documentation, *European Tax Surveys* (2006); HUGH J. AULT & 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, Bulgaria, Canada, Czech Republic, Denmark, Estonia, Finland, France Germany, Greece, Hungary, Iceland, Italy, Ireland, Japan, Korea, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Serbia, Slovenia, Spain, Sweden, Switzerland, Turkey, U.K. and the U.S.

inherited illiquid assets with interest at a market rate until he sold them. This would eliminate disincentives and (unlike current law) incentives to hold wealth in illiquid forms. However, the advisability of this relief provision would depend critically on it charging interest on any deferred tax, and at a market rate.

State Wealth Transfer Taxes. A second potential concern is the effect of a comprehensive inheritance tax on state wealth transfer taxes and revenue sharing. Prior to 2005 (and under 2011 law and thereafter), the federal government effectively shared estate tax revenues with the states through a wealth transfer tax credit. Under a comprehensive inheritance tax, this and any other form of revenue sharing could also be replicated.

Moreover, if full federal revenue sharing were not reinstated, a comprehensive inheritance tax could leave states freer to retain wealth transfer taxes if they so wish. States would likely act to conform their wealth transfer tax to the inheritance tax model in order to piggyback on the new federal reporting requirements, as they did under the federal estate tax credit (even the states that had an inheritance tax). Because it is generally easier for a retired individual to move to a state with no estate tax than it is for all of her potential heirs to move to states without inheritance taxes, such a shift could reduce the pressure on states to eliminate wealth transfer taxes when competing for wealthy residents.

Giving Patterns and Charitable Contributions. A third potential concern is the effect of shifting to a comprehensive inheritance tax on giving patterns and charitable transfers. While such a shift should not have a large effect on the magnitude of wealth transfers if implemented on a revenue-neutral basis, it could change the identity of individuals receiving inheritances and the amount of charitable contributions.

A comprehensive inheritance tax should induce donors to give slightly more broadly, especially to lower-income heirs or those to whom the donor would not have given previously. These incentives would arise because the tax rate would turn in part on the heir's income tax rate, and because transfers to additional heirs would be exempt if below the heir's remaining lifetime exemption. How much donors would respond to these changed incentives is unclear. Nevertheless, to the extent donors did respond, the fairness benefits of the reform would be magnified as it would further narrow disparities in inherited income. Notably, neither of these incentives exists under current law. A wealthy donor can give to 100 heirs or 1, to Paris Hilton or a foster child, and the tax rate is unaffected.

On the other hand, the reform could affect charitable bequests. In some respects, it would strengthen incentives for charitable giving. For example, contributions to nonprofits that are ineligible for the charitable deduction under the income and estate taxes (e.g., 501(c)(4)s) would be tax-exempt. But the fact that the donor could potentially make more tax-free transfers by giving to more individuals might weaken incentives to make charitable transfers on net. Once again, how much donors would respond to these changed incentives is unclear.[27] To the extent that donors did make fewer charitable

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[27] Joint Committee on Taxation, *supra* note 12, at 45.

transfers, however, it would generally be because they were spreading their wealth transfers out over more individuals.

Administrability and Transition Costs. A fourth potential concern is that replacing the estate tax system with a comprehensive inheritance tax would entail unacceptably high transition costs, or result in an unadministrable system. Experience in other jurisdictions suggests that a comprehensive inheritance tax would be administrable. Each element of the tax has been implemented at a state level or in other countries. Indeed, seven U.S. states have some type of inheritance tax in place, and Figure 10 shows that inheritance taxes are much more common than estate taxes cross-nationally.

Moreover, shifting from the estate tax system to a comprehensive inheritance tax would not require reinventing the wheel. A valuable infrastructure of legal rules and administrative practices has arisen under the estate tax, all of which help to prevent evasion and to promote compliance. Virtually all of these rules and practices could be retained. For example, the existing rules governing when a transfer has occurred, how it is valued, and what transfers are taxable could remain unchanged.

Any large shift in tax policy can result in transition winners and losers. This tendency could be minimized by making the new tax fully effective (with no look-backs) on a date before enactment, such as the date the bill was introduced. Ireland, which is the only jurisdiction I have identified that moved directly from an estate tax to an inheritance tax, applied these transition rules. This approach would limit gaming around the transition by preventing donors from making transfers up to the lifetime gift tax exemption once enactment appears likely. It would also be reasonably equitable. Most individuals receive only one substantial inheritance over their lifetime so disregarding prior inheritances and estate taxes should have little effect. For example, among those who receive a bequest greater than \$1.7 million, on average that bequest represents 94 percent of their lifetime inheritances to date.

Compliance Costs and Tax Planning. Finally, one might worry that moving to a comprehensive inheritance tax would increase compliance costs and tax planning after the transition. A wealth transfer 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 engage in gaming and tax planning by structuring transfers in ways that are economically identical but taxed more lightly.

If anything, a comprehensive inheritance tax would likely reduce gaming and tax planning incentives relative to the current system for three general reasons. First, it would eliminate the need for careful planning of spousal transfers. Currently spouses can reduce their joint tax liability by making sure that each transfers to their heirs an amount equal to the lifetime exemption, for example, through a credit shelter trust. Some well-advised wealthy donors take advantage of this opportunity; others do not. But under a comprehensive inheritance tax, it would not matter which spouse transfers what. Any tax would be based on the amount the heir receives, regardless of whether it was from the mother or father.

Second, the comprehensive inheritance tax outlined would significantly narrow the current substantial differences in how gifts and bequests are taxed. Unlike the current estate and gift taxes, the same lifetime exemption and the tax rate would apply to the pre-tax inheritance. Additional features worth consideration could further narrow these differences. For example, indexing the lifetime exemption to inflation would reduce the incentive to transfer (or appear to transfer) wealth earlier in time, when the present value of the exemption is higher. Replacing stepped-up basis for bequests with carryover basis would eliminate the incentive to hold on to appreciated assets until death in order to eliminate the capital gains tax liability—and ensure that all capital income is taxed once regardless of the donor's access to sophisticated tax advice. The associated compliance costs would be minimized if stepped-up basis still applied to bequeathed assets worth less than a certain amount (e.g., $10,000) and not held for the production of income (e.g., jewelry and furniture). Moreover, given that Germany, Japan and Australia have successfully applied carryover basis to bequests, it should be administrable.[28]

Finally, moving to a comprehensive inheritance tax would permit a different and simpler method for taxing split or contingent transfers made, for instance, through trusts. In particular, the new tax system could wait to see who gets what before taxing transfers for which the taxable status of the beneficiary is unclear. In the meantime, it could 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). Family-owned businesses and other illiquid assets could be treated in a manner I describe below. Essentially, this approach would be economically equivalent to the tax system having perfect foresight regarding which potential beneficiaries will receive what.

This approach would reduce current tax incentives to engage in valuation games. While it would create more valuation points, it would limit incentives to try to shift value to tax-exempt spouses and charities when the ultimate beneficiary is unclear by waiting to see how much is received by whom. As a result, a wide swath of current rules could be eliminated. Indeed, the current rules to address valuation games—including those governing marital trusts, charitable trusts, grantor trusts, and Crummey trusts—compose one-quarter of a leading casebook.[29] An estate tax system cannot adopt this wait-and-see approach. Because its tax rate is based on the amount transferred and not on the amount received, it has to be levied at the time of transfer.

The advantages of shifting to a comprehensive inheritance tax with respect to tax planning should only be partially offset by changes in direct compliance costs. A comprehensive inheritance tax would probably result in about twice as many taxable returns because there are more heirs than estates and the tax filer would be the heir. If it entailed a $1.9 million lifetime exemption and 15 percent surtax, however, there would only be about 13,000 taxable returns annually. The more important source of new direct compliance costs would be information reporting requirements as heirs and donors

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[28] Ault and Arnold, *supra* note 26, at 184.

[29] PAUL R. MCDANIEL, JAMES R. REPETTI & PAUL R. CARON, FEDERAL WEALTH TRANSFER TAXATION (5th ed., 2003).

should have to report (but not pay tax on) gifts and bequests falling above the annual exclusions but below the lifetime exemption.

The reduction in tax planning costs under a comprehensive inheritance tax should substantially exceed any new information reporting and filing costs. Moreover, this reduction should be mirrored at the governmental level. With fewer rules to enforce and fewer tax planning strategies to address, administrative burdens should decline.

A comprehensive inheritance tax would thus strengthen the ability of the estate tax system to achieve its underlying goals with fairly limited downsides. It would be more effective at reducing disparities in inherited income. The tax rate would be based on the ability to pay of the person predominantly bearing the tax: the heir. It could also enhance efficiency and tax simplification. Finally, it would make the income tax more equitable by adopting a more comprehensive measure of the taxpayer's receipts.

Estate Tax Reform

Replacing the estate tax system with a comprehensive inheritance tax has many advantages that cannot be achieved by reforming the current system. Inherently, the estate tax system can only roughly target the unearned income that inheritances represent because the tax rate is based on the amount transferred. It cannot link the tax rate to the amount inherited or to the earnings capacity of the heir. Indeed, even if donors received additional exemptions based on the number of children they have, the estate tax system would not be better targeted on inherited income because the number of donor children is actually a poor proxy for the total number of the donor's heirs and their economic circumstances.[30]

Nevertheless, there are a number of ways in which the estate tax system could be improved if replacing it with an inheritance tax is considered too ambitious. In particular, several of the simplification benefits of a comprehensive inheritance tax that I have discussed could be replicated within the estate tax system. Adopting these simplification options and others would better focus the current system on the amount transferred, and limit the extent to which the tax burden depends on the donor's access to sophisticated tax advice. This, in turn, should make the current system better targeted on inherited income because the amount a donor transfers is a proxy, albeit an imperfect one, for the heir's inherited income.

Five simplification options worth consideration are as follows. Each could be adopted on a revenue-neutral basis, and the rate structure could be adjusted to ensure that adoption does not alter the distribution of tax burdens in aggregate.

- First, and most importantly, the tax rate on wealth transfers over the next several years should be smoothed in order to limit tax planning. The dramatic changes to the top marginal tax rate and exemption amount create incentives for donors and heirs to spend enormous amounts of time and resources making it appear that a gift or bequest occurred in a low-tax year.

[30] Batchelder & Khitatrakun, supra note 1.

- Second, the benefits of a comprehensive inheritance tax with respect to spousal tax planning could be replicated by permitting a surviving spouse to use any unused lifetime exemption of his or her deceased spouse. Then the tax rate on an inheritance would not depend on whether the donor couple was savvy enough to split their transfers or use spousal trusts in order take full advantage of their lifetime exemptions.

- Third, the complex relief provisions for family-owned businesses could be simplified and made more efficient if replaced with a single new relief provision for all illiquid assets. Specifically, to the extent that the tax due on illiquid assets exceeded the liquid assets that an heir inherited, he could be allowed to defer the tax due with interest at a market rate until he sold the illiquid assets. Such a provision might address concerns about the forced sale of family-owned businesses more effectively even if, as the evidence suggests, no such forced sale has ever occurred.[31] In addition, if the interest rate were set correctly, it would eliminate both incentives and disincentives to hold wealth in illiquid forms. It is only worth consideration, however, if interest were applied and at a market rate. Otherwise, it could result in substantial gaming by sophisticated donors and heirs who do not need protection.

- Fourth, replacing stepped-up basis for bequests with carryover basis would remove one of the most common traps for the unwary. Many elderly investors sell underperforming appreciated assets without realizing that, in doing so, they are reducing the value of their estate by paying the associated capital gains tax liability. Under current law, the tax due can be avoided forever if the donor instead bequeaths the asset and the heir sells it.

- Finally, the countervailing incentives to inherit wealth transfers as gifts under current law could be mitigated through several changes. Indexing the lifetime exemption to inflation would reduce the incentive to receive inheritances earlier in time when the present value of the exemption is higher. Applying the gift tax on a tax-inclusive basis (like the estate tax) and unifying the gift tax and estate tax lifetime exemptions would further limit tax planning. In addition, reducing the annual gift tax exclusion would limit the incentive to set up complicated tax planning vehicles, such as Crummey trusts, in order to take advantage of each year's exemption.

IV. Conclusion

Inherited income tends to exacerbate existing economic disparities and may be the most important barrier to intergenerational economic mobility. As a result, any equitable tax system should account for whether a household has inherited an extraordinarily large amount when allocating tax burdens. As Franklin D. Roosevelt declared: "inherited economic power is as inconsistent with the ideals of this generation, as inherited political

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[31] For instance, 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. MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126 (2005).

power was inconsistent with the ideals of the generation which established our government."[32]

Presently, 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, and, on average, its burdens rise rapidly with the amount inherited. However, the relationship between the heir's financial circumstances and his or her estate tax burden is relatively imprecise. Some individuals who receive extraordinarily large inheritances bear little or no tax burden, while a small number who inherit relatively small amounts bear a substantial tax burden.

The scheduled repeal of the estate tax in 2010 and reinstatement at higher levels in 2011 create an opportunity to better focus the estate tax system on the unearned income that inheritances represent—an opportunity that should not be missed. One reform option worth consideration is simplifying the estate tax system so that it better targets the amount transferred as a proxy for the amount inherited. An even better option would be to replace it with a comprehensive inheritance tax that directly taxes extraordinary amounts of inherited income at the same or higher rates than earned income.

Either way, we should use the upcoming opportunity for change—not to increase inherited economic power by repealing the estate tax or reducing the share of revenue it raises—but to *reform* it so as to tax inherited income in a more equitable way.

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[32] 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).

United States Senate Committee on Finance Hearing
Alternatives to the Current Federal Estate Tax System
March 12, 2008

Responses to Questions Submitted for the Record
Lily L. Batchelder
NYU School of Law
June 24, 2008

Senator Baucus

*1.) **Professor Batchelder, some wealth transfer tax systems tax the transferee of a gift or bequest. Some believe this type of wealth transfer tax system is more equitable. Rather than taxing the donor, it taxes the income of the beneficiary.***

*a. **Would the effect of your proposal simply be to shift the payment, planning and recordkeeping burden to the beneficiary, as opposed to the estate?***

The proposal would do much more than shift compliance burdens on to heirs. It would improve the fairness of wealth transfer taxes—and the tax system as a whole—by better linking tax burdens to the ability to pay of the person burdened by the tax, the heir. At the same time, it would make the tax system more transparent and simple.

As explained in my written testimony, both the estate tax and the proposed inheritance tax are generally borne by heirs receiving extraordinarily large inheritances, not donors or heirs receiving small inheritances. According to my estimates with Surachai Khitatrakun, approximately 96 percent of estate tax revenue in 2009 will be derived from individuals inheriting more than $1 million.

Currently the estate tax is the only tax that applies to these extraordinarily large inheritances because gifts and bequests received are exempt from the income and payroll taxes. Such a tax exemption may be appropriate for ordinary inheritances, which are often associated with the family bonds that we should and do value. But it is not for extraordinarily large inheritances, which confer an unearned advantage on those fortunate enough to be born into wealthy households.

If the estate tax were repealed so that such extraordinarily large inheritances were also tax-free, the government would effectively be conferring a further advantage on such heirs. At the same time, it would be penalizing those who work for their wealth because the revenue to finance estate tax repeal would have to come from non-heirs. The estate tax thus plays a critical role in ensuring the fairness of the tax system overall because it is the only tax that applies to inheritances so large that they are a major source of income for the taxpayer.

While the estate tax does a very good job of targeting extraordinarily large inheritances, however, it can create substantial inequities in individual cases. The fact that the estate tax centers by design on the donor means, in practice, that it burdens some heirs receiving relatively small inheritances quite heavily, and burdens others receiving extremely large inheritances quite lightly. For example, according to our estimates, 22 percent of heirs burdened by the estate tax have inherited less than $500,000, while 21 percent of heirs inheriting more than $2,500,000 bear no estate tax burden.

The proposed inheritance tax would eliminate these inequities. All heirs inheriting less than roughly $2 million would bear no tax burden on their inheritances, while all heirs inheriting more would bear some tax burden. As a result, it would better link wealth transfer tax burdens—and tax burdens overall—to the ability to pay of the taxpayer.

A further benefit of the proposal is that it would improve public understanding of the wealth transfer tax system. The fact that the estate tax focuses by design on the donor tends to lead the public to believe that its economic burdens fall on donors in practice as well. Moreover, many erroneously believe that heirs are taxed on their inherited income under the income tax because all other major sources of income are so taxed.

These understandable misconceptions have been exploited by advocates of estate tax repeal who have framed the estate tax as a double tax on frugal, hard-working, generous donors who are taxed at the moment of death. Instead, the estate tax is a single tax (and the only tax) imposed on the fortunate few in our society who inherit amounts so extraordinarily large that they can elect not to work their entire lives and still support a family at a standard of living better than nine out of ten American families.

The proposed inheritance tax can help correct these misperceptions because it falls on heirs both by design and in practice. Moreover, it explicitly subjects a portion of extraordinarily large inheritances to the income tax. As a result, under the proposal, the public would probably be able make a more informed decision about whether to exempt such extraordinarily large inheritances from taxation or not.

The final advantage of the proposal is that it would simplify the wealth transfer tax system, for the reasons outlined next.

b. If so, would your proposal actually simplify the U.S. wealth transfer tax system?

I believe the proposal would simplify the U.S. wealth transfer tax system. Tax experts tend to distinguish between three kinds of tax complexity: rule complexity, compliance complexity, and transactional complexity.[1] I expect that

[1] DAVID BRADFORD, UNTANGLING THE INCOME TAX 266-67 (1999).

the proposal would alter the mix of these types of complexity, but simplify the law on net.

Under the proposal, rule complexity, or the costs generated by uncertain legal rules, should decline. Many of the existing estate tax rules—such as those governing when a transfer has occurred, how it is valued, and what transfers are taxable—could be improved or simply remain part of the law. But many others, for reasons explained below, could be eliminated entirely.

Compliance complexity should increase slightly due to the shift of some recordkeeping and filing burdens to heirs, but the overall burden should remain quite small. We estimate that 0.3 percent of heirs (12,972) would be subject to and burdened by the inheritance tax in 2009. By comparison, the 2009 estate tax would impose payment obligations on about 0.3 percent of estates (6,795) and burden about 0.5 percent of heirs (21,519).

Most importantly, the proposal should reduce transactional complexity—or the tax planning costs incurred when tax law treats economically-similar arrangements differently. It should do so in three ways.

First, the proposal would eliminate the need for careful planning of spousal transfers. Currently spouses can reduce their joint tax liability by making sure that each transfers an amount equal to the lifetime exemption to their heirs. Under the proposal, this would no longer be necessary. The tax would be based on the amount the heir receives, regardless of whether it was from his mother or father.

In addition, the proposal would significantly reduce current incentives to characterize wealth transfers as gifts rather than bequests. Unlike current law, it would apply the same lifetime exemption and effective tax rate to gifts and bequests. Moreover, if the lifetime exemptions were indexed to inflation, it would also reduce the incentive to transfer (or appear to transfer) wealth earlier in time, when the present value of the exemption is higher.

Finally, the proposal should reduce the tax benefits of engaging in valuation games. While it would create more valuation points, it would reduce incentives to shift value to tax-exempt spouses and charities when the ultimate beneficiary is unclear because it could wait to see how much is received by whom before applying the final tax. As a result, a wide swath of current rules could be eliminated.

Transactional complexity tends to be the most costly kind of complexity. While many of these simplification reforms could be adopted under the estate tax, the final category could not be. Thus, shifting to the proposed inheritance tax should simplify the law overall.

2.) Professor Batchelder, you describe a tax deferral proposal for heirs inheriting illiquid assets. You state that this would prevent an heir from having to sell off the family business to pay the taxes, at least until the heir sold the assets.

a. ***What would be the filing requirement for the heir? Would the heir be required to get the property appraised or valued? If so, how often? Wouldn't this create a huge burden on the taxpayer?***

If such a proposal were considered politically necessary, I would suggest requiring heirs to submit a form annually to the IRS stating whether the heir had received any distributions from the business or sold all or a portion of it, probably with confirmation from the business. The definitions of distributions and sales could parallel those in Section 6166(g). However, it is critical that, unlike under Section 6166, interest should accrue at a market rate, and the taxpayer should be required to use all distributions and sale proceeds first to satisfy the accrued tax liability and interest.

The annual filing requirement should not be a huge burden on the taxpayer and businesses as it simply requires confirmation of a fact of which both should be well aware—whether the heir has sold or received cash from the business. Moreover, the number of heirs who could conceivably need to sell part of an inherited business in order to pay the proposed inheritance tax absent this provision—and thus the number eligible for the tax deferral proposal—should be miniscule.

Specifically, we have estimated that less than 3 in 1,000 heirs (12,972) would be subject to the inheritance tax. In addition, the Tax Policy Center has estimated that fewer than 3 percent of taxable estates are composed of more than 50 percent business assets. Thus, it is likely that far fewer than 400 heirs[2] would be eligible for the deferral provision if it were considered politically necessary.

I do not think it would be necessary for the heir or IRS to appraise the business annually after it was inherited, although the IRS should be able to do so as part of an audit if the IRS thought that the taxpayer was evading the tax by failing to report sales or distributions.

b. ***What happens in the event that the heir never sells the asset? When and how would the tax be collected?***

If the heir never sold the asset or business, the tax liability and interest payments would continue to accrue at a market rate indefinitely. However, to the extent that the heir withdrew funds from the business through distributions or partial sales, he should be required to use those funds to satisfy the tax liability and interest.

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 the inherited business, he could be

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[2] Three percent of 12,972 is about 400. The number of heirs eligible should be much less 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.

forcing it to sell assets to another business he controlled at a nominal price, and then forcing that second non-inherited business to distribute the proceeds to him. Alternatively, if an heir controlled an inherited business, he could cause it 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 above a certain level, and sales to other businesses controlled by the heir, as *de facto* distributions to the heir after a period of time.

3.) Professor Batchelder, you have testified about different forms of wealth transfer tax systems.

a. What are the disadvantages to these different systems?

The disadvantages of each approach to taxing wealth transfers are generally the advantages of the others.

The first option is to impose no tax on extraordinarily large wealth transfers. In my view, the disadvantages of this approach are the greatest. Assuming income from gifts and bequests continues to be tax-free under the income and payroll taxes, this option would entirely exempt a major source of income from taxation—and the only source of income directly attributable to privilege. As a result, holding revenue constant, it would necessarily result in a lower tax burden on those who have benefited from extraordinarily large inheritances and a higher tax burden on those whose income is the result of their own saving and hard work. Essentially, it would permit extraordinarily wealthy heirs to live off their inheritance without ever working and to pay taxes at a lower rate than their housekeeper or personal assistant.

Further drawbacks of this approach arise once one considers how the lost revenue would be replaced. If the revenue were not replaced, it would likely result in larger deficits and cuts to programs that middle- and low-income Americans rely upon. If it were replaced with less progressive taxes, it would magnify economic disparities and increase tax burdens on middle- and low-income Americans. And if it were replaced with taxes that were comparably progressive on an aggregate level, it could result in significantly higher marginal tax rates on those whose earned (as opposed to inherited) income places them in the top 1 percent of the economic income distribution, thereby resulting in greater distortions to work and saving decisions relative to the status quo. Moreover, all three possibilities would send a perverse signal about the value society places on able-bodied adults supporting themselves.

Lastly, exempting large inheritances from tax would magnify current incentives to shelter income by making it appear that it was earned by a relative in a lower tax bracket. It could therefore result in more tax planning costs and tax evasion.

The second option is to apply an estate and gift tax to wealth transfers, as under current law. I confess that I see no disadvantages of an estate tax relative to having no wealth transfer tax at all. Some argue that estate taxes are relatively inefficient because they may depress private savings but the evidence is weak and can be explained by avoidance activities.[3] Moreover, others contend that estate taxes may be one of the most efficient types of taxes—and more efficient than income, payroll, and consumption taxes—because a very large share of wealth transfers is unresponsive to the tax rate.[4]

Relative to an inheritance tax, the principal disadvantages of an estate tax are inequities in individual cases, a lack of transparency, and greater transactional complexity, as described in my response to Question 1(a). On average, the estate tax does quite a good job of correcting for the income tax and payroll tax exemptions for extraordinarily large amounts of inherited income—and of basing tax burdens on the ability to pay and privilege of the person bearing the tax, the heir. Nevertheless, because the tax rate is not directly linked to the ability to pay or privilege of the heir bearing the tax, it can result in substantial overtaxation or undertaxation in individual cases, as described above. It also contributes to the public misconception that the burden of wealth transfer taxes falls on the donor, not the heir. Perhaps for this reason, a number of countries that had estate taxes have repealed them, while inheritance taxes have been much more political stable.

The third option is an inclusion-type inheritance tax, under which gifts and bequests (perhaps above an exempt amount) are included in annual income under the income tax. One drawback of this approach is that, depending on the year, it would result in a 10 to 15 percentage point cut to the top marginal rate applied to wealth transfers—and in labor income being subject to higher tax rates than extraordinarily large inheritances. This rate cut in turn would necessitate a much lower exemption than the estate tax or the other inheritance tax alternatives in order to raise the same amount of revenue. As a result, far more taxpayers would be subject to recordkeeping and filing burdens. A further drawback is the annual (as opposed to lifetime) exemption of an inclusion tax. It would create significant tax planning incentives for families to spread out their wealth transfers over time. As a result, heirs from families that obtained good tax advice would be taxed at much lower rates than those from less savvy families. For these reasons, I view this approach as superior to having no wealth transfer tax, but inferior to an estate tax or the other inheritance tax options.

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[3] *See* William G. Gale and Maria Perozek, *Do Estate Taxes Reduce Savings?*, *in* RETHINKING ESTATE AND GIFT TAXATION 216 (William G. Gale et al, eds, 2001); David Joulfaian, T*he 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).

[4] *See, e.g.*, Wojciech Kopczuk and Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007).

The fourth option is to adopt an accessions-type inheritance tax, which taxes gifts and bequests received (above a very large lifetime exemption) at a tax rate separate from that of the income tax. The principle drawback of this approach is that the tax rate would not be as equitable as that of a comprehensive inheritance tax because the tax rate would not take into account the heir's other income. For example, unlike a comprehensive inheritance tax, it would tax a disabled person inheriting $3 million at the same rate as a hedge fund manager inheriting $3 million. It would also entail slightly more recordkeeping burdens than an estate tax, although the burdens under both would be very small.

The final option is a comprehensive inheritance tax, which taxes amounts inherited (above a very large lifetime exemption) at the heir's income tax rate plus an additional tax. Like an accessions tax, it would entail slightly higher recordkeeping burdens than an estate tax. The main disadvantage relative to an accessions tax is that it requires a lower exemption. However, this is the price of taking into account the other income of the heir when allocating the tax burden. Consequently, I view this approach as entailing the greatest benefits and fewest drawbacks on balance.

b. What effect would these alternative tax systems have on small businesses?

The effect of an estate tax and the different types of inheritance taxes on small businesses depends on how large the exemption is and what rules apply to small businesses and other illiquid assets. If each alternative were implemented on a revenue-neutral basis, the only inherent difference between an estate and inheritance tax is that a small business would be more likely to exceed the inheritance tax exemption if it were given to one heir, and more likely to exceed the estate tax exemption if it were given to multiple heirs.

As noted in my response to Question 1(a), very few family businesses should be affected by either the estate tax or an inheritance tax at existing revenue levels. Indeed, neither the American Farm Bureau nor New York Times were able to identify a single family farm that had been sold to pay the estate tax.[5]

That said, the current provisions governing gifts and bequests of illiquid assets should certainly be improved, as explained above. In my view, the goal should be to eliminate biases both in favor of and against investing in family businesses.

c. What type of transition rules would have to be developed to change a system from taxing the donor to taxing the beneficiary?

d. What steps would the Government have to take to make these changes?

Regarding questions (c) and (d), there is only one critical transition rule that would need to be established if a comprehensive inheritance tax or accessions tax

[5] MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126 (2005).

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, each 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 was actually enacted.

Beyond this fundamental rule, there are two principle approaches Congress could take when developing transition rules. The first would be to exempt all inheritances 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. Effectively, the transition date would then be the introduction date. The second option would be to count all prior inheritances an heir had received towards his lifetime inheritance tax exemption, and simultaneously give him credit for any prior estate and gift taxes paid on amounts he inherited. Effectively, the transition date would then be the heir's date of birth.

The advantage of the first approach is that 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 due. The first approach would also prevent heirs who do have 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. The advantage of the second approach is that it is more precise.

While I tend to favor the first approach, either is reasonable and the stakes should be relatively small. Data from the Survey of Consumer Finances suggest that among children who receive a bequest greater than $1.7 million, the bequest on average represents 94 percent of their lifetime inheritances to date. As a result, relatively few inequities should result if the first approach were adopted, and relatively little evasion if the second were embraced.

The transition to an inclusion-style inheritance tax would be more complicated. Although inclusion taxes traditionally involve an annual exemption, I would recommend applying a lifetime exemption as well in order to limit inequities and wasteful tax planning. In other words, inheritances below a small annual exemption would not be reportable as under current law, and inheritances below a much larger lifetime exemption would not be taxed even if reportable. Inheritances exceeding both exemptions would be included in income. If this recommendation were adopted, prior inheritances and estate and gift taxes paid could count under the new regime in the manner described above.

e. How would the Government administer the new system?

If an heir has received a "reportable inheritance" (*i.e.*, a gift or bequest exceeding the annual exemption amount) at some point, I would suggest requiring the heir to file an annual information return reporting his cumulative reportable inheritances. Alternatively, if the IRS information technology infrastructure is improved as planned, the requirement could simply be for the heir to submit an updated information return each time he receives a reportable inheritance. Either way, most individuals never will have to file an information return because two-thirds of bequests received are worth less than $50,000.

Because third party reporting and withholding are essential for maximizing compliance, donors or their estates should also be required to file information returns on reportable inheritances and remit a withholding tax on them. The heir would be responsible for claiming any excess tax withheld or paying any excess tax due if his lifetime reportable inheritances exceed the lifetime exemption.

If the beneficiaries of a wealth transfer are unclear, the donor or estate should still remit the withholding tax. However, the heir should only be able to claim a credit for the taxes withheld when he receives a distribution or it became clear what his share will be. As I have explained in prior work, this credit could be calculated in such a manner that it accrues interest at a rate equal to the rate of return earned by the assets in the interim.[6]

Senator Grassley

1.) Professor Batchelder, in reviewing your testimony as well as your writings we determined that the transition to the potential new inheritance based system would be immediate and would not provide any credit for gift or estate taxes paid unless an estate had been closed prior to the effective date in question. How did you make this decision, and how could we justify to our constituents a system that does not provide any credit or exemptions for payments that individuals have already made to the government within the structure of the current wealth transfer system?

I apologize that my testimony and writings were unclear. If the proposed inheritance tax were adopted, my intention was not to count inheritances previously received towards the new lifetime exemption while disregarding estate and gift taxes paid on prior inheritances. Instead, as explained in my reply to Questions 3(c) and 3(d) from Senator Baucus, I believe that some or all estate and gift taxes paid on inheritances received prior to the date of enactment should be counted, but only if such inheritances count towards the new lifetime exemption as well.

To be more specific, the only transition rule that I consider essential is to provide that (1) inheritances received after a date prior to enactment (such as the date the

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[6] Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* 25, Box 1 (Hamilton Project Discussion Paper 2007-07, June, 2007).

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. This rule is critical because otherwise each 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 was actually enacted.

Beyond this fundamental rule, there are two approaches Congress could take in developing further transition rules. The first would be to exempt all inheritances received prior to, for example, the introduction date, from the lifetime inheritance tax exemption, while giving heirs no credit for estate and gift taxes paid on those inheritances. Effectively, the transition date would then be the introduction date. The second option would be to count all inheritances an heir has ever received towards his new lifetime inheritance tax exemption, and simultaneously give him credit for any estate and gift taxes paid on amounts he has ever inherited. Effectively, the transition date would then be the heir's date of birth. I do not have strong feelings about which approach is better. While I tend to favor the first, either is reasonable and the stakes should not be very large for the reasons explained in my response to Senator Baucus' questions.

2.) In your opinion, would the value of the prevention of potential "gaming" of the system outweigh the value of the gift taxes submitted by many Americans based on attempts at sound estate planning?

Again, I apologize for my lack of clarity. I do not think prior gift taxes paid should be disregarded to the extent that the inheritance on which gift tax was paid is counted under the inheritance tax as well. The only gaming I am concerned about is the possibility of heirs claiming credit for gift taxes paid on inheritances that they are not obliged to report.

Senator Hatch

1.) Professor Batchelder, in your written testimony you mentioned either an inheritance tax or an accessions tax. Please outline for me the differences between the two and contrast the benefits and disadvantages of each to our current system.

In my view, there are actually three kinds of inheritance taxes: an inclusion tax, an accessions tax, and a comprehensive inheritance tax. Under an inclusion tax, gifts and bequests (above an annual exemption) are included in annual income under the income tax. Under an accessions tax, gifts and bequests received (above both an annual exemption and a very large lifetime exemption) are taxed at a rate separate from that of the income tax. Finally, under a comprehensive inheritance tax, gifts and bequests received (again, above both an annual exemption and a very large lifetime exemption) are taxed at the heir's income tax rate plus an additional tax. I believe both an accessions tax and a comprehensive inheritance tax would be superior to the current wealth transfer tax system, although a comprehensive inheritance tax would be the best.

The principle difference between an accessions tax and a comprehensive inheritance tax is that the tax rate under the former is based solely on the amount inherited, while the tax rate under the latter is based on both the amount inherited and the heir's other income. For example, an accessions tax would tax a disabled person inheriting $3 million at the same rate as a hedge fund manager inheriting $3 million. By contrast, a comprehensive inheritance tax would tax the disabled individual less heavily and at a rate based on his income tax rate. A comprehensive inheritance tax would also be integrated with the income tax, thereby making the current income tax exclusion for inherited income apparent. I prefer a comprehensive inheritance tax for these reasons.

Relative to the current system, the principal advantages of both an accessions tax and a comprehensive inheritance tax are greater equity in individual cases, greater transparency, and less complexity, as described in my responses to Questions 1(a) and 1(b) from Senator Baucus.

In particular, as explained in my written testimony, both the estate tax and the proposed inheritance tax are generally borne by heirs receiving extraordinarily large inheritances—not by donors or heirs receiving small inheritances. For example, according to my estimates with Surachai Khitatrakun, approximately 96 percent of estate tax revenue in 2009 will be derived from individuals inheriting more than $1 million. Currently the estate tax is the only tax that applies to these extraordinarily large inheritances because gifts and bequests received are exempt from the income and payroll taxes. The estate tax thus plays a critical role in ensuring the fairness of the tax system overall because it is the only tax that applies to inheritances so large that they are a major income source over one's lifetime.

Nevertheless, while the estate tax does a very good job of targeting extraordinarily large inheritances, it can create substantial inequities in individual cases. The fact that the estate tax centers on the donor by design means, in practice, that it burdens some heirs receiving relatively small inheritances quite heavily, and burdens others receiving extremely large inheritances quite lightly. For example, according to our estimates, 22 percent of heirs burdened by the estate tax have inherited less than $500,000, while 21 percent of heirs inheriting more than $2,500,000 bear no estate tax burden.

An accessions tax or comprehensive inheritance tax would eliminate these inequities. For example, under the proposed comprehensive inheritance tax, all heirs inheriting less than roughly $2 million would bear no tax burden on their inheritance, while all heirs inheriting more would bear some tax burden. As a result, the proposal would better link wealth transfer tax burdens—and tax burdens overall—to the ability to pay of the taxpayer.

A further benefit of both an accessions tax and a comprehensive inheritance tax is that each would improve public understanding of the tax system. The fact that the estate tax focuses on the donor by design tends to lead the public to believe that its economic burdens fall on donors in practice as well. Moreover, because the income tax generally taxes income from all sources, many believe that heirs are taxed on their inherited income. These understandable misconceptions have been exploited by advocates of estate tax repeal who have framed the estate tax as a double tax on frugal, hard-working, generous donors who are taxed at the moment of death. Instead, the estate tax is a single tax—and the only tax— imposed on the fortunate few in our society who inherit amounts so extraordinarily large that they can elect not to work their entire lives and still support a family at a standard of living better than nine out of ten American families.

Both an accessions tax and a comprehensive inheritance tax can help correct these misperceptions because they fall on heirs both by design and in practice. Moreover, a comprehensive inheritance tax has the further benefit of explicitly taxing a portion of extraordinarily large inheritances under the income tax. As a result, both approaches—but especially a comprehensive inheritance tax—could help the public make more informed decisions about whether we should continue to tax extraordinarily large inheritances or exempt them from all federal taxes.

Finally, for the reasons outlined in my response to Question 1(b) from Senator Baucus, both an accessions tax and a comprehensive inheritance tax should be simpler than the current system. While both would probably increase the number of people required to file returns if implemented on a revenue-neutral basis, both would reduce the number of rules the IRS enforces and decrease incentives for tax planning—the most costly type of tax complexity.

2.) From my viewpoint, one of the biggest problems with any kind of wealth transfer tax is the difficulty it poses to a family business being passed from one generation to the next. As you all know, there is a high mortality rate for small businesses anyway, and this is only exacerbated by taxes that can make an intergenerational transfer difficult or impossible. What can be done in designing a wealth transfer tax to mitigate these problems?

This is a difficult issue because it requires walking a delicate line when designing a relief provision for family businesses and other illiquid assets in order to maximize fairness and efficiency. On the one hand, the goal should be to prevent any tax on wealth transfers from forcing the sale of a well-run family business, thereby creating disincentives to hold wealth in this form. On the other hand, the goal should be to prevent any relief provision from creating an incentive to hold wealth in a family business when the donor would prefer to hold it elsewhere. If a relief provision is either too generous or too restrictive, it will create these incentives and disincentives. Both are bad for the donor, and the economy more generally. Thus, in my view, the goal of any relief provision should be to eliminate biases both in favor of and against holding wealth in family businesses.

The current wealth transfer tax rules governing family businesses are both overly generous and overly restrictive. They create an incentive to hold wealth in a family business in many cases. 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. The heir, then, effectively receives a below-market loan from the government because part of his inheritance is a family business. At the same time, the existing rules do not succeed in protecting all family business from ever being sold to pay the estate tax—at least at a theoretical level. (In practice, there is little evidence of family businesses being sold to pay the estate tax[7] and we estimate that fewer than 400 heirs would conceivably have to do so under the proposal if it included no relief provision, as explained in my response to Question 2(a) from Senator Baucus.)

The solution I have proposed is to permit unlimited deferral of wealth transfer tax liability at a market rate of interest to the extent that the tax liability exceeds the liquid assets inherited by the heir (minus a reasonable cushion). The advantages of this proposal are twofold. It would reduce the distortions created by the current relief provisions, which provide preferences in favor of investing in closely-held businesses even when the estate has plenty of liquid assets available to pay the associated tax liability. At the same time, it would completely eliminate even the theoretical possibility that an estate or heir would have to sell an inherited illiquid asset, such as family businesses, in order to pay the wealth transfer tax. Instead, that portion of the tax liability and the associated interest could be deferred forever. Importantly, applying a true market interest rate to the deferred tax liability is critical to ensuring these advantages and preventing revenue loss within the budget window.

I have provided further details on this proposed relief provision in my responses to Questions 2(a) and 2(b) from Senator Baucus, Question 3 from Senator Cantwell, and my prior writings.[8]

3.) Do you believe the primary goal of a wealth transfer tax is to raise revenue or to achieve certain social goals? How might the goal of such a tax determine the best way it is structured?

I tend to believe that the role of government is to achieve the goals that society democratically decides upon, subject to certain fundamental rights. These goals can be achieved through fiscal policy (i.e., taxes, tax expenditures and direct expenditures) or regulation. As such, the fiscal system is inseparable from social goals; we would not have a fiscal system if the public had no social goals and believed that government should not exist. However, given that the public appears to believe that we should have a fiscal system, its objective should be to further our social goals in the simplest, fairest and most efficient manner.

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[7] MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126 (2005).

[8] Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* 21-23 (Hamilton Project Discussion Paper 2007-07, June, 2007).

As discussed in my testimony, the burden of wealth transfer taxes generally falls on members of society who receive extraordinarily large inheritances. Such extraordinary amounts of inherited income are not taken into account when allocating income and payroll tax burdens, which strikes me as unfair and inefficient. It means that—if we didn't have a wealth transfer tax—the most privileged members of society would bear the lowest tax burdens. It also means that these individuals would tend to work less or not at all because they could support themselves and their families solely on inherited income. At the most general level, therefore, I view wealth transfer taxes as a critical way of partially offsetting the unfairness and inefficiency of the income and payroll tax exemptions for inherited income.

I agree, however, that the ideal structure for a wealth transfer tax depends on one's social goals, and reasonable people may disagree with each other (and me) about what these goals should be. In particular, they may believe that the fiscal system should further at least three different goals: (1) funding programs unrelated to economic fairness, such as national security or a court system, (2) providing a level playing field for each member of society, and/or (3) mitigating poverty and economic disparities. Although each goal generally implies that the ideal fiscal system should include a wealth transfer tax, the relative priority of these goals should affect the ideal structure of this tax.

Starting with the first, if society's goal is to fund programs unrelated to economic fairness, such as national security, the goal of the fiscal system should be to raise revenue and spend it in the most efficient manner. A wealth transfer tax can further this goal by targeting wealth transfers that economists refer to as "life cycle savings" or "egoistic." Such transfers occur to the extent that a donor has accumulated wealth solely for his consumption needs in retirement or simply because he enjoys being wealthy—not because he wants to transfer wealth to others. Economists generally consider a tax on such wealth transfers to be "perfectly efficient" because the tax does not affect the donor's work, saving, or giving behavior. Moreover, it should result in more work by heirs, and thus more revenue from them. Somewhat surprisingly, life cycle savings and egoistic wealth transfers appear to comprise the majority, or vast majority, of bequests.[9] Unfortunately, however, we do not yet know enough about who makes such wealth transfers to effectively design a wealth transfer tax targeted solely upon them.

A second possibility is that society seeks to level the playing field, implying that the objective of the fiscal system is to redistribute from the most advantaged to the least advantaged members of society. Wealth transfer taxes can help achieve this goal by requiring those who receive unusually large inheritances to share their good fortune with those who are not so privileged. Indeed, wealth transfer taxes should be indispensible for achieving this goal because inherited wealth is

[9] *See, e.g.*, Wojciech Kopczuk and Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. 207 (2007).

perhaps the most important source of advantage, as explained in my written testimony. The ideal wealth transfer tax structure to further this objective might be an accessions tax, where the tax rate is determined solely by the amount inherited. Alternatively, it could be a comprehensive inheritance tax if an individual's non-inherited income is a good proxy for other sources of advantage that are not taxed, such as being able to attend better schools.

The final possibility is that society is interested in using the fiscal system to mitigate poverty and economic disparities, regardless of whether they arise from inherited traits or bad luck. If so, a wealth transfer tax should also be critical because inheritances affect economic disparities and whether someone is living in poverty. The ideal wealth transfer tax structure for achieving this final goal might be an inclusion tax, given that inheritances currently are not taken into account under the income and payroll taxes. Then again, if receiving a large inheritance tends to induce an heir to work less[10] or confers other non-pecuniary benefits, the ideal structure might be a comprehensive inheritance tax because it weights inheritances more heavily than other income when allocating tax burdens.

In short, regardless of one's social goals, the ideal fiscal system should include a wealth transfer tax and, under several goals, the ideal structure is plausibly a comprehensive inheritance tax.

4.) Professor Batchelder, I am puzzled at something in your written statement. You said that inheritances are perhaps the most important barrier to intergenerational economic mobility, or the ability of a child to achieve a different standard of living than that of his parents. Please explain to me how, particularly in the case of a family-owned business or farm, imposing a tax on the value of that inherited business or farm helps lower-income children achieve a higher income level than that of their parents.

Inheritances are potentially the most important barrier to intergenerational economic mobility because the size of a child's inheritance tends to be correlated with his parent's position on the economic ladder. Put differently, a child who inherits $10,000 likely comes from a low- or middle-income family and a child who inherits $10 million probably comes from an extraordinarily wealthy household. The latter heir is much more likely to end up at the top of the economic ladder because he has $10 million in income before ever working. Indeed, recent evidence suggests that inheritances account for about 40 percent of the correlation between parent and child lifetime income.[11]

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[10] *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); Douglas Holtz-Eakin et al, *The Carnegie Conjecture: Some Empirical Evidence*, Q. J. ECON. 413 (May 1993).

[11] Samuel Bowles, et al, *Introduction* 1, 18-19, *in* UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS 1, 18-20 (Samuel Bowles et al, eds., 2005)

My view that wealth transfer taxes can increase intergenerational economic mobility rests on the assumption we will always have some level of government, which requires some level of taxes. As a result, when we cut taxes for one group in society, we necessarily must raise taxes on others.

Currently the estate tax is the only component of the federal tax system that takes inheritances into account when allocating the burdens of financing government. If the estate tax were repealed, a child who comes from a wealthy family and receives an extraordinarily large inheritance could live off his inheritance without ever working or contributing to the fisc for his entire life.[12] The tax cut this individual would receive would further increase the likelihood that his economic rank in society would end up being similar to that of his parents. Meanwhile, children who are not so fortunate would have to pay more taxes in order to make up for the lost revenue. Their increased tax burden after estate tax repeal would create an additional barrier to them achieving a higher economic position than their parents.

The same logic applies to a child inheriting a family-owned business or farm. While family businesses can foster and solidify family bonds in important ways, they also are assets that can be bought and sold. If an individual inherits a business worth $10 million, he has the opportunity to live off the profits of a $10 investment or to sell it and spend the $10 million immediately. As a result, he is much better off than most Americans whose net worth is about $60,000.[13] If we exempt this individual's inheritance from all taxes, he will be even more likely to end up among the super rich, presumably like his parents. Meanwhile, all others—whose taxes must be raised to pay for his tax cut—would be less likely to make it to the top of the economic hierarchy.

Senator Roberts

1.) When visiting farmers and small business owners I hear repeatedly that the biggest cost of the estate tax may not be the tax bill itself, but rather the amount of time and money they spend in estate planning. In light of the current economic climate, I think it particularly important to consider this point. The money these individuals have paid to accountants, lawyers, insurance companies and others in preparing for the estate tax could have been reinvested to grow their business. I think that begs the question: how would a move to an inheritance tax impact the planning costs for these farms and businesses?

The effect of moving to an inheritance tax on the planning costs for family businesses depends on whether it is coupled with reform of the wealth transfer tax treatment of illiquid assets more generally. If it were not, the move should only affect planning costs when the future owners of the transferred business are

[12] In order to avoid *all* income taxes, technically he would have to realize zero return or invest in tax-exempt assets.

[13] Alfred O. Gottschalck, *Net Worth and the Assets of Households: 2002* (U.S. Census Bureau, Current Population Reports, Apr., 2008), *available at* http://www.census.gov/prod/2008pubs/p70-115.pdf.

unclear (*e.g.*, if the business is transferred in trust and the beneficiaries of the trust are to be determined). Then, as I have explained in prior work,[14] the inheritance tax should reduce planning costs by eliminating current incentives to try to shift value to tax-exempt spouses and charities by waiting to see how much is received by whom before applying the final tax. As a result, a wide swath of current rules could be eliminated. Indeed, the current rules to address such valuation games—including those governing marital trusts, charitable trusts, grantor trusts, and Crummey trusts—compose one-fourth of a leading casebook.[15]

If the shift were accompanied by reform of the treatment of illiquid assets, an inheritance tax could reduce planning costs for family businesses even further. As I have outlined in my responses to Question 2 from Senator Baucus and Question 2 from Senator Hatch, if it is considered politically necessary, I have proposed permitting unlimited deferral of wealth transfer tax liability at a market rate of interest to the extent that it exceeds the liquid assets inherited by an heir (minus a reasonable cushion). The advantages of this provision are twofold.

First, it would eliminate the planning incentives generated by the current relief provisions, which create incentives to shift wealth into family businesses even when the estate has plenty of liquid assets available to pay any estate tax liability. For example, under current Section 6166, taxes due on bequests that include a family business can be deferred for 15 years at a below-market interest rate if the family business composes at least 35 percent of the gross estate. The heir, then, effectively receives a below-market loan from the government if his donor ensures that the family business composes at least 35 percent of the value of his bequest—and no below-market loan if he does not.

Second, this relief provision would completely eliminate even the theoretical possibility that an estate or heir would have to sell an inherited illiquid asset in order to pay the associated wealth transfer tax liability. Instead, that portion of the tax liability could be deferred indefinitely. Importantly, applying a true market interest rate to the deferred tax liability is critical to ensuring these advantages and preventing revenue loss within the budget window.

2.) Often, farms and small businesses derive much of their financial worth from assets such as land and equipment. For farmers and ranchers in particular, significant increases in land values are having a marked impact on the value of their estate.

Under current law, however, the fact that many assets are not liquid does not stop us from levying an often burdensome tax on these families. Thus, even in cases where the next generation wishes to continue with the business or the farm, they may be forced to break up and sell off assets—assets that are key to the operation of their business or farm, in order to foot the tax bill.

[14] Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* 41-46 (Hamilton Project Discussion Paper 2007-07, June, 2007).
[15] PAUL R. MCDANIEL, JAMES R. REPETTI, AND PAUL R. CARON, FEDERAL WEALTH TRANSFER TAXATION (5th ed., 2003).

Can you tell me how replacing our current estate tax with an inheritance tax would impact farmers, rangers and other small business owners whose 'wealth' is primarily composed of assets like land or equipment?

I would hate for concern about this issue to distract lawmakers from the importance of having a wealth transfer tax as part of the fiscal system in the first place. Neither the American Farm Bureau nor the New York Times were able to identify a single instance of a family farm being sold to pay the estate tax.[16] Moreover, under the inheritance tax I have proposed, we estimate that far fewer than 400 heirs would conceivably need to sell business assets in order to pay the proposed tax even if there were *no* relief provisions for illiquid assets or family businesses.

That said, if it is considered necessary politically, the relief provision I have proposed should fully address your concern. As noted above, it would completely eliminate even the theoretical possibility that an heir would need to sell business assets in order to pay the inheritance tax. Moreover, by shifting the focus of current relief provisions to include all illiquid assets—not just those held in a business—it would address your concerns about equipment. Further details on this proposal are provided in my responses to Question 2 from Senator Baucus, Question 2 from Senator Hatch, Question 3 from Senator Cantwell, and my prior writings.[17]

Senator Schumer

1.) I am intrigued by the inheritance tax proposal, but I have some questions. The proposal would tax the individual that receives the inheritance, but doesn't that pose a significant problem if the bulk of the assets given to a particular individual are not cash or liquid assets? It's not unusual to have specific bequests of property that can't be readily sold to pay an inheritance tax. With an estate tax, all of the assets (liquid and non-liquid) are available to pay whatever tax is owed before the property is distributed. I understand how your proposal would deal with businesses, but what about other illiquid assets?

I apologize that my testimony was unclear but, to the extent that relief for businesses is considered politically necessary, my intention is for the tax deferral proposal to apply at the heir level and to all illiquid assets, not just businesses. For example, if an heir inherited more than the lifetime exemption and all of the assets he inherited were illiquid, he could defer the tax and accrued interest indefinitely until he sold some or all of the assets or otherwise withdrew funds from them.

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[16] MICHAEL J. GRAETZ AND IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 126 (2005).
[17] Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* 21-23 (Hamilton Project Discussion Paper 2007-07, June, 2007).

Further details on this proposal are provided in my responses to Question 2 from Senator Baucus, Question 2 from Senator Hatch, Questions 1 and 2 from Senator Roberts, Question 3 from Senator Cantwell, and my prior writings.[18]

2.) ***Decisions of how you distribute your lifelong gain are very personal decisions. Often there are legitimate reasons for distributing more wealth to one child or another.***

a. ***What are the ramifications of a reform system that punishes someone for not spreading the value of his or her estate among as many heirs as possible?***

b. ***For example, consider a case where the bulk of an estate is left to a handicapped child to provide for his or her care. Should we tax this child more heavily because his needs are so great that the bulk of the inheritance went to him?***

This is an important issue, and I actually think that the inheritance tax proposed may address some of your fairness concerns more effectively than the estate tax.

To begin, I tend to view the principal fairness issue when allocating wealth transfer tax burdens not as how much donors should bear relative to each other—but rather how much individual heirs should bear relative to each other and individuals who inherit nothing. This view is based on two facts. First, the incidence of wealth transfer taxes (whether structured as an estate tax or inheritance tax) appears to fall predominantly on recipients not donors, as explained in my written testimony and prior writings. Second, inherited income is currently exempt from the income and payroll taxes.

Given these facts, in my view the fairest way to allocate federal tax burdens amongst heirs—and between heirs and non-heirs—is to require inclusion of extraordinarily large inheritances in the tax base, and to subject such inheritances to a tax rate roughly comparable to that imposed on income from work. That is, essentially, what the proposed comprehensive inheritance tax does. This approach ensures that heirs are taxed on their economic income, not the wealth of their benefactors. It also ensures that extraordinary amounts of inherited income are taxed at the same rate as income of those who pull themselves up by their own bootstraps by personally earning their income.

While the estate tax does a very good job of accomplishing these objectives, it can create substantial inequities between individual heirs, as described in response to your fifth question. These inequities would never arise under the proposal because, unlike the estate tax, it allocates tax burdens based on the amount inherited and the heir's tax rate on labor income by design.

[18] Id.

It is true that the proposal creates incentives for an extremely wealthy donor to distribute wealth more broadly and to those with less income from other sources in certain circumstances—but in my view this is a salutary effect. I tend to view a tax exemption as appropriate for ordinary inheritances or those meeting the basic needs of the heir. But at some point an inheritance can become so large that it is not furthering family bonds or meeting any conceivable financial need—instead it is creating an entrenched economic elite. At this point, it becomes appropriate to tax additional inherited income just like income from work, and to start creating incentives for the donor to give further wealth to those outside her inner circle who have not inherited so much. The $2 million lifetime exemption under the proposal seems easily to have passed this threshold—an heir who inherits this amount at age 18 can never work a day in his life and still support a family at a higher standard of living than nine of ten American families.

One final thing to note is that the proposal would actually create an incentive to give more to the disabled child in your example. Just as it creates an incentive to give to those with little inherited income once one's "regular" heirs have already inherited extraordinary large amounts, it also creates an incentive to give more to a "regular" heir with less earning ability. This occurs because any tax imposed on a very large inheritance is linked to the heir's income tax bracket. A disabled heir would presumably fall into the zero income tax bracket prior to receiving his inheritance because he should have little earned income and large deductions for medical expenses. If so, he would be taxed at a lower rate than another heir who inherited the same amount but had greater earning potential. Moreover, he would pay no inheritance tax on the first $2 million inherited. The estate tax, by contrast, takes no account of the needs of the recipient. Consequently, it creates no incentive to give more to a disabled indiviudal and theoretically could impose tax burdens on him that were quite substantial.

3.) When this Committee held a hearing on the current estate tax system last November, the discussion focused on upcoming uncertainty due to the phase-out and then re-instatement of the estate tax in 2009 and 2010. Witnesses also discussed how the current system can be planned around to catch the most favorable tax treatment. How will adopting an inheritance tax or accessions tax cut back on strategies to game the system?

The scheduled one-year repeal of the estate tax in 2010 creates massive uncertainty and tax planning opportunities, as well as fairly gruesome incentives. The best way to address these problems is to enact legislation preserving some kind of wealth transfer tax for the year of 2010 by the middle of 2009.

As you have noted, however, the current system also creates substantial tax planning opportunities even when it is not being repealed and reinstated in the course of a single year. These opportunities stem from at least five sources: (1) differential treatment of gifts and bequests, (2) incentives for spouses to split wealth transfers made to taxable beneficiaries, (3) valuation games involving split or contingent transfers where some of the potential beneficiaries are tax exempt,

(4) preferences for holding wealth in farms or family businesses, and (5) other opportunities to reduce the taxable value of transferred assets. The proposal should reduce tax planning incentives on the first four dimensions and have little effect on the fifth.

First, the proposal would significantly reduce current incentives to characterize wealth transfers as gifts rather than bequests (or occasionally the reverse). Current law applies different lifetime exemptions and effective tax rates to gifts and bequests. It also creates an incentive to give earlier in time because the exemption thresholds are not indexed, making the same nominal exemption worth more at earlier points in time. The proposal, by contrast, would apply the same, inflation-indexed lifetime exemption and effective tax rate to all wealth transfers, regardless of whether the transfer is made during life or at death.

Second, the proposal would eliminate the incentive to carefully plan spousal transfers. Currently spouses can reduce their joint tax liability by making sure that each transfers an amount equal to the lifetime exemption to their heirs. Under the proposal, this would no longer be necessary. The tax would be based on the amount the heir receives, regardless of whether it was from one parent or both.

Third, the proposal would eliminate the planning opportunities created by the current relief provisions for family businesses, which generally create incentives to shift wealth into family businesses and farms. For example, under current Section 6166, the tax liability due on bequests that include a family business can be deferred for 15 years at a below-market interest rate if the family business composes at least 35 percent of the gross estate. The heir, then, effectively receives a below-market loan from the government if his donor ensures that the family business composes at least 35 percent of the value of his bequest. This creates an incentive to hold wealth in a family business, even if the donor and heir would prefer for the wealth to be invested in more diversified assets. It also creates an incentive to overvalue the business if it comprises less than 35 percent of the gross estate. These incentives exist even if the estate has plenty of liquid assets available to pay the tax liability associated with the family business.

If continued relief for family businesses were considered politically necessary, the proposal would replace the current relief provisions with a provision permitting unlimited deferral of wealth transfer tax liability at a market rate of interest to the extent that the heir's tax liability exceeds the liquid assets he has inherited (minus a reasonable cushion). This reform would get rid of the current planning incentives to shift wealth into family businesses, while completely eliminating even the theoretical possibility that an estate or heir would have to sell an inherited illiquid asset in order to pay the associated wealth transfer tax liability. Importantly, it is critical for this proposed new provision to apply a true market interest rate to the deferred tax liability in order to prevent it from creating new planning opportunities.

Finally, the proposal should reduce the tax benefits of engaging in valuation games. While it would create more valuation points, it would reduce the incentive to try to shift value to tax-exempt spouses and charities when the ultimate beneficiary is unclear by waiting to see how much is received by whom before applying the final tax. As a result, a wide swath of current rules could be eliminated. Indeed, the current rules addressing such valuation games—including those governing marital trusts, charitable trusts, grantor trusts, and Crummey trusts—compose one-fourth of a leading casebook.[19]

Many of these reforms could (and should) be adopted within the context of an estate tax, but not all of them could be. Specifically, the final reform could not be adopted under an estate tax because it requires waiting to see how much each heir receives. As a result, the proposal should reduce tax planning opportunities relative to both current law, and a reformed estate tax system.

4.) In his written testimony, Professor Dodge dismisses an inheritance tax as a viable alternative to the current estate tax system, writing, "An inheritance tax distorts bequest choices by creating tax incentives in favor of certain classes of legatees. An inheritance tax also creates an incentive for the dispersion of wealth among legatees, but such an incentive isn't especially needed in contemporary American legal practice and culture, which has generally abandoned primogeniture." Professor Batchelder, you advocate adopting an inheritance tax. How would you respond to Professor Dodge criticism that an inheritance tax would only incentivize making several smaller bequests to help recipients avoid a large jump in their income as a result of an inheritance? Would this really be such a bad thing?

As discussed in my response to your second question, I actually think that the incentives an inheritance tax creates (after a certain point) to share wealth more broadly are a positive aspect of the tax. Moreover, these incentives are a necessary byproduct of the fact that under an inheritance tax, an heir's tax burden is directly based on his ability to pay tax, unlike an estate tax.

Professor Dodge's criticism of inheritance taxes as creating incentives to give to certain legatees and to spread out transfers to a recipient over time appears to refer to a type of inheritance tax that I would not support—an inheritance tax with an annual exemption where the exemption depends on the heir's and donor's relationship. Under the type of inheritance tax I support, individuals would receive only one, large exemption for all inheritances they receive over their lifetime, and it would apply regardless of the heir's relationship to the donor (unless the donor was the heir's spouse). The only benefit of spreading inheritances over time under the proposal would therefore be the possibility that such spreading would place the heir in a lower income tax bracket. However, even this advantage should arise relatively rarely because the proposal would average inheritances over time when determining the heir's income tax bracket.

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

*5.) **Professor Batchelder, in your written testimony you point out that the current estate tax system puts the brunt of the tax burden on the intended heir. Because an estate is taxed before it passes to the recipient, he or she is necessarily receiving less than the donor had granted in his or her will. However, the comprehensive inheritance tax that you propose centers the tax by design on the recipient. What is the ultimate benefit then of making a switch to an inheritance tax? Is this simply adopting a more transparent and fair method of taxing inheritances?***

Yes, the principal benefits of the proposal would be a fairer and more transparent method for taxing inheritances. However, the reason I support such a shift is that I believe these fairness and transparency differences are not simply theoretical, but also have substantial real world consequences.

As discussed in my written testimony, the estate tax is the only tax that applies to extraordinarily large inheritances because gifts and bequests received are exempt from the income and payroll taxes. While the estate tax does a very good job of targeting these extraordinarily large inheritances, however, the fact that it centers by design on the donor means that it can create substantial inequities in practice in individual cases. For example, according to our estimates, 22 percent of heirs burdened by the estate tax have inherited less than $500,000, while 21 percent of heirs inheriting more than $2,500,000 bear no estate tax burden. The proposed inheritance tax would eliminate these inequities. All heirs inheriting less than roughly $2 million would bear no inheritance tax burden, while all heirs inheriting more would bear some tax burden. As a result, it would better link wealth transfer tax burdens—and tax burdens overall—to the ability to pay of the person actually bearing the tax (in this case, the heir).

A further benefit of the proposal is that it would improve public understanding of the wealth transfer tax system. The fact that the estate tax focuses on the donor by design tends to lead the public to believe that its burdens fall on donors in practice as well. Moreover, many erroneously believe that heirs are taxed on their inherited income under the income tax because all other major sources of income are so taxed. These understandable misconceptions have been exploited by advocates of estate tax repeal who have framed the estate tax as a double tax on frugal, hard-working, generous donors who are taxed at the moment of death. Instead, the estate tax is a single tax—and the only tax—imposed on the fortunate few in our society who inherit amounts so extraordinarily large that they can elect not to work their entire lives and still support a family at a standard of living better than nine out of ten American families.

An inheritance tax can help correct this misperception because it falls on heirs both by design and in practice. Thus, by more transparently taxing the heir, the proposal should enable the public to make a more informed decision about whether to exempt such extraordinarily large inheritances from taxation or not.

Finally, for the reasons outlined in response to your third question and Question 1(b) from Senator Baucus, the proposal should simplify the wealth transfer tax system.

Senator Cantwell

1.) If Congress moves away from an estate tax, either by extending repeal beyond 2010 or establishing a new inheritance tax regime, what changes to the individual income tax and capital gains tax rules would have to simultaneously be considered so that we can maintain progressivity in the overall tax system?

If Congress were to repeal the estate tax without replacing it with an inheritance tax, I do not think it would be possible to maintain the current level of progressivity in the overall tax system at an individual level. It might be possible to maintain the same level of progressivity at an aggregate level, but doing so would entail substantial efficiency costs and inequities.

Progressivity can be determined at an individual or aggregate level. It also can be based on a number of measures of ability to pay but the most widely-supported measure is economic income. Economic income, sometimes referred to as Haig-Simons income, includes an individual's annual consumption and change in net worth. It therefore includes inheritances.

As explained in my written testimony, the lion's share of estate tax burdens fall on individuals who receive extraordinarily large inheritances and are very well-off. For example, according to our estimates, 96 percent of estate tax revenue is derived from the 1 percent of heirs who inherit more than $1 million, and 88 percent is derived from the 1 percent of heirs whose economic income exceeds $500,000.[20] If the estate tax were repealed, these wealthy individuals would receive their sizable inheritances tax-free.

Nevertheless, while the estate tax does a very good job of targeting these extraordinarily large inheritances and strengthening the progressivity of the tax system at an aggregate level, it can create substantial inequities in individual cases. This reduces (but certainly does not eliminate) its progressivity at an individual level. For example, according to our estimates, 22 percent of heirs burdened by the estate tax have inherited less than $500,000, while 21 percent of heirs inheriting more than $2.5 million bear no estate tax burden. Similarly, 25 percent of heirs burdened by the estate tax have economic income of less than $200,000, while 12 percent of heirs whose economic income exceeds $1 million bear no estate tax burden.

If the estate tax were repealed without replacing it with an inheritance tax, the current level of progressivity of the tax system at an individual level could not be maintained by changing the taxation of ordinary income or capital gains.

[20] For this purpose, economic income is defined as the heir's income from labor and saving plus one-fifth of his inherited income.

One possibility would be to tax heirs at higher rates on their income from work and savings. But if this higher tax were imposed disproportionately on recipients of extraordinarily large inheritances, it would essentially be a wealth transfer tax, because the tax rate would depend on how much the individual had inherited.

Another possibility would be to change the income and capital gains tax treatment of gifts and bequests specifically, for example by repealing the income tax exclusion for gifts and bequests, stepped-up basis for bequests, and carryover basis for gifts. Heirs would then be taxed on all inherited income under the income tax, and would also be taxed immediately on any accrued gains embedded in inherited assets. Unfortunately, while this option would target heirs specifically, it would still be more regressive than the estate tax at an individual (and aggregate) level because it would tax all inheritances, not just extraordinarily large ones. The inheritances of most Americans are relatively small—we estimate that 93 percent of heirs inherit less than $250,000. Nevertheless, inherited income comprises a meaningful share of the lifetime economic income of most households and accrued gains are a substantial share of the value of all inheritances, including relatively small ones.[21] Thus, full wealth transfer tax repeal necessarily involves a more regressive tax system at an individual level, with heirs of extraordinarily large inheritances winning and all other heirs and non-heirs losing.

If all wealth transfer taxes were repealed, Congress might at least be able to maintain the same degree of progressivity at an aggregate level (i.e., by economic income). However, the only way it could do so would be by raising the tax rate (e.g., income or payroll tax rate) on those with the largest amounts of economic income more generally. According to our estimates, less than three in 10,000 tax units earn more than $1 million per year. Consequently, this approach could result in significantly higher rates on those who earn such large amounts through their own work and savings efforts in order to compensate for the new zero tax rate on those who inherit such large amounts. Because the deadweight loss associated with a tax on labor earnings tends to rise with the square of the tax rate, this approach would probably result in substantial efficiency losses relative the estate tax or any wealth transfer tax. It would also, as noted, result in serious inequities between those who work for their wealth and those who do not.

Maintaining the progressivity of the overall tax system would be much simpler if Congress instead replaced the estate tax with an inheritance tax. Indeed, the overall tax system would become more progressive at an individual and aggregate level under the inheritance tax I have proposed because tax burdens would be more tightly linked to the economic income of the taxpayer burdened. Under the proposal, the tax rate on inherited income would be directly based on a measure of the heir's economic income (one-fifth of any income from inheritances that

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[21] Edward N. Wolff, *Inheritances and Wealth Inequality, 1989-1998*, 92 AM. ECON. REV. 260, tbl.2 at 262 (May, 2002); James M. Poterba and Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, *in* RETHINKING ESTATE AND GIFT TAXATION 422, 439, tbl.10-10 at 443 (William G Gale et all, eds., 2001).

exceeds $2 million over his lifetime, plus his annual income from work and savings). By contrast, the estate tax rate is only indirectly linked to the heir's economic income (because inherited income and non-inherited income tend to rise, on average, with estate size). Moreover, the proposal should not entail any additional efficiency losses relative to the estate tax because it is revenue neutral.

In short, replacing the estate tax with the proposed inheritance tax would strengthen the progressivity of the overall tax system without creating new efficiency losses. Repealing all wealth transfer taxes would necessarily reduce the progressivity of the overall tax system at an individual level (e.g., between heirs and non-heirs), and could only maintain the current degree of progressivity at an aggregate level at the price of substantial new efficiency costs.

2.) ***Professor Batchelder, it seems somewhat punitive to treat an inheritance as income to the beneficiary yet impose a surtax of 15 percent on top of their income tax rate. Can you explain the rationale of imposing a 15 percent surtax on bequests that exceed the exemption amount?***

The principal rationale is that income from work is generally subject to the income tax and a 15.3 percent FICA tax, neither of which currently apply to income from inheritances. Admittedly, the full FICA tax does not apply to the roughly 15 percent of wages that exceed the $102,000 payroll tax cap[22] so income from work generally is not subject to a marginal tax rate of 50 percent. However, income from work also is not eligible for a $2 million exemption.

Under the proposal I have outlined, the average tax rate on inherited income for someone who is already in the 35 percent income tax bracket would only reach 50 percent if the individual had inherited more than $190 million. In my view, this is such an extraordinary sum of unearned money that a 50 percent effective tax rate is not punitive.

3.) ***Under your proposal for how family-owned businesses and other illiquid asset transfers would be treated, you recommend a deferral of the tax until the assets are sold or there are sufficient liquid assets to pay the tax.***

a. ***Can you elaborate on how this system would work in practice? For instance, would the business account for this deferred obligation?***

b. ***Would the IRS' secured interest in the asset be related only to the portion of the business that each individual heir owns?***

c. ***Is there any concern that over time the tax liability itself would become so large it would force a business to liquidate?***

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[22] Debra Whitman, *Social Security: Raising or Eliminating the Taxable Earnings Base* (CRS Report for Congress, May 2, 2005).

d. Would the IRS need to establish a new regime to monitor the disposition of illiquid assets and to collect the interest?

e. Would liens be required as are required now under Section 6166?

Regarding questions (a) through (e), I would first like to provide some background on the scope of the problem. The Tax Policy Center has estimated that less than 3 percent of taxable estates are composed of more than 50 percent business assets. Moreover, we have estimated that less than 3 in 1,000 heirs (12,972) would be subject to the inheritance tax in the first place. Accordingly, the circumstances in which an heir could conceivably need to sell part of an inherited business in order to pay the inheritance tax absent *any* relief provision for illiquid assets should be extremely rare. Indeed, we estimate that far fewer than 400 heirs[23] would be eligible for the deferral provision if it were considered politically necessary.

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, I have suggested adopting a relief provision permitting 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).

Under this relief provision, the tax liability would be that of the individual heir. If an heir inherited liquid assets sufficient to pay the tax (with an appropriate cushion), he would pay the tax with these liquid assets and inherit the business tax-free. If not, he would be required to use what liquid assets he did inherit (again subject to some reasonable cushion) to pay a portion of the associated tax liability. The remainder would 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. As a result, the heir would never have to sell the business in order to pay the associated tax liability and interest. Because the tax due would be a liability of the heir, I see no reason for the accruing liability and interest to be reported on the books of the business.

This proposal would require ongoing monitoring by the IRS. I would suggest requiring heirs to submit a form annually to the IRS stating whether the heir 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 in Section 6166(g). However, it is critical that, unlike under Section 6166, interest should accrue at a market rate, and the taxpayer should be required to use all distributions and proceeds from sales first to satisfy the accrued tax liability and interest. The annual filing requirement should not be a huge

[23] Three percent of 12,972 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.

burden on the taxpayer and business as it simply requires confirmation of a fact of which both should be well aware—whether he has sold or received cash from the business.

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 the inherited business, he could be forcing it to sell assets to another business he controlled at a nominal price, and then forcing that second non-inherited business to distribute the proceeds to him. Alternatively, if an heir controlled an inherited business, he could cause it 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 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.

Jim Bunning

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Alternatives to the Current Federal Estate Tax System"
March 12, 2008

Thank you, Mr. Chairman.

There are those that contend that the estate tax only affects our Nation's wealthiest and that we do not need permanent repeal or reform. Apparently those people have never spent any time in our nation's farming communities. Well, I have.

My home state of Kentucky has been a land of family farms and small, close-knit communities ever since Daniel Boone led settlers through the Cumberland Gap. I have witnessed on a first-hand basis how estate taxes can destroy family-owned farms when the tax, which can be as high as 45 percent, forces farmers to sell their land or equipment.

Family farms and small towns across our country have made us strong. It's a legacy that we must continue to nurture. We need make sure that in the years to come the farming way of life always remains part of our Nation's character. Through permanent repeal or substantial reform of the estate tax we can ensure that America's food and fiber producers will be able to pass along farming operations from generation to generation.

I thank the Chairman for holding this important hearing to consider alternatives to the present death tax that is expiring. But, we must act quickly. The year 2010 is fast approaching, and many families are attempting to plan the transition of their farms and businesses in an uncertain environment. If we act this year, we can live up to our responsibility as good stewards.

I look forward to working with the Chairman to see these reforms enacted.

Senator Maria Cantwell
Opening Statement

Senate Finance Committee Hearing
Federal Estate Tax

March 12, 2008

Mr. Chairman, thank you for holding this hearing today. As I said at the committee's hearing in November, I am pleased we are working to move forward with permanent, meaningful reforms.

The prospect of returning to a tax rate of 55 percent on estates over $1 million in 2011 is unacceptable.

As we consider our federal policy options, I will be looking carefully at the alternative approaches that our witnesses today will offer. Maybe it is time to think outside the box and craft a better, more workable set of rules.

I have raised my concerns that we should preserve the viability of our small businesses and family farms. These institutions are more valuable to all of us if they can continue to thrive, create jobs and reinvest in those farms and business operations.

When someone works for a lifetime to build a business and opts to leave that business to an heir rather than sell it outright, they should have some comfort that the IRS is not going to step in and impose a crippling tax on that business. We have tried hard to reach a sensible, permanent, and fiscally responsible solution to this problem, and I will continue to work toward that goal this year. Time is running out on us and on the businesses that are wondering when, or if, Congress will act before the clock in 2011 turns back to 2001.

I welcome the ideas of our witnesses today and appreciate the time that you, Mr. Chairman, are devoting to this important issue.

Thank you.

Testimony of Joseph M. Dodge
Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor of Law
Florida State University College of Law
before

COMMITTEE ON FINANCE
U. S. SENATE

March 12, 2008

Thank you for inviting me to appear before this distinguished body to testify concerning possible alternatives to the current federal transfer taxes. I am testifying on my own behalf and do not speak for any other person, organization, or entity. My extensive writings in this area are noted in an Appendix at the end. A somewhat more formal comparison of (1) the accessions tax, (2) the income-inclusion approach, and (3) the deemed-realization-at-gift-or-bequest approach is found in Appendix A to the Task Force Report on Federal Transfer Taxes (item 2 of the Articles listed in the Appendix), of which I am a co-author. (However, my comments today differ in a few respects from the analysis in the Task Force Report.) More detailed discussions of the topics covered by this testimony are found in items 4, 5, and 16 of the Articles listed in the Appendix. (For some of my views on reforming the current system, see items 9 and 13 of the Articles listed in the Appendix.)

A. Possible Alternatives to the Current Transfer Taxes

There are five possible alternatives to the current estate, gift, and generation-skipping system:

(1) classic inheritance tax

(2) accessions tax

(3) income-inclusion approach

(4) deemed-realization-at-gift-or-bequest approach, and

(5) carryover-basis approach.

What these approaches have in common is the imposition of tax (sooner or later) by reason of a gratuitous transfer. The first two (inheritance tax and accessions tax) are transfer taxes. A transfer tax is a separate tax from the income tax, and a transfer tax can operate as a "second" tax on previously-taxed income of the transferor. The last two (deemed-realization and carryover-basis approaches) are designed to overturn the current rule, found in § 1014, that eliminates unrealized gains of a decedent permanently from the income tax. The motivation of either proposal is to eliminate an existing hole in the income tax. Since transfer taxes can exist simultaneously with an income tax, it is possible to combine either (1) or (2) above (or an estate tax) with either of (4) or (5).

Alternative (3) is more of a "fusion" approach: it imposes a tax on the gratuitous transfer itself (like a transfer tax) but "within" the income tax. Alternative (3) entails taxing a (non-charitable) gratuitous transfer to the transferee by including the transfer in the annual income tax base, without deduction by the transferor. Since the value of the transfer is taxed in full to the transferee, the transferor's basis is irrelevant, and becomes an obsolete datum of tax history. Hence alternative (3) could not be comprehensively combined with alternatives (4) and (5), both of which play off of the transferor's income tax basis.

A general theme of my testimony is that each "system" has an internal logic of its own, and caution should be used in transplanting features of one system into another system.

B. Inheritance Taxes and Carryover Basis Should Be Taken Off the Table

Alternatives (1) and (5) should be rejected. An inheritance tax is basically like an estate and gift tax, but with a more complicated rate and exemption structure. An inheritance tax distorts bequest choices by creating tax incentives in favor of certain classes of legatees. An inheritance tax also creates an incentive for the dispersion of wealth among legatees, but such an incentive isn't especially needed in contemporary American legal practice and culture, which has generally abandoned primogeniture. Finally, it is hard to integrate a gift tax with an inheritance tax.

A carryover-basis rule under the income tax suffers from the following defects: (1) it attributes gain that accrued to one party to another party, (2) it creates inequities among legatees receiving equal-value bequests, (3) it requires keeping basis data for excessively long periods of time, (4) it is procedurally awkward in positing a basis-determination date that is different from the taxable event (realization by the legatee), and (5) it has, in its 1976 and 2010 incarnations, already proven to be so complex as to be unworkable.

C. Mitigating Valuation Problems

Alternatives (2), (3), and (4) share a common advantage over the current transfer tax system, which requires all relevant facts (including values) to be determined as of the date of transfer (usually, the decedent's death). Valuation is a costly and fact-specific exercise that is best avoided where feasible. All of alternatives (2), (3), and (4) would involve valuation at the time of gratuitous transfer as a general rule, but allow for deferral of the taxable event (or even exclusion) in appropriate circumstances. For example, under the deemed-realization approach, the general rule would be that a gratuitous transfer of property would produce realized gain to the decedent (or donor) in an amount equal to the difference between the asset's basis and its fair market value at the time of transfer. However, a transfer to one's spouse would not be a realization event, and the transferor spouse's basis would carry over to the transferee spouse, which is an extension of current § 1041 of the income tax. Similarly, gain with respect to a principal personal residence could be covered by the exclusionary rule of current § 121.

In all three systems, difficult valuation problems (as with closely-held business interests) could be postponed, though "tailored" deferred-realization rules, as are common under the income tax.

D. Transfer Tax Features Do Not Necessarily "Transfer" to the Income Tax

None of alternatives (3), (4), and (5), which are all located within the income tax, should incorporate transfer tax features unless there is a compelling reason to do so. These approaches all have internal-to-income-tax rationales. In contrast, the transfer taxes, with high rates and large exemptions, serve the external-to-tax purpose of curbing undue accumulations of wealth. Hence, there should be no "minimum" stepped-up basis within the income tax designed to serve as an income-tax proxy for a lifetime transfer tax exemption. Similarly, it should not be simply assumed that an unlimited marital exemption is warranted. In terms of system design, each alternative should be approached with a view to internal consistency with the aims, norms, and principles that govern that system.

E. Comparing the Accessions Tax with the Income-Inclusion Approach

I wish now to focus on the income-inclusion approach, with particular attention to comparing it with an accessions tax. These two approaches might appear to be virtually identical, except for the rate and exemption structure, but it turns out that there could be significant differences.

1. The value of a transferee-oriented approach

Instead of the current transfer taxes, which can be perceived as a penalty on a decedent's success in the market economy, a transferee-oriented tax is can be sold as a tax on "unearned windfalls" of transferees. Furthermore, a tax that bears explicitly on transferees can be perceived as compatible with the goal of equality of opportunity.

Although carry-over basis is a transferee-oriented approach, it operates erratically and capriciously in terms of trying to achieve any non-tax goals, because the built-in gain bears no systematic correlation with the value of what is received. The deemed-realization approach is not transferee-oriented at all. The inheritance tax only considers the mostly-irrelevant factor of closeness of relationship. That leaves the income-inclusion and accessions-tax approaches, which both explicitly impose taxes on transferees.

Under a transferee approach, the amount subject to tax is net of transaction costs, such as debts, funeral costs, administration expenses, and costs of obtaining gratuitous receipts. Since the tax is imposed on the transferee with respect to the net amount received, the transferee tax is not itself subtracted from the tax base. In this respect, all gratuitous receipts are treated equally, whether in the form of gifts or otherwise.

2. Rate and exemption structure

The main difference between the accessions tax and the income-inclusion approach is the rate and exemption structure. An accessions tax would look like the present system because there would be a cumulative lifetime tax base consisting only of gratuitous receipts, a substantial lifetime exemption, and a potentially high rate on accessions above the exemption. These features are appropriate to carry out the principal purpose of such a tax, namely, to curb undue accumulations of unearned wealth by a given individual. The accessions tax is conceived of separately from the income tax, which is a tax on the acquisition of wealth by whatever means, with an aim to generate substantial revenue without undue economic distortion. The income tax is an annual tax that, ideally, does not discriminate according to source or use. The annual "exclusion" under an income tax is basically a set of allowances that eliminate subsistence income from the tax base. Under the income-inclusion approach, gratuitous receipts of low-income persons would be shielded from tax by these subsistence allowances.

3. The exclusion for support and its penumbra

Under both the accessions tax and the income tax, support received in kind is inherently excluded on the ground that it is not a true wealth transfer. Support in-kind basically involves one person spending money in a way that benefits another. Even support in cash can be excluded on the theory that its purpose is consumption spending of the donee, rather than one aimed to effectuate a true wealth transfer.

If support is excluded, both the accessions tax and the income-inclusion approach would be required to draw the line between support (which is not taxed) and gratuitous receipts (which would be taxed). This problem already exists under the existing gift tax, and it is probably fair to say that the annual gift tax exclusion is best rationalized as a mechanism for managing this difficult borderline area. The fact that the exclusion is an annual one (and on a per-donee basis) has the effect of expanding the category of support. This same general approach could be adopted for both the accessions tax and the income tax.

The annual exclusion concept should nevertheless be re-designed to conform to the transferee orientation of the accessions tax and the income-inclusion approach. For starters, there should be a single fixed-amount annual exclusion of a transferee for all includible gratuitous receipts during the year from all *living* transferors. Perhaps only transfers from persons who plausibly owe a support obligation to the transferee should be eligible. The exclusion should be designed to exclude donor-financed donee consumption (within reason) from being a taxable gratuitous receipt.

4. Gratuitous accessions are income under a personal income tax

The rationale of the income inclusion approach is that gratuitous receipts really are "income" under a personal income tax. The exclusion of current law is an historical anachronism based on trust accounting rules and the concept that income is distinct from "original endowment." But there are different concepts of income that serves different purposes, both tax and non-tax. For example, there's "national income" (GDP). A VAT of a certain type would be a tax on national income. Transfers are ignored under a tax on national income. In contrast, a tax on *personal* income is a tax on an individual's net accessions to wealth "from whatever source derived." (If that phrase sounds familiar, it is because it is found both in the 16th Amendment to the Constitution and the § 61(a) definition of catch-all income.) If § 102(a) were repealed, gratuitous receipts would then become non-excluded gross income.

A personal income tax is founded on the concept of the ability to pay of an individual taxpayer relative to that of others. Gratuitous receipts constitute an increase in the recipient's ability-to-pay tax base to the same extent as wages, lottery winnings, or any other accession to wealth. There is no reason why a gratuitous transfer should bear a lighter tax than wages paid for a personal service (such as a home repair): in both cases, the transferee has income and the transferor has a non-deductible expense.

Including gratuitous receipts in income, which is an annual tax, implies that there are no lifetime exclusions or special rates. However, as with the existing income tax, there *could* be special rates (as with net capital gains) or an income-averaging rule (or maximum rate) to mitigate the "bunching effect." Similarly, some kind of lifetime exclusion *could* be incorporated into the system, although such a feature would be inconsistent with the nature of an income tax. A lifetime exemption would require the keeping of records over time, and this would be the only feature of an income-inclusion approach that would create a new record-keeping obligation. (In contrast, an annual exclusion – conceived as a way of defining "support" – is not inconsistent with an income tax.)

An accessions tax, being keyed to a cumulative lifetime tax base (and lifetime exemption) mandates the long-term record-keeping obligations.

An income-inclusion approach without a large cumulative lifetime exclusion has the potential (even with an annual exclusion) to raise a lot more tax revenue than the existing system, even though the highest income tax rates are lower than the highest estate tax rates. The incremental revenue yield could be used to lower rates generally, or for any other purpose.

5. Deferred-realization rules

As mentioned earlier, deferred realization rules are common in the income tax, and can be deployed specially in the income-inclusion scheme for gratuitous-receipts. Likely candidates for deferred realization are non-liquid assets, hard-to-value assets, and tax-favored assets. Assets that are likely to depreciate in value should not be eligible for any deferred-realization rule.

Deferred realization allows avoidance of valuation until the asset is disposed of in a market transaction or ceases to meet any applicable "qualified use" requirement.

An asset that has not yet been included in income would have a zero basis. An asset that has been included in income takes a basis equal to the amount included.

Even where deferred realization is not allowed, modest valuation errors would be tolerable, because the erroneous amount included, memorialized as the asset's new basis, is automatically "corrected" upon subsequent realization. This correction does not occur under an accessions tax, where the value at the time of the accession is fixed.

The income-inclusion system has the big advantage of wiping out the "historical" basis of the asset in the hands of the transferor.

An accessions tax could also have deferral rules, but they would presumably not be modeled on the realization principle of the income tax, but would instead be confined to tax-favored assets and transactions, such as bequests of interests in closely-held business. Since an accessions tax is a transfer tax, valuation thereunder (whenever it occurs) is "final," as under the current estate tax.

The operation of an accessions tax produces no necessary consequences under an income tax, which is a separate tax. For example, it would be hard to justify a step-up in basis of an asset that is "subject to" the accessions tax but avoids tax on account of the lifetime exemption. Indeed, a basis step-up for a taxed accession would undermine the very purpose of the accessions tax: the accessions tax would be partially offset by a reduction in the future income tax of the same person.

6. Hybrid transfers

A problem under the current system is the necessary reliance on actuarial tables to value future interests. A related problem is created by the need to design timing rules for "hybrid" (retained-interest-or-power) inter vivos transfers. Actuarial tables are not only inaccurate in individual cases, but can be "gamed" by such devices as GRATs and private annuities.

Hindsight is better than estimates and guesses. Under both the accessions tax and income-inclusion system, the taxable event is generally the receiving of an outright transfer or (as will be explained below) of a trust distribution. The gratuitous receipt of a present or future interest in property (or the vesting of any such interest) would generally not be considered to be an accession or income-realization event. There is no norm that commands that tax law must slavishly follow property law all of the time. The income tax has never been burdened by property-law concepts.

7. Life insurance

The receipt of life insurance proceeds would be taxable as a gratuitous receipt regardless of who held the incidents of ownership and regardless of the owner's income tax basis in the policy. If the beneficiary was also the owner, the receipt of the proceeds would result in investment gain or loss, as opposed to being gratuitous-receipt income.

The same analysis would apply under the accessions tax.

8. Spousal transfers

A major design issue is that of inter-spousal transfers. Inter-spousal *gifts* would be ignored (exempted) under both approaches, but death-triggered transfers might be viewed differently. Since inter vivos inter-spousal transfers would be ignored, transfers *to* either spouse from any third party should be attributed 50-50 to each spouse.

Under an accessions tax, each spouse would be considered a separate taxpayer, because the purpose of the accessions tax is to curb undue concentrations of unearned wealth. Thus, a person should not be allowed to accumulate twice as much unearned wealth simply by reason of having been married, or three times as much unearned wealth by reason of having been married twice. Likewise, a widow or widower should not be favored relative, say, to a person who receives accessions from two ancestors. It follows that there should not, in principle, be an unlimited inter-spousal exclusion over and above the lifetime exemption, because it is the lifetime exemption that is supposed to operate as the baseline for ascertaining what is an "undue" accumulation of unearned wealth by a given individual.

Wealth acquired by earnings avoids the accessions tax. Stated differently, asserting control over one's own wealth is not an accession. A common legal and cultural norm is to view marriage as a kind of economic partnership. Accordingly, it is not unreasonable to stipulate that accessions from the deceased spouse, not to exceed half of the value of the deceased spouse's estate (or half of the combined estates), are really "earned" wealth that is already equitably owned by the surviving spouse (and not really an accession at all). Most current estate plans involving the wealthy do not give the surviving spouse fee ownership of the entire marital estate, but rather create interests in individuals other than the surviving spouse. If this pattern continues under an accessions tax, it is unlikely that the limitation on the marital exclusion will be exceeded. Moreover, the surviving spouse still has her own lifetime exclusion. Thus, it is quite unlikely that the surviving spouse will receive accessions from the decedent that exceed both the marital exclusion and the surviving spouse's own exclusion. Accessions by third parties from the deceased spouse will be scattered among such persons' separate accessions tax bases and lifetime exclusions. Even if the surviving spouse actually pays accessions tax, there is no necessary estate planning disaster, because the surviving spouse can control both the timing and the existence of accessions tax at the next generation, because the surviving spouse would be able to control the disposition of virtually everything that appears in her accessions tax base.

Under the accessions tax, there would be no terminable interest rule to impede qualification for the spousal exclusion, since the accession occurs upon the actual receipt of money or property, not upon the acquisition of a future interest.

Under the income tax, a married couple is treated as a single taxable unit for many purposes, one of which is that inter vivos inter-spousal transfers are ignored, and another of which is that there is a common basis in spousal assets, regardless of the form of ownership or the mode of disposition. This income tax taxable unit can be treated as continuing beyond the death of the first spouse to the extent that the surviving spouse ends up with the marital estate. It follows that amounts that were previously subject to income tax prior to, or during, marriage would not be taxed again to the surviving spouse simply by reason of the death of the deceased spouse, and unrealized gains and losses would continue in their unrealized state. Thus, the survivor should, in principle, (1) obtain an exemption for all cash received from the deceased spouse, (2) obtain sole ownership of marital assets in kind without a deemed-realization event, and (3) inherit the couple's common basis (without adjustments). These results are wholly consistent with current § 1041. Again, there would be no qualification rules.

9. Treatment of trusts and beneficiaries

The accessions tax and income-inclusion approaches differ slightly in the case of trusts. The accessions tax is potentially simpler: the trust is not a taxpayer under the accessions tax, and distributions (whether out of income or corpus) are accessions of the distributees in full. This approach allows for deferral, but deferral is revenue neutral (assuming a flat rate with no exemptions) if the tax base increases at a rate no less than the discount rate. If anything, the tax-avoidance concern would be with attempts to accelerate accessions (say, by a sale of a remainder interest) at a time when the value of such interest is low relative to its likely future yield.

If deferral is deemed to be a problem, a more complicated approach – that might be suitable for large trusts - would be to impose a withholding tax on the trust when receiving the funding gift or bequest. Thereafter, a distribution of income or corpus would be a taxable accession to the distributee, but the distributee would receive a (refundable) credit, without interest, against accessions tax for her appropriate share of the earlier withholding tax.

Under the income tax, a trust is currently treated as a taxpayer. Therefore, the receipt by the trust of funding gifts and bequests would be treated as current income of the trust. Otherwise, a gratuitous transfer to a trust would be treated more favorably than an equivalent transfer to an individual. Whatever deferred-realization rules that are available to individuals would be available to trusts as well. Thereafter the rules of Subchapter J would operate as they do at present to allocate post-transfer income and gains of the trust to the beneficiaries or the trust. (The trust would not itself be viewed as if it were a donor. That is, distributions would be deductible by the trust to the extent included by distributees. In the absence of a distribution deduction, trust transfers would be treated worse than transfers to individuals.)

10. The effect of powers

Under the current system, possession of a general power of appointment results in a person being treated as the owner of property and the income therefrom. If this concept were carried over to the accessions tax and an income-inclusion system, it would result in taxing the same gratuitous receipt to two taxpayers: the holder of the power would be deemed to have received the distribution, and then the actual distributee would be deemed to receive a gift from the holder of the general power. This result seems unnecessarily harsh. At the same time, general powers should not be allowed to be used as artificial devices to attribute gratuitous receipts from a high bracket distributee to a low bracket power holder. Accordingly, general powers of appointment should be ignored under both the accessions tax and the income-inclusion system, and the receipt should be attributed only to the person who actually receives it.

A related issue is that of grantor trusts. Under the accessions tax, the grantor trust rules would attribute income to the grantor, but any distribution to a person other than the grantor would be an includible accession. This result would somewhat inhibit the use of "defective grantor trusts."

Under the income-inclusion approach, the grantor-trust rules, unless modified, would result in double taxation of distributions to third parties: the income would be taxed to the donor, and the distributee would include the distribution as a gift from the donor. One option is to allow this result to occur in all cases in which the trust or its income is deemed to be owned by the grantor under current law, in which case the distributee might (or might not) avoid tax (in whole or in part) under the annual exclusion. Apart from the annual exclusion, it cannot be the case under an income-inclusion system that a distribution is wholly excluded by a distributee simply because the income represented by the distribution is taxed to the grantor. To avoid such a back-handed generic (as opposed to annual) gift exclusion, the remaining option would be to limit the double taxation result only to revocable trusts, provided that the creation of any irrevocable trust would result in an income inclusion by the trust, followed by application of the Subchapter J rules (rather than grantor-trust rules).

F. Conclusion

The foregoing is an overview of the obvious issues. Other issues would need to be worked out.

The general conclusion is that income-inclusion system and the accessions tax are superior to the other alternatives as possible replacements for the current transfer taxes. (If Congress decides that no "replacement" is desirable, it should at least eliminate the hole in the income tax created by § 1014.) Both the accessions tax and the income-inclusion system offer numerous advantages relative to the existing system. The income tax alternative seems better than the accessions tax by being able to raise the most revenue with the least administrative effort and minimal changes in existing law.

In any event, any replacement system should be constructed from the ground up, as opposed to being a grafting of existing transfer tax features onto some new, but barely visible, root stock.

APPENDIX – Writings of Joseph M. Dodge on the Federal Transfer Taxes and Alternatives Thereto

I. Articles (in reverse chronological order)

1. *Debunking the Basis Myth under the Income Tax* (with Jay Soled, Rutgers University), 81 Ind. L. J. 539 (2006) (61 pp.)

2. *Alternatives to the Current Federal Wealth Transfer Tax System* (with Joseph Kartiganer and Sherwin Kamin), *published as* Appendix A to Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes, 58 The Tax Lawyer 93, 279-312 (2004).

3. *Inflated Tax Basis and the Quarter-Trillion Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005) (with Jay Soled), reported in (*inter alia*) David Cay Johnson, "Overstating of Assets Is Seen To Cost U.S. Billions of Dollars," New York Times (Jan. 24, 2005), p. C-2, and Albert B. Crenshaw, "First, Go After The Tax Cheats," The Washington Post (Sunday, Jan. 30, 2005), p. F-1.

4. *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 S.M.U. Law Rev. 551 (2003) (49pp)

5. *Why a Deemed-Realization Rule for Gratuitous Transfers Is Superior to Carryover Basis and Avoids Most of the Problems of the Present Estate and Gift Tax*, 54 Tax L. Rev. 421 (2001) (132pp)

6. *What's Wrong with Carryover Basis, Especially the Carryover Basis Provisions of H.R. 8*, 91 Tax Notes 961 (May 7, 2001)

7. *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 Am. J. Tax Policy 127 (1997) (127pp), and *A Pass-Through Replacement to Subchapter J - Putting It in Perspective*, 14 Am. J. Tax Policy 267 (1997) (14 pp)

8. *Lifting the Shroud over Estate of Hubert: The Logic of the Income and Estate Tax Treatment of Estate Administration Expenses*, 3 Fla. Tax Rev. 647 (1998) (30pp), and *How the Treasury Should Solve the Estate of Hubert Problem*, 78 Tax Notes 1715 (March 30, 1998)

9. *A Feminist Perspective on the QTIP Trust and the Unlimited Marital Deduction*, 76 N. Car. L. Rev. 1729 (1998) (30pp).

10. *Taxation of Gratuitous Transfers under a Consumption Tax*, 51 Tax Law Rev. 529 (1996) (70pp)

11. *Further Thoughts on Realizing Gains and Losses at Death*, 47 Vand. L. Rev. 1827 (1994) (34pp), *excerpts reprinted in* P. Caron et al., Federal Wealth Transfer Tax Anthology 373-80 (1997).

12. *Rethinking Section 2036(c)*, 49 Tax Notes 199 (Oct. 8, 1990) (12pp)

13. *Redoing the Federal Estate and Gift Taxes Along Easy-to-Value Lines*, 43 Tax Law Review 241 (1988) (151pp), *excerpts reprinted in* P. Caron et al., Federal Wealth Transfer Tax Anthology 192-96, 246-47, 284-88, and 373-80 (1997).

14. *The Taxation of Wealth and Wealth Transfers: Where Do We Go After ERTA?*, 34 Rutgers L. Rev. 738 (1982) (38pp)

15. *Retentions, Receipts, Transfers, and Accumulations of Income and Income Rights: Thoughts on the Post-Byrum Role of Federal Estate Tax Sections 2036, 2037, 2039, and 2043*, 58 Texas L. Rev. 1 (1979) (89pp)

16. *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978) (34pp), excerpts reprinted in P. Oliver and F. Peel, Jr., Tax Policy Readings and Materials 428-435 (1976)

17. *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. Pa. L. Rev. 1265 (1977) (43pp), *reprinted in* April, 1978, Monthly Digest of Tax Arts., p. 16

18. *Substantial Ownership and Substance vs. Form: Proposals for Unification of Federal Estate and Gift Taxes and for Taxation of Generation-Skipping Transfers*, 1976 U. Ill. L. F. 657 (1976) (60pp)

II. Monographs and Casebooks

1. Transfers with Retained Interests and Powers, 50-5th T.M. (1986) (revised edition 1992) (Tax Management Portfolio), and Transfers Taking Effect at Death, 256 T.M. (1972) (predecessor Tax Management Portfolio)

2. Wills, Trusts, And Estate Planning (1988) (West)

3. Federal Taxation Of Estates, Trusts, And Gifts (1981) (West), with Teacher's Manual (1981), and Supplement (1982)

Hon. Max Baucus
Senate Committee on Finance
April 9, 2008

Dear Senator Baucus:

Below are answers to the questions submitted by Senators relating to the Senate Finance Committee Hearing of March 12, 2008, on Alternatives to the Existing Federal Transfer Taxes. The Senators' questions are in boldface, and my replies are in ordinary typeface.

My answers represent my own personal views, and do not represent the views of any organization with which I am affiliated.

Respectfully submitted,

- Joseph M. Dodge
Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor of Law
Florida State University College of Law

United States Senate Committee on Finance Hearing
Alternatives to the Current Federal Estate Tax System
March 12, 2008
Questions Submitted for the Record

Questions for Professor Dodge:

Senator Baucus

(1) Professor Dodge, some wealth transfer tax systems tax the transferee of a gift or bequest. Some believe that this type of wealth transfer tax system is more equitable. Rather than taxing the donor, it taxes the income of the beneficiary.

(a) Would the effect of your proposal simply be to shift the payment, planning and recordkeeping burden to the beneficiary, as opposed to the estate?

The payment would be the responsibility of the beneficiary. A system of estate withholding could be considered. The tax burden could not be shifted away from the beneficiary. Non-liquid transfers would raise separate issues. Generally, no tax would be due upon the receipt of present and future interests in trusts; only distributions from trusts would be included. Rules can be designed so that other non-liquid assets (working farms, closely-held business interests) would not be taxed on receipt but rather only on conversion to a liquid asset (or cash) or cessation of qualified use.

The recipient would keep track of lifetime taxable accessions under an accessions tax (just as a donor must keep track of lifetime gifts under the present system), but not under the income-inclusion approach (which is an annual system).

Planning would be shared among the transferor and trustees. Presumably, a transferee-oriented tax would create an incentive for discretionary trusts and special powers of appointment. The amount of planning depends on how easy it is to avoid tax by means other than directing bequests and distributions to low-bracket beneficiaries.

More generally, I don't view the accessions tax as just a mirror of the estate tax. It's a different tax based on a different principle. It should be designed from the ground up.

The income-inclusion approach uses the existing income tax (especially Subchapter J) to do most of the work.

(b) If so, would your proposal actually simplify the U.S. wealth transfer tax system?

The existing tax is complex because of (1) over-reliance on property-law concepts, (2) the necessity of valuing assets no later than the transferor's death, and (3) dealing with problems by enacting a statutory overlay rather than addressing the problems at their roots. It would be easier to enact a simplified transferee-oriented system than to simplify the existing system.

There is no GST under the transferee systems. Generation-skipping is not a problem in itself. An accession should not be more heavily taxed because it comes from a grandparent.

Most of the serious valuation issues could be avoided, as would most issues relating to timing (retained-interest transfers).

People would not have to plan for liquidity. Liquidity would be built into the system, like the realization requirement under the income tax.

(2) You have testified about different forms of wealth transfer tax systems.

I assume you are referring to the accessions tax and the income-inclusion system, but not to taxing gains at death (which is not a wealth transfer tax).

(a) What are the disadvantages to these different systems?

I think there are a lot of technical advantages. The disadvantage of the accessions tax (as I would design it) is that there would be deferral of the taxable event in the case of trusts and non-liquid interests. Unless the per-transferee exemption were about $1M, the revenue would be reduced in the near term, especially considering likely transition rules (no tax of property already taxed under the existing system). The accessions tax also requires that persons keep track of lifetime accessions. That wouldn't be so hard if they file returns on receiving accessions, and can retrieve these returns from the IRS if necessary.

Under the income-inclusion system, there is no deferral for trusts, because a receipt by a trust would be income to the trust or beneficiaries. In fact, an income-inclusion system has no "lifetime" exemptions or rates. Depending on the design of the annual exclusion, there could be a large revenue-raising potential, which could reduce rates generally, etc.

(b) What effect would these alternative tax systems have on small businesses?

The taxable event can be delayed, without interest. The deferral lasts until conversion to liquid form or cessation of qualification. In the case of conversion to liquid form, there is no need ever to value the interest. This approach is better than having to value business interests (which is often hard) and then charging interest, on the one hand, or a permanent exclusion, on the other.

(c) What type of transition rules would have to be developed to change a system from taxing the donor to taxing the beneficiary?

Either one would exempt receipts previously subject to estate or gift tax or else one would provide a credit for estate or gift tax attributable to a taxable receipt. The former approach would be simpler.

(d) What steps would the Government have to take to make these changes?

In not sure what changes you are referring to. Basically, Congress would do it by legislation. Congress did it with the GST. I think it would be better if the new system were developed inside, with outside help, if necessary, rather than by a public commission where various interests have to be represented. The main interests here are family businesses (including working farms).

(e) How would the Government administer the new system?

A transferee-oriented system would require information returns supplied by estates, trustees, third parties (such as insurance companies), and donors. A withholding system is a possibility; transferees would then have an incentive to report items in order to obtain credit for withheld taxes.

Senator Grassley

(1) What safeguards could be put into an accession or income inclusion system which would protect the potentially illiquid owners of small businesses or family farms that could be directly affected by these systems?

Qualified non-liquid assets (working farms, closely-held business interests) would not be taxed on receipt but rather only on conversion to a liquid asset (or cash) or cessation of qualified use. Dividends and other distributions from qualified non-liquid assets would be taxable; profits reinvested in the qualified asset would not be taxable.

(2) Many of these theorists, such as Ms. Batchelder, have suggested that a potential shift from stepped up basis to carryover basis for bequests would help to maintain the taxable consequences of assets which pass following death. Would you please expand on your opposition to this shift that you mentioned in the early portion of your testimony and explain why that would be ill advised? The main reason I am wondering about your opinion is that a lot of people who suggest reforms to the estate tax start with changing stepped up basis to carry over basis and I just wanted to hear a pragmatic argument for why you believe we should keep the stepped up basis rules as they are currently.

I don't favor stepped-up basis as it exists under the present system, because gain permanently escapes the income tax without necessarily giving rise to estate tax. Dealing with the income tax is a separate issue apart from the wealth transfer tax. I don't know of any theorist who favors the current stepped-up basis system.

I have said that I would prefer taxing gains at death to carryover basis. The carryover-basis rules slated to take effect in 2010 are especially unfortunate, in my opinion, because they import transfer tax features (lifetime exemption, marital exclusion through stepped up basis) that don't belong in an income tax. Under a system that generally taxes gains at death, there would be carryover-basis "exceptions" for transfers to spouses (thereby extending § 1041 past death) and for qualified non-liquid assets. Where gains *are* taxed at death, the successor would obtain a stepped-up basis.

Senator Hatch

(1) In your written testimony you mentioned either an inheritance tax or an accessions tax. Please outline for me the differences between the two and contrast the benefits and disadvantages of each to our current system.

An inheritance tax is like an estate tax except that there are different rate and exemption structures for different classes of legatees (surviving spouses, descendants, ancestors, collaterals, and non-relatives). The estate of each decedent is taxed independently of other estates. Gift taxes are separate taxes.

An accessions tax is a tax, at a progressive rate with a lifetime exemption, on the cumulative gratuitous *receipts* ("accessions") of a person over his or her lifetime. All gratuitous receipts (gifts, bequests, inheritances, life insurance proceeds, taking under survivorship rights, etc.) go into the tax base. There would be a per-taxpayer lifetime exclusion designed to separate accessions from non-taxable "support" (broadly defined).

(2) From my viewpoint, one of the biggest problems with any kind of wealth transfer tax is the difficulty it poses to family business being passed from one generation to the next. As you all know, there is a high mortality rate for small businesses anyway, and this is only exacerbated by taxes that can make an inter-generational transfer difficult or impossible. What can be done in designing a wealth transfer tax to mitigate these problems?

Under an transferee tax (like an accessions tax), qualified non-liquid assets (working farms, closely-held business interests) would not be taxed on receipt but rather only on conversion by the recipient to a liquid asset (or cash) or cessation of qualified use. Dividends and other distributions from qualified non-liquid assets would be taxable; profits reinvested in the qualified asset would not then be taxable under the wealth transfer tax.

In contrast, under the current estate tax you can't defer the taxable event past the decedent's death. Either the property is taxable or it is wholly excluded. If it is taxable, you have to deal with valuation and liquidity issues. If the tax payment is deferred, then interest accrues. Setting the interest rate and term of deferral are a problem. The deferred tax has to come from somewhere: either the business itself or life insurance that would otherwise not have been purchased.

(3) Do you believe the primary goal of a wealth transfer tax is to raise revenue or to achieve certain social goals? How might the goal of such a tax determine the best way it is structured?

It's the job of Congress to set and implement goals. The ability of a wealth transfer tax to raise revenue is limited by the fact that only a small percentage of the population dies every year. It is further limited if the lifetime exemption is set high to exclude 99% of decedents. Including gratuitous receipts in income (with no lifetime exemption but an annual exclusion, and regular income tax rates) could generate a lot more revenue than a wealth transfer tax.

It is sometimes said that the goal is to curb undue accumulations of wealth. But an estate tax doesn't serve that goal particularly well, because it only acts well after the wealth has been accumulated. Also, the income tax is the tax that operates on the accumulation process. Finally, accumulating wealth is tied to the idea of the "American Dream," and it is unseemly to penalize success. I think that a better way of stating the non-revenue goal is to state that the aim is to curb undue accumulations of *unearned* wealth by persons who were not involved in earning the wealth. (We can assume that surviving spouses and some people involved in family farms, etc., *were* involved in the creation of wealth, and that can justify a marital exclusion and/or deferral of the taxable event.) Then the tax is a tax on "unfair material advantage" of persons who had the luck to be born to rich parents. A tax on unfair advantage is an accessions tax (or treating gratuitous receipts as income). The accessions tax directly creates a strong incentive to disperse wealth.

(4) Professor Dodge, you outlined five alternatives to the current estate tax regime. Which of these five most closely resembles our current system? I am not sure I understand why you suggest that we reject an inheritance tax system.

There are pure income tax solutions (taxing gains at death or carryover basis), pure wealth transfer tax solutions (like the accessions tax), and the solution of including gratuitous receipts in income (which is kind of an "umbrella" solution).

I don't know of any theorist in the U.S. that favors the inheritance tax. The inheritance tax idea dates back to the early 19th century, and maybe earlier, and seems to be based on the idea that the government has more claim to an estate the weaker the legatee's formal relationship to the decedent. But this idea directly conflicts with freedom of testation. Who is to say that my dearest friend should have a higher tax burden under my bequest than my sibling that I've never gotten along with? The inheritance tax can't really be integrated with a gift tax or a GST. The inheritance tax serves no policy goal. The contemporary concern is with excessive concentrations of wealth (especially unearned wealth). The accessions tax is better tailored to that issue.

Senator Roberts

When visiting with farmers and small business owners, I hear repeatedly that the biggest cost of the estate tax may not be the tax bill itself, but rather the amount of time and money they spend in estate planning. In light of the current economic climate, I think it is particularly important for us to consider this point. The money these individuals have paid to accountants, lawyers, insurance companies and others in preparing for the estate tax could have been reinvested to grow their business. I think that begs the question: how would a move to an inheritance tax impact the planning costs for these farms and businesses?

None of us on the panel favored a traditional inheritance tax. We were talking about an accessions tax, which is a tax on the person who receives a gratuitous receipt. An accessions tax is a tax, at progressive rates, on the cumulative lifetime gratuitous receipts of an individual reduced by a fixed-amount lifetime exemption. I think that an accessions tax better deals with liquidity and planning issues than the current system.

As to liquidity, under an transferee tax (like an accessions tax) qualified non-liquid assets (such as working farms and closely-held business interests) would not be taxed on receipt but rather only on conversion by the recipient to a liquid asset (or cash) or cessation of qualified use. Dividends and other distributions from qualified non-liquid assets would be taxable; profits reinvested in the qualified asset would not then be taxable under the accessions tax. There would be no need to borrow cash or buy life insurance.

Other advantages of an accessions tax (as I would design it) include:

(1) a spousal exclusion without difficult qualification rules;

(2) no generation-skipping tax;

(3) no advantage for gifts over bequests;

(4) no relevance of powers of appointment;

(5) vastly simpler rules relating to timing (basically, an accession occurs upon a trust distribution, not earlier);

(6) rational and simple treatment of life insurance.

Senator Schumer

(1) I am intrigued by the inheritance tax proposal, but I have some questions. The proposal would tax the individual that receives the inheritance, but doesn't that pose a significant problem if the bulk of the assets given to a particular individual are not cash or liquid assets? It's not unusual to have specific bequests of

property that can't be readily sold to pay an inheritance tax. With an estate tax, all of the assets (liquid and non-liquid) are available to pay whatever tax is owed before the property is distributed. I understand how your proposal would deal with businesses, but what about other illiquid assets?

The three witnesses on March 12 were all talking about an accessions tax. The term "inheritance tax" is just a kind of shorthand for a transferee-oriented wealth tax.

I can only guess at what you mean by "other illiquid assets." I'll assume that you mean such things as personal effects, collectibles, and real estate. I'd probably exclude personal effects, within reason. Personal effects are really deferred consumption and not real wealth. Valuation would rarely be worth the effort. My inclination would be treat other non-business non-liquid assets as falling within a single category which can be called "hard-to-value assets." I view these assets as being assets that have significant lasting value but which cannot be valued apart from appraisals and which take time to sell (or involve transaction costs in selling), as opposed to assets that are tied up with a "way of life." Some of these assets (commercial real estate) throw off income. Under an accessions tax, you can use hindsight. First, the tax would be based on a good faith valuation upon receipt. For this purpose, "receipt" can be defined with some flexibility. For example, in the case of an estate, it might be defined as the earlier to occur of the date of sale or the date which is three years after the decedent's death. (This approach is similar to the Alternate Valuation Date approach of the current system.) In case of sale, only the net proceeds would be taxable. In this case, there's liquidity. If there is no sale prior to the cut-off date, then a tax would be due on the basis of a value determined at the cut-off date. However, the tax in this type of case could be deferred with market-rate interest. If a sale occurs after the cut-off date, the unpaid tax obligation would be accelerated. An issue would be whether later sale would trigger an additional tax (or refund) based on the difference between the net sales proceeds and the original value. In valuing such assets, there would be no discounts from wrapping the assets in holding companies or other entities or packages.

(2) Decisions of how you distribute your lifelong gain are very personal decisions. Often there are legitimate reasons for distributing more wealth to one child or another.

(a) What are the ramifications of a reform system that punishes someone for not spreading the value of his or her estate among as many heirs as possible?

The person who is punished under an accessions tax is the legatee, who is receiving an unearned windfall. I don't view this as "punishment," because the person still comes out way ahead.

(b) For example, consider a case where the bulk of an estate is left to a handicapped child to provide for his or her care. Should we tax this child

more heavily because his needs are so great that the bulk of the inheritance went to him?

This person will be a trust beneficiary. In the case of trusts, accessions occur only on actual distributions. The accession would not occur upon acquiring an interest in the trust, even if the interest is vested. Thus, only amounts actually distributed or use would count.

This person also has a substantial lifetime exemption. If the person is receiving transferred wealth only from the trust (which seems likely), it would take a long time to run through the exemption.

There would be an annual exclusion for inter vivos support-type spending. This could be extended to trust distributions from a special-needs type of trust. The idea would be similar to present § 2503(e): spending for health care would be excluded. The notion of "health care" could be expanded somewhat in this context, to include, for example, recurring costs associated with institutionalization.

(3) When this Committee held a hearing on the current estate tax system last November, the discussion focused on upcoming uncertainty due to the phase-out and then re-instatement of the estate tax in 2009 and 2010. Witnesses also discussed how the current system can be planned around to catch the most favorable tax treatment. How will adopting an inheritance tax or accession tax cut back on strategies to game the system?

No system is perfect. But the basic planning strategy would be simple: dispersal to zero- (or low-) bracket persons. This accords with the non-tax goal of an accessions tax, so there is nothing illegitimate about this planning. There would be these advantages, for starters:

(1) The spousal exclusion system is simpler. Basically, the spouse is not taxed on what she actually receives, and other persons are taxed on what they actually receive, but there is no need to qualify trust interests in advance. There would be no need to have separate marital and by-pass trusts, and no need for formula clauses. There would be nothing special about deferral by way of using the marital exemption, because deferral can be obtained anyway by using trusts.

(2) There is no generation-skipping tax. If dynastic trusts are viewed as a problem, Congress can deal with that separately; for example, it can require minimum distributions from long-term trusts.

(3) Unlike the present system, there would be no advantage for gifts over bequests.

(4) Powers of appointment would be ignored. The Crummey trust problem would disappear. General powers could not be used to avoid tax illegitimately.

(5) Timing rules would be much simpler, and actuarial tables would be irrelevant. Basically, an accession occurs upon a trust distribution, not earlier. There would be no point in creating a GRAT.

(6) Valuation would be based on what the legatee gets, not what the transferor had.

(7) Charities would be exempt beneficiaries. There would be no qualification rules for split-interest charitable trusts. Actuarial tables would be irrelevant.

Senator Cantwell

If Congress moves away from an estate tax, either by extending repeal beyond 2010 or establishing a new inheritance tax regime, what changes to the individual income tax and capital gains tax rules would have to simultaneously be considered so that we can maintain progressivity in the overall tax system?

I don't favor stepped-up basis as it exists under the present system, because gain permanently escapes the income tax without necessarily giving rise to any wealth transfer tax. If there is no wealth transfer tax, then the hole in the income tax is exacerbated, and closing it would be imperative. I don't know of any theorist who favors the current stepped-up basis system.

I have said that I would prefer taxing gains at death to carryover basis. Carryover basis exacerbates the lock-in effect, requires keeping records for long periods of time, and taxes equally-situated legatees inequitably. The carryover-basis rules slated to take effect in 2010 are especially unfortunate, in my opinion, because they import transfer tax features (lifetime exemption and marital exclusion, both through stepped up basis) that don't belong in an income tax.

Under a system that generally taxes gains at death, there would be carryover-basis "exceptions" for transfers to spouses (thereby extending § 1041 past death) and for qualified non-liquid assets. Where gains *are* taxed at death, the successor would obtain a stepped-up basis.

Dealing with the income tax is a separate issue apart from the wealth transfer tax. Thus, one could fix the income tax loophole and have a wealth transfer tax, but presumably the latter would only apply to the very wealthy.

Alternatives to the Current Federal Estate Tax System
Testimony to the Senate Committee on Finance

David G. Duff
Faculty of Law, University of Toronto

March 12, 2008

Introduction

I would like to begin by thanking the Chairman and the Committee for giving me the opportunity to speak with you today.

My name is David Duff, and I'm a professor of tax law and policy at the University of Toronto Faculty of Law, where I've taught since 1996. Before that, I worked for a tax commission in the Province of Ontario, and as a tax associate in a Toronto law firm. I received by law degree from the University of Toronto in 1989, and have Masters degrees in economics, politics, and law, the last of which I received from Harvard in 1991.

I have appended two articles to this testimony. The first presents a philosophical argument for wealth transfer taxation in the form of an accessions tax, which would turn the current U.S. wealth transfer tax system on its head by applying to the cumulative amount of gifts and inheritances received by individuals over the course of their lifetimes rather than aggregate amounts given by donors over the course of their lifetimes. The second article reviews the abolition of wealth transfer taxes in Canada, Australia and New Zealand, and attempts to derive lessons from this experience for the future of these taxes. My testimony is based on both articles and addresses the rationale for an accessions tax and lessons to be derived from the abolition of wealth transfer taxes in Canada, Australia and New Zealand.

Why an Accessions Tax?

Beginning with the rationale for an accessions tax, let me explain briefly why I think that that a society should tax transfers of wealth, and why an accessions tax is a better tax for this purpose than the current federal wealth transfer tax system in the United States.

As a philosophical matter, I believe that it is both legitimate and desirable for a society to moderate extreme inequalities in the distribution of wealth and in the opportunities that wealth provides, by taxing substantial gifts and inheritances above a generous exemption. While I believe that a society should value and encourage the family bonds that can be associated with the transfer of assets from one generation to another, I also believe that this value needs to be balanced against the negative social and political consequences for a democratic society that can result from the transfer of large dynastic fortunes from one generation to the next. In addition, to the extent that recipients have not earned the gifts and inheritances that they receive largely by the luck of their birth, I do not think that they cannot legitimately complain about a tax that would require them to share some of their good fortune with others who have not been so lucky.

From this perspective, it is clear why an accessions tax would be better than the current federal wealth transfer tax system in the United States. While the current gift and estate tax applies to aggregate amounts transferred by donors over the course of their lifetimes and at death, regardless of how this wealth is distributed among recipients, an accessions tax would apply to the cumulative value of gifts and inheritances that are received by beneficiaries over the course of their lifetimes – which are the amounts that actually contribute toward inequalities in wealth and opportunities. As well, the gift and estate tax sends exactly the wrong message about a wealth transfer tax by taxing successful, hardworking and generous donors who have accumulated wealth out of income on which they have often paid tax already. In contrast, an accessions tax sends a very different and justifiable message by taxing the beneficiaries of substantial gifts and inheritances on amounts that they have not themselves earned and on which they have not themselves paid any tax.

Why Did Canada, Australia, and New Zealand Abolish their Wealth Transfer Taxes?

This brings me to the abolition of wealth transfer taxes in Canada, Australia and New Zealand, and the lessons that may be derived from this experience. Although the story in each country is necessarily unique, I think that three factors are common.

First, in each country legislative action or inaction led to increased burdens on small- and medium-sized estates – either because the rates on these estates were increased, because the value of exemptions eroded with inflation, or because of other tax changes like the introduction of capital gains taxation in Canada which applies to transfers of property by gift or bequest. With much higher exemptions, the U.S. wealth transfer tax system does not face the same pressure. Canadian experience, however, suggests that attention should be paid to the combined effect of a wealth transfer tax and capital gains taxes applied to gifts and bequests.

Second, in each country competition between jurisdictions hastened the demise of these taxes. In Canada and Australia, this occurred at the sub-national level when the federal governments in each country repealed their estate and gift taxes in 1972 and 1979. In New Zealand, concern about wealthy retirees moving to Australia contributed to the government's decision to eliminate its estate tax in 1992. Although these kinds of competitive pressures are not as great in a large country like the U.S., they point to a further deficiency of donor-based gift and estate taxes – that they are easier to avoid through emigration by affluent retirees than accessions taxes that apply to younger and less geographically-mobile recipients.

Third, and perhaps most importantly, the wealth transfer taxes in each of these countries took the form of donor-based estate taxes, either on their own or integrated with donor-based gift taxes. To the extent that these kinds of taxes send the wrong message about the taxation of wealth transfers, it is not surprising that they failed to generate many defenders when they were under attack. In contrast, it is worth noting that recipient-based inheritance taxes appear to have been far more resilient over the last 30 years, accounting for a larger share of total tax revenue and GDP in some countries today than they did in the early 1970s.

Conclusion

As a citizen and resident of Canada, I am obviously not directly affected by the decisions that the United States makes with respect to its wealth transfer tax system.

As you know, however, many countries around the world pay close attention to the United States when they formulate their own tax policies. This is particularly true of Canada, which shares with the United States not only the world's longest border between two countries, but also similar political values and an extremely close trading relationship.

As a result, the decisions that the United States makes for its own wealth transfer tax system can have a huge effect on the tax systems of other countries, including Canada. I hope that the United States will set a positive example for other countries of the world by replacing the current federal wealth transfer tax system with an accessions tax that would be a model for wealth transfer taxation in the 21^{st} century.

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Faculty of Law

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THE ABOLITION OF WEALTH TRANSFER TAXES: LESSONS FROM CANADA, AUSTRALIA AND NEW ZEALAND

DAVID G. DUFF

REGNUM JURIS REGNUM PACIS

The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand

David G. Duff*

I. Introduction

When the U.S. Congress voted to phase-out the federal estate tax by 2010 and President Bush signed the legislation in June 2001,[1] the United States joined a small but growing number of developed countries in which taxes on the transfer of wealth have been abolished.[2] In Canada, federal gift and estate taxes were repealed in 1972 and provincial wealth transfer taxes were abolished in the 1970s and 1980s. In Australia, State and Commonwealth wealth transfer taxes were repealed in the late 1970s and early 1980s. New Zealand followed suit in the 1990s, reducing estate tax rates to zero in 1992 and repealing the tax in 1999. While the United Kingdom continues to collect taxes on the transfer of wealth, the role of these taxes has declined substantially over the last 30

* Associate Professor, Faculty of Law, University of Toronto. I am indebted to Alan Macnaughton, Richard Schmalbeck and Larry Zelenak for helpful comments on earlier drafts. I am also indebted to Doug Robertson, a J.D. student at the University of Toronto Faculty of Law, for excellent research assistance, and to the Social Science and Humanities Research Council of Canada for financial support.

[1] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (2001). The phase-out is accomplished by increasing the exclusion amount and reducing rates between 2002 and 2009, culminating in repeal for the year 2010. Under a sunset provision, however, the legislation providing for this phase-out and repeal is itself repealed after December 31, 2010 – resulting in the restoration of the tax in 2011. For a detailed description of this legislation, see Tye J. Klooster, "Repeal of the Death Tax? Shoving Aside the Rhetoric to Determine the Consequences of the Economic Growth and Tax Relief Reconciliation Act of 2001" (2003), 51 *Drake L. Rev.* 633-65. According to one commentator, "[t]he fact that there will be two presidential and four congressional elections before the estate tax is fully repealed means that it is possible that the repeal will never happen at all or that the sunset provision will stand and the estate tax will return in 2011." Mary R. Wampler, "Repealing the Federal Estate Tax: Death to the Death Tax, or Will Reform Save the Day?" (2001), 25 *Seton Hall L.J.* 525 at 534.

[2] For an excellent account of the events leading up to repeal in the U.S., see Michael J. Graetz and Ian Shapiro, *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth*, (Princeton: Princeton University Press, 2005). For a recent argument that Congress might benefit from uncertainty regarding repeal of the federal gift and estate taxes, see Edward J. McCaffery and Linda R. Cohen, "Shakedown at Gucci Gulch: A Tale of Death, Money and Taxes" University of Southern California Law and Economics Research Paper No. 04-20, available at http://ssrn.com/abstract=581084.

years,[3] and calls for repeal are often heard.[4] As a result, U.S. repeal should no be viewed as an isolated event but as part of a broader international trend.

Whatever the advantages or disadvantages of these taxes,[5] commentators are often puzzled by the apparent political vulnerability of wealth transfer taxes since they generally apply only to a small percentage of substantial estates.[6] For some, political opposition to these taxes stems from psychological factors, such as the association between the tax and death,[7] or an irrational optimism on the part of many people that they will actually be subject to the tax.[8] For others, it is largely ideological, reflecting a conservative emphasis on individual enterprise and an increased hostility to redistributive

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[3] See Organisation for Economic Cooperation and Development, *Revenue Statistics of O.E.C.D. Countries*, (2003), available online at http://hermia.ingentaselect.com/vl=4595239/cl=65/nw=1/rpsv/ij/oecdstats/16081099/v55n1/contp1-1.htm (in 1972, estate and gift taxes accounted for 2.3 percent of total revenues in the U.K. and 0.7 percent of gross domestic product; in 2002, these figures were 0.6 percent and 0.2 percent respectively).

[4] See, e.g., Barry Bracewell-Milnes, *Euthanasia for Death Duties: Putting Inheritance Tax Out of its Misery*, (London: Institute of Economic Affairs, 2002). The Conservative Party's 2005 election platform calls for cuts to the U.K. Inheritance Tax, but not repeal.

[5] The merits of these taxes are widely disputed. Advocates tend to emphasize their contribution to tax progressivity, their social role to lessen inequalities and unequal opportunities, and their assumed economic superiority to income taxes. See, e.g., Michael J. Graetz, "To Praise the Estate Tax, Not to Bury It" (1983), 93 *Yale L.J.* 259; Eric Rakowski, "Transferring Wealth Liberally" (1996), 51 *Tax L. Rev.* 419; and Joseph A. Pechman, *Federal Tax Policy*, 5th ed., (Washington, D.C.: Brookings Institution, 1987) at 234 (commenting that wealth transfer taxes have "less adverse effects on incentives than do income taxes of equal yield"). Critics, on the other hand, condemn their relatively low revenue yield, high collection costs, avoidability, and alleged impact on savings and entrepreneurship. See, e.g., Richard E. Wagner, *Death and Taxes: Some Perspectives on Inheritance, Inequality, and Progressive Taxation*, (Washington, D.C.: American Enterprise Institute, 1973); Joel C. Dobris, "A Brief for the Abolition of All Transfer Taxes" (1984), 35 *Syracuse L. rev.* 1215; Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxation" (1994), 104 *Yale L.J.* 283; and Edward J. McCaffery, "The Political Liberal Case Against the Estate Tax" (1994), 23 *Phil. & Pub. Aff.* 281. For my own views on wealth transfer taxation, see David G. Duff, "Taxing Inherited Wealth: A Philosophical Argument" (1993), 6 *Can. J. L. & Juris.* 3.

[6] In the United States. for example, only 4.3 percent of decedents were required to file estate tax returns in 1998, and only half of these were required to pay any tax. See William G. Gale and Joel Slemrod, "Overview" in William G. Gale, James R. Hines Jr., and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washingston, D.C.: Brookings Institution, 2001) 1-64 at 7-9. In the United Kingdom, it is estimated that only 3.5 to 4 percent of estates pay inheritance tax. See Domenic Maxwell, *Fair Dues: Towards a more progressive inheritance tax*, (London: Institute for Public Policy Research, 2004) at 11.

[7] See, e.g., Richard Bird, "The Taxation of Personal Wealth in International Perspective" (1991), 17 *Can. Pub. Pol'y* 322 at 330 (pointing to "the conjuncture of two events [death and taxes] that few people contemplate with pleasure").

[8] See, e.g., Graetz, *supra* note 5 at 285.

taxation.[9] Although conservative electoral victories have certainly contributed to the decline of wealth transfer taxes,[10] however, more progressive political parties have also been willing to abandon these taxes and have been reluctant to restore them once repealed.[11]

In addition to these explanations for the decline and repeal of wealth transfer taxes, public choice theory provides an alternative account, emphasizing the political costs and benefits of different tax policies and the tendency for electoral competition to promote "political efficiency" in the revenue structures adopted by governments over time.[12] To the extent that wealth transfer taxes entail greater political costs and fewer perceived benefits than other tax measures yielding comparable revenue yields, it is not surprising that they might be politically vulnerable.

This paper examines the abolition of wealth transfer taxes in Canada, Australia and New Zealand, relying on public choice theories of politically efficient revenue structures to help explain the repeal of these taxes in each country. Part II outlines the essential elements of this theoretical approach and its implications for tax policy. Part III

[9] See, e.g., Keith G. Banting, "The Politics of Wealth Taxes" (1991), 17 *Can. Pub. Pol'y* 351 at 364. See also Edward J. McCaffery, *Fair Not Flat: How to Make the Tax System Better and Simpler*, (Chicago: University of Chicago Press, 2003) at 66 (suggesting that wealth transfer taxes contradict "common-sense morality"). For a detailed study of the relationship between ideological perspectives and wealth transfer taxes in Canada, see Lisa Philipps, *Taxing Inherited Wealth: Ideologies About Property and the Family in Canada*, LL.M. Thesis, Osgoode Hall Law School (1992).

[10] In the United States, for example, Republican control of the Congress and the White House precipitated repeal of the federal estate tax in 2001. See Graetz and Shapiro, *supra* note 2. Likewise, in Australia, electoral victory by the Liberal Party under Malcolm Fraser preceded the repeal of the federal estate tax effective 1 July 1979.

[11] In Canada, for example, it was the Liberal Party under Prime Minister Pierre Trudeau which repealed the federal gift and estate taxes in 1971, notwithstanding that Trudeau had campaigned and won the 1968 election by promising a "Just Society". Similarly in Australia, Labour Prime Minister Gough Whitlam promised to abolish federal death duties in 1975 in an unsuccessful bid to stay in office. In the U.S. as well, as Graetz and Shapiro document, Democrats have been reluctant to defend the estate tax. See Graetz and Shapiro, *supra* note 2.

[12] See, e.g., Walter Hettich and Stanley L. Winer, *Democratic Choice and Taxation: A Theoretical and Empirical Analysis*, (Cambridge: Cambridge University Press, 1999); and W. Irwin Gillespie, *Tax, Borrow*

surveys the history of wealth transfer taxes in Canada, Australia and New Zealand, examining in detail the events leading up to the repeal of these taxes, and illustrating the relevance of public choice theory to their abolition in each country. Part IV offers brief conclusions on the significance of this experience for the future of wealth transfer taxation.

II. Public Choice Theory and Tax Policy

In the fields of public finance and tax policy, much writing is essentially normative, establishing criteria for an ideal tax structure and evaluating actual tax regimes against this ideal.[13] In contrast, public choice theories of politically efficient revenue structures are largely positive, attempting to explain the kinds of tax structures and tax reforms that actually exist in modern democratic societies.[14] The following sections provide a brief introduction to this theoretical approach, explaining the main determinants of political efficiency within this framework and the manner in which political efficiency is apt to be pursued through tax policy.

A. Public Choice and Political Efficiency

and Spend: Financing Federal Spending in Canada., 1867-1900, (Ottawa: Carleton University Press, 1991).

[13] This is true of traditional public finance as well as more recent theories of optimal taxation. See, e.g., Richard A. Musgrave, Peggy B. Musgrave, and Richard M. Bird, *Public Finance in Theory and Practice*, (Toronto: McGraw-Hill Ryerson Ltd., 1987); and James A. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation" (1971), 38 *Rev. Econ. Stud.* 175. It is also true of much legal tax scholarship, particularly scholarship based on the Haig-Simons concept of income, and the concept of tax expenditures pioneered by Stanley Surrey. See Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, (Chicago: University of Chicago Press, 1938); and Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures*, (Cambridge, MA: Harvard University Press, 1973).

[14] Gillespie, *supra* note 12 at 14-17. Not surprisingly, of course, these positive theories may have normative implications regarding, for example, constitutional arrangements regarding the manner in which revenue decisions are made. See, e.g., James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, (Ann Arbor: University of Michigan Press, 1962). See also

Public choice theory has been defined as "the economic study of nonmarket decision making" or "the application of economics to political science."[15] As such, it concerns itself with traditional topics of political science such as voting behaviour, party politics, and interest group activities, but examines these phenomena through the lens of economic methodology premised on rational choice subject to constraints.[16] As economic analysis predicts that a perfectly competitive market tends toward an equilibrium at which economic resources are efficiently allocated, so public choice theory predicts that competition among political parties tends toward a political equilibrium where public policies assume a politically efficient form.[17] In order to understand this concept of political efficiency and the form that it is likely to take, it is useful to examine the motivations and constraints that public choice theory assigns to the central actors in the political process: voters, politicians and political parties, and organized interest groups.[18]

1. Voters

The starting point for a public choice theory of political efficiency is a set of assumptions regarding voters and the reason why they vote. Sharing with economic theory the premise that individuals are rational utility maximizers,[19] public choice theory postulates that voters will generally cast their ballots for candidates and political parties

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Gillespie, *supra* note 12 at 17 (suggesting that "a positive model of revenue structure could assist those of us who advise governments on the tax changes that ought to be made").

[15] Dennis C. Mueller, *Public Choice II*, (Cambridge: Cambridge University Press, 1989) at 1.

[16] *Ibid.* at 1-2.

[17] See, e.g., Hettich and Winer, *supra* note 12 at 2; and Gillespie, *supra* note 12 at 16.

[18] Although it is not essential for the purpose of this paper, many public choice theories also consider the behaviour of the bureaucracy and the mass media. See, e.g., Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada: A Public Choice-Rent Seeking Perspective*, Canadian Tax Paper No. 81 (Toronto: Canadian Tax Foundation, 1988) at 35-68.

[19] See, e.g., Mueller, *supra* note 15 at 2.

whose policies are expected to maximize their net utility.[20] In the context of government expenditure and revenue policies, public choice theories generally assume that voters will favour candidates and political parties whose policies are expected to maximize the benefits that they receive from government expenditures while minimizing the taxes that they are required to pay.[21] Voters may also favour certain kinds of taxes over others, notwithstanding that amounts owing are the same, suggesting that differential preferences for different kinds of taxes may also play a role in voting decisions.[22]

In addition to the hypothesis that voters will select candidates and political parties whose policies are expected to maximize their net utility, public choice theory also predicts that voting decisions are generally based on limited knowledge of actual policies and their likely consequences. Since the time and effort to obtain this information is considerable, and the probability of one's vote affecting the outcome of an election is negligible, public choice theory predicts that most voters will remain "rationally ignorant" of most policies – ignoring specific details and basing their choices on perceived impacts on net utility as well as more general perceptions of trustworthiness

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[20] For an early expression of this rational voter hypothesis, see Anthony Downs, *An Economic Theory of Democracy*, (New York: Harper and Row, 1957). See also Gordon Tullock, *Towards a Mathematics of Politics*, (Ann Arbor: University of Michigan Press, 1967) at 110-114; and William Riker and Peter Ordeshook, *Introduction to Positive Political Theory*, (Englewood Cliffs, N.J.: Prentice-Hall, 1973). While the concept of "utility" for this purpose might be broadly defined to include an inter-subjective interest in the welfare of others or a Kantian concern with just social institutions, public choice theory tends to ignore this possibility by assuming an egoistic conception of human beings and a narrow and self-interested notion of utility.

[21] See, e.g., Gillespie, *supra* note 12 at 17 (explaining that political parties in the pursuit of electoral victory attempt to "maximize the political benefits from spending and minimize the political costs of financing the spending").

[22] *Ibid.* at 26-27. To the extent that differential preferences for different kinds of taxes reflect notions of tax fairness, the recognition of these tax preferences as a factor in voting decisions suggests that voters may be motivated by something other than self-interest narrowly understood. For an attempt to rationalize ideas of tax fairness in terms of utility maximization, see Douglas G. Hartle, *Political Economy of Tax Reform: Six Case Studies*, Discussion Paper No. 290 (Ottawa: Economic Council of Canada, 1985) at 52-54.

and feelings of emotional attachment.[23] In the field of tax policy, this phenomenon is likely to be particularly pronounced given the complexity of the issues involved.[24] Since the expected benefits of acquiring information are greater where policies touch on one's most immediate interests, however, voters are likely to devote more resources to inform themselves about these measures.[25] As a result, affluent individuals and corporations can be expected to be much better informed and well-advised than most about the taxes they pay and about the tax policies proposed by politicians and political parties.[26]

Not surprisingly, critics have challenged as limited and unrealistic both the self-interested view of voting that public choice theory assumes and the egoistic conception of human beings on which it is based.[27] Indeed, since it is irrational to expect that a single vote will affect the outcome of an election, the very act of voting itself suggests that voters must be motivated by considerations other than self-interested utility maximization narrowly defined.[28] While one might attempt to rescue the theory of self-interested voting by assuming a psychological benefit from the act of voting,[29] or distinguishing the

[23] See, e.g., Downs, *supra* note 20, chapters 11-13.
[24] See, e.g., Douglas G. Hartle, "Some Analytical, Political and Normative Lessons from Carter" in W. Neil Brooks, ed., *The Quest for Tax Reform*, (Toronto: Carswell, 1988) at 415 (suggesting that most voters' perceptions of their own interests are "more likely than not, seriously flawed when it comes to the details of the tax structure as a whole"); and Banting, *supra* note 9 (emphasizing that "[m]ost voters are not well-informed about the complex world of taxation" and that "[t]here is limited understanding not only of technical language and abstract concepts such as equity, but also of elementary issues such as whether one would benefit from a specific proposal").
[25] Hartle, *supra* note 22 at 25.
[26] See, e.g., Banting, *supra* note 9 at 353 (observing that "those with a large stake in tax battles inform themselves and equip themselves with a phalanx of professional advisors").
[27] See, e.g., Joseph P. Kalt and Mark A. Zupan, "Capture and Ideology in the Economic Theory of Politics" (1984), 74 *Am. Econ. Rev.* 279; and Herbert Hovenkamp, "Legislation, Well-Being and Public Choice" (1990), 57 *U. Chi. L. Rev.* 63. For more general criticisms of public choice theory, see Mark Kelman, "On Democracy-Bashing: A Skeptical Look at the Theoretical and 'Empirical' Practice of the Public Choice Movement" (1988), 74 *Va. L. Rev.* 199; and Daniel A. Farber and Philip P. Frickey, *Law and Public Choice: A Critical Introduction*, (Chicago: University of Chicago Press, 1991).
[28] See the discussion of this "paradox" of voting, see Mueller, *supra* note 15 at 348-69.
[29] See, e.g., Daniel Shaviro, "Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1990s" (1990), 139 *U. Penn. L. Rev.* 1 at 77 (suggesting that the act of voting can be understood as a source of utility in itself, "involving symbolic or expressive behavior").

(unselfish) decision to vote from the (selfish) choice of candidate or political party, it seems more realistic to admit that altruistic and ethical motivations are likely to mix with more selfish considerations when voters case their ballots.[30] At the same time, the theory that most voters remain rationally ignorant of actual policies calls into question the significance of their votes for public policy more generally.[31]

While these criticisms undoubtedly lessen the predictive power of public choice theory to some extent, they do not render it worthless. On the contrary, although it is probably mistaken to assume that altruistic and ethical motivations play no role in voting decisions, it is also likely that selfish considerations have a significant effect on the choices that are ultimately made. Similarly, while imperfect information weakens the link between voting decisions and public policy outcomes, it seems unlikely that voters will systematically ignore their own interests on a consistent basis, and it is important to recognize that voters are likely to be more knowledgeable about policies affecting their most immediate interests. For these reasons, the basic premise of public choice theory that voters will tend to favour candidates and political parties whose policies are perceived to maximize their net utility is likely to have considerable predictive value, notwithstanding the phenomenon of rational ignorance and the narrow conception of human motivation on which public choice theory is based.

2. Politicians and Political Parties

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[30] See, e.g., Robert E. Goodin and Kevin W.S. Roberts, "The Ethical Voter" (1975), 69 *Amer. Pol. Sci. Rev.* 926; Howard Margolis, *Selfishness, Altruism, and Rationality*, (Cambridge: Cambridge University Press, 1982); and Amitai Etzioni, "The Case for a Multiple Utility Conception" (1986), 2 *Econ. & Phil.* 159.

[31] See, e.g., Geoffrey Brennan and James M. Buchanan, "Voter Choice: Evaluating Political Alternatives" (1984), 28 *American Behavioral Scientist* 185 (arguing that voting decisions are primarily expressive or symbolic rather than instrumental).

For public choice theory, politicians and political parties, like voters, are also assumed to be rational utility maximizers.[32] Unlike voters, however, who pursue this goal by casting ballots for candidates and political parties whose policies are perceived to maximize their net utility, politicians and political parties are presumed to maximize their utility by winning elections.[33] Since voters are assumed to favour candidates and political parties whose policies are expected to maximize their net utility, moreover, it follows that elections are most likely to be won by politicians and political parties whose platforms are perceived to maximize the net utility of the largest number of voters.[34] However, because voter preferences are not immediately transparent to politicians and political parties, and voters themselves are generally unfamiliar with specific policies, public choice theories also predict that politicians and political parties can increase the likelihood of electoral success by employing strategies and obtaining resources that enable them to better discern voter preferences (e.g., by consulting with interest groups, polling, and pre-testing policies with focus groups) and to promote their policies and images (e.g., through media exposure and advertising).[35]

As with public choice theories of voting behaviour, critics have also questioned the assumption that politicians and political parties are driven solely by the goal of electoral success.[36] Ideological objectives, for example, are undoubtedly also present, as politicians and political parties certainly seek to influence voters' perceptions of their own best interests in order to win elections and to shape public policy outcomes

[32] Mueller, *supra* note 15 at 179.
[33] See, e.g., Downs, *supra* note 20 at 28.
[34] See, e.g., Mueller, *supra* note 15 at 214 (suggesting that "competition for votes between candidates leads them 'as if by an invisible hand' to platforms that maximize social welfare").
[35] See the discussion of "probabilistic voting" in *ibid.* at 196-216.
[36] See, e.g., Shaviro, *supra* note 29 at 81-87.

according to their ideological preferences once in government or in opposition.[37] More sophisticated public choice theories of politicians and political parties should also account for different institutions and electoral rules which may create different strategies for electoral success.[38] In countries with proportional representation, for example, parties and politicians may pursue a narrow voting base instead of a majority block.

Notwithstanding other motivations, however, the logic of electoral competition suggests that politicians and political parties will over time not only seek electoral success, but will also devise campaign strategies and political platforms designed to appeal to the largest number of voters.[39] Through a process of "natural selection", therefore, one can expect that public policies in a democratic society will tend toward political efficiency.[40]

3. Organized Interest Groups

Interest groups constitute a third group of political actors who are central to public choice theories of political efficiency. Unlike voters and politicians, who are assumed to maximize their own individual utilities, interest groups are assumed to promote the common interests of their members.[41] This is accomplished by informing members about public policy issues affecting their interests,[42] lobbying politicians and political parties in

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[37] See the analysis of ideology in Mueller, *supra* note 15 at 286-301.
[38] See the discussion in *ibid.* at 217-28.
[39] See, e.g., Hartle, supra note 18 at xviii-xix (noting that when policies are politically inefficient, "there is an opportunity afforded the opposition parties to form a new coalition that will gain power at the expense of the ruling coalition).
[40] See, e.g., Shaviro, *supra* note 29 at 88 (referring to a process of "natural selection" that can play a role notwithstanding the motivations of some politicians or political parties).
[41] See, e.g., Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, (Cambridge, MA; Harvard University Press, 1971) at 5-8.
[42] See, e.g., Hartle, *supra* note 18 at 62-63 (referring to this as the "intelligence function" of organized interest groups).

order to obtain policies favourable to members,[43] and promoting policies that advance the common interests of members through direct advertising and the mass media.[44] As a general rule, these services take the form of public or collective goods the benefits from which cannot easily be limited to those who are willing to incur their costs through membership.[45]

Of particular importance to public choice theory is the existence of information and transactions costs and collective action (free-rider) problems that affect the likelihood that persons with common interests will establish and maintain an organized entity to promote their interests. Because persons are expected to be better informed about matters affecting their most immediate interests than about more general or public interests, public choice theory predicts that narrow or special interests will be better represented by organized interest groups than more general and public interests. Moreover, since the costs to establish and maintain an organized group and the incidence of free-riders are likely to increase as the number of potential members increases, public choice theory also predicts that relatively small numbers of persons with common interests are more likely to be represented by organized interest groups than large numbers of persons with common interests.[46] In the field of tax policy, these considerations suggest that relatively small groups of taxpayers with common interests are much more likely to exercise

[43] *Ibid.* at 61 (observing that this lobbying generally involves the provision of information or funding). See also Mueller, *supra* note 15 at 205 (noting that interest groups "try to increase the welfare of their membership by reducing candidate uncertainty over how their membership votes").
[44] See, e.g., *ibid.* at 61 (referring to "costly publicity campaigns designed to convince tens of thousands of voters to support a desired candidate or party on a desired policy decision); and Hartle, *supra* note 24 at 414 (emphasizing the "capacity of special interest groups to influence the mass media").
[45] Olson, *supra* note 41 at 15.
[46] See, e.g., *ibid.* at 46-52 (describing large unorganized interest groups as "latent" groups).

political influence through organized interest groups than large groups of taxpayers with more diffuse interests.[47]

4. Public Policy and Political Efficiency

The motivations and constraints that public choice theory assigns to the central actors in the political process influence not only their expected behaviour within this framework, but also the kinds of public policies that are likely to maximize political efficiency. Since voters are predicted to be better informed about matters that touch on their immediate interests and less knowledgeable about other issues, for example, public choice theory suggests that political efficiency may be achieved by targeting government benefits to groups of voters who are apt to be well-informed about the benefits that they receive while distributing the related costs widely among groups of voters who are less likely to perceive the burdens that they bear.[48] The more complex the nature of the specific policy, moreover, the less likely it is that those who bear these costs will perceive the burden, lessening further the political costs of the policy.[49] Differential transactions costs and collective action problems suggest a similar strategy for politically efficient public policies, involving the conferral of benefits on selected groups of voters who are well-represented by organized interest groups, and the allocation of related costs among more diffuse groups of voters for whom the financial and organizational barriers to collective political action are much greater.[50] As a result, as Mancur Olson emphasized,

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[47] See, e.g., Banting, *supra* note 9 at 353; and Hartle, *supra* note 24 at 413-15 (emphasizing the influence of narrow and special interest groups in tax policy).
[48] See, e.g., Hartle, *supra* note 18 at 67.
[49] *Ibid.* at 67-68.
[50] *Ibid.*

differential information and organizational costs create "*a systematic tendency for 'exploitation' of the great by the small!*"[51]

B. Political Efficiency and Tax Policy

If voters regard benefits from government expenditures as utility enhancing and taxes as utility reducing, the pursuit of political efficiency suggests that governments will attempt to maximize the political benefits from spending programs and minimize the political costs from the taxes necessary to finance these programs.[52] For a given level of government expenditure, therefore, a politically efficient revenue structure will minimize the political costs associated with each tax – utilizing each revenue source, as one theorist explains, "up to the point at which the marginal political cost is equal for all such sources."[53] Over time, moreover, a tendency toward political efficiency suggests that governments will increase and decrease tax rates on specific revenue sources as their relative political costs change, introduce new taxes when the political costs of so doing are less than the political costs from increasing the rate of an existing tax, and repeal old taxes when their political costs exceed those associated with other taxes.[54] The key questions for a public choice theory of tax policy, therefore, concern the factors that affect the political costs of different taxes and the reasons why these political costs change over time.

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[51] Olson, *supra* note 41 at 29 [emphasis in original].
[52] Gillespie, *supra* note 12 at 17. Jean Baptiste Colbert made a similar point long ago, explaining that: "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."
[53] *Ibid.* at 18.
[54] *Ibid.*

Beginning with the factors affecting the political costs of different taxes, many can be identified.[55] Most obviously, perhaps, the political costs of a tax can be expected to increase as its rate increases, since organized opposition to the tax is increasingly cost-justified as tax burdens increase.[56] The same reason also suggests that the political costs of a tax will increase as the costs to comply with the tax increase.[57] Political costs are also likely to increase as costs to administer the tax increase, since diminished net revenues attributable to higher administrative costs necessitate higher tax rates or other taxes to maintain revenues – both of which involve political costs.[58] Conversely, the political costs of a tax tend to be lower where the number of taxpayers is large, since the burden is spread widely and the costs of organized opposition substantial.[59] As the number of taxpayers affected by an established tax increases, however, political costs can be expected to increase because groups opposing the tax are likely to attract new members.[60]

Other important determinants of the political costs of taxes include vertical tax competition (the occupation of the same revenue source by different levels of government in a federal system), horizontal tax competition (the pursuit of mobile revenue sources by different national or sub-national governments), and base elasticity (the extent to which

[55] For more general discussions, see *ibid.* at 20-32; and Hartle, *supra* note 22 at 41-54. The factors considered in the text are by no means comprehensive, omitting for example several of those discussed in Gillespie, *supra* note 12. Indeed, Gillespie himself emphasizes that "[t]here may well be" determinants of political costs other than those that he identifies, explaining that "[t]he model is general enough to permit the appropriate adaptations." *Ibid.* at 31. For the purpose of this paper, I discuss only those factors that seem most relevant to the decline and abolition of wealth transfer taxes, particularly in Canada, Australia and New Zealand.
[56] Gillespie, *supra* note 12 at 21. To the extent that adverse economic consequences associated with different taxes increase as rates increase, this effect is a further reason why the political costs of a tax are likely to increase at its rate increases.
[57] *Ibid.* at 29-30; and Hartle, *supra* note 22 at 52 (observing that higher compliance costs "can be thought of as an increase in the tax burden").
[58] Gillespie, *supra* note 12 at 29-30; and Hartle, supra note 22 at 52.
[59] Gillespie, *supra* note 12 at 22-23; and Hartle, supra note 22 at 48. The political costs of a tax may also be reduced by introducing concessions for narrow and special interest groups who are generally well-informed

revenues automatically increase with economic growth). In principle, the occupation of a revenue source by one level of government tends to increase the political cost of its imposition by another level of government, since at least some organized opposition to the tax is likely to exist already, the collection of tax by the second government increases the effective rate of the tax, and the first government itself can be expected to oppose the measure.[61] Political costs are also high for mobile revenue sources, since those subject to the tax may threaten to or actually relocate these sources to jurisdictions with lower taxes, thereby depriving the higher-tax jurisdiction of revenue and economic activity.[62] Base elasticity, on the other hand, decreases the political costs of a tax, since economic growth allows governments to increase spending without having to increase effective tax rates.[63]

A final factor affecting the political costs of taxes is what W. Irwin Gillespie describes as "tax preference" – a preference for one kind of tax versus another notwithstanding that amounts owing under each tax would be identical.[64] While different tax preferences might turn on compliance costs or other non-revenue impacts,[65] they might also depend on judgements about the appropriateness or fairness of alternative

about taxes that affect them and already represented by organized interest groups. On the politically efficient use of tax concessions, see *ibid.* at 37-39.

[60] Gillespie, *supra* note 12 at 22-23.

[61] *Ibid.* at 27-28. See also Hartle, *supra* note 22 at 49 (explaining that governments are likely to oppose occupation of the same revenue source by another level of government because "taxpayers may incorrectly assign the 'blame' to the 'wrong' government; second, taxpayer opposition probably mounts exponentially as effective rates rise on a given base [so that] the political costs of future revenue increases by the 'prior' occupant are raised even further; [and] thirdly, with higher tax rates evasion and avoidance becomes increasingly attractive and enforcement costs are raised").

[62] Gillespie, *supra* note 12 at 28-29.

[63] *Ibid.* at 30.

[64] *Ibid.* at 26 (hypothesizing that voters "may not be indifferent between two revenue sources, for each of which the tax per dollar's worth of tax base could be equal for a given taxpayer").

[65] See, e.g., *ibid.* (suggesting that different tax preferences "could arise because verification of one revenue source interferes more directly in the conduct of a citizen's affairs (say, a direct tax on incomes, compared with an indirect tax on imports)").

revenue sources.[66] As Gillespie explains, a preference for one tax over another "could arise because one revenue source is judged by citizens to be the product of their own, meritorious efforts (say, labour income), whereas another revenue source is judged not to be the result of hard work (say, an inheritance, a gift or a lottery win)."[67] Alternatively, he suggests, different tax preferences might exist "because one revenue source is judged by taxpayers to have unhealthy, immoral or sinful connotations (expenditures on alcoholic beverages and tobacco products), whereas the connotations of another revenue source are seen as healthy, moral or meritorious (expenditures on milk, footwear and clothing for children and expenditures on charitable donations)."[68] Whatever the reasons for these tax preferences, the political cost to introduce, maintain or increase a tax for which a large number of voters have a lower preference will be greater than the political cost to introduce, maintain or increase a tax for which a large number of voters have a greater tax preference.[69]

Having identified some of the key factors affecting the political costs of different taxes, it is possible to speculate on various reasons why these political costs might change over time. Changes in government expenditures, for example, are likely to affect the political costs of taxes – increasing these costs where rates are increased or exemptions reduced in order to finance increased spending, and decreasing these costs where spending reductions allow taxes to be cut. Actions by other governments can also affect the political costs of different taxes – increasing these costs where other levels of government introduce or increase taxes on the same revenue source, but decreasing these

[66] *Ibid.* at 27 (noting that voters may be less politically opposed to taxes that are perceived to be fair than they are to taxes that are perceived to be unfair).
[67] *Ibid.* at 26.
[68] *Ibid.*

costs where neighbouring governments at the same level introduce or increase taxes on the same revenue source. Another reason why the political costs of different taxes might change involves broader economic changes, as increasing economic integration has undoubtedly increased the political costs of taxes on mobile revenue sources. Inflation can also increase the political costs of a tax, if exemptions are not indexed or adjusted to offset their declining real value. Finally, ideological shifts are likely to change the political costs of different taxes to the extent that they influence people's preferences for different kinds of taxes. For public choice theories of political efficient revenue structures, however, the reasons for changes in the political costs of different taxes are considered exogenous and not themselves subjects of inquiry.

III. Wealth Transfer Taxes in Canada, Australia and New Zealand

Wealth transfer taxes were first introduced in the Australian colonies and New Zealand in the second half of the nineteenth century,[70] and by all Canadian provinces between the years 1892 and 1903.[71] In Australia and New Zealand, these taxes were generally based on the estates of persons domiciled in the taxing jurisdiction, though Queensland and South Australia opted for succession duties with rates and exemptions

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[69] *Ibid.*

[70] On the early history of death duties in the Australian colonies, see Julie P. Smith, *Taxing Popularity: The Story of Taxation in Australia*, (Canberra: Federalism Research Centre, 1993) at 16-18. For a history of the estate tax in New Zealand, see L. McKay, "Historical Aspects of the Estate Tax" (1978), 8 *N.Z.U.L. Rev.* 1. In Australia, New South Wales enacted the first death duty in 1851. Tasmania followed in 1865, Victoria in 1870, South Australia in 1876, Queensland in 1886, and Western Australia in 1895. In New Zealand, a tax on estates was first introduced in 1866.

[71] J. Harvey Perry, *Taxes, Tariffs, & Subsidies: A History of Canadian Fiscal Development*, (Toronto: University of Toronto Press, 1955), Vol. 1 at 110-111. See also George E. Carter, "Federal Abandonment of the Estate Tax: The Intergovernmental Fiscal Dimension" (1973) 21 *Can. Tax J.* 232 at 233. Ontario was the first Canadian province to introduce a succession duty, which was modeled closely after similar legislation enacted a few years earlier in the states of New York and Pennsylvania. R.A. Bayly, *Succession Duty in Canada*, (Toronto: The Carswell Company, Limited, 1902) at 10. Later that year, succession duties were also introduced in Quebec, New Brunswick, and Nova Scotia. Manitoba enacted a succession duty in

applied to amounts received by beneficiaries,[72] and New Zealand's tax depended both on the size of the estate and the degree of consanguinity between the beneficiary and the deceased.[73] In Canada, the constitutional restriction on provincial taxing powers to "Direct Taxation within the Province"[74] meant that provinces limited their death duties to property situated within the province upon the death of the owner, and to property situated outside the province only if the deceased was domiciled in the province and the beneficiary was resident or domiciled in the province.[75] Rates were determined both by the value of the estate and by the relationship between the deceased and the beneficiary.[76]

In each of these jurisdictions, wealth transfer taxes were the first major direct taxes to be imposed, marking a major departure from an earlier era in which governments were financed almost entirely from customs duties and excise taxes.[77] Although the introduction of these taxes reflected an important political shift from regressive indirect

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1893, and British Columbia and Prince Edward Island followed the next year. Alberta and Saskatchewan introduced similar levies in 1903 under the Northwest Territories Ordinance.

[72] Peter Saunders, "An Australian Perspective on Wealth Taxation," in John G. Head, ed., *Taxation Issues of the 1980s*, (Sydney: Australian Tax Research Foundation, 1983) 397 at 398. In South Australia, legislators favoured the latter approach on the grounds that "a man should leave his property to several persons instead of one only". *Parliamentary Debates*, 1893, I, 342, cited in Stephen Mills, *Taxation in Australia*, (London: McMillan & Co., 1925) at 140.

[73] McKay, *supra* note 70 at 1. In 1881, the legislature abandoned the succession duty basis of the tax, adopting a pure estate-type tax with an exemption and progressive rates based on the size of the estate. In 1909, however, a succession duty was reintroduced to operate in tandem with the estate tax. *Ibid.* at 3-4.

[74] *Constitution Act, 1867*, s. 92(2).

[75] Carter, *supra* note 71 at 233. For a summary of the leading constitutional cases that shaped the evolution of provincial succession duties in Canada, see G.V. LaForest, *The Allocation of Taxing Power Under the Canadian Constitution*, Canadian Tax Paper No. 65 (Toronto: Canadian Tax Foundation, 1981) at 106-09. For a more detailed analysis of the impact of Canadian constitutional law on the design of these succession duties, see Wolfe D. Goodman, "Provincial Wealth Taxes," In *Report of the Proceedings of the Twenty-Third Tax Conference*, 1971 Conference Report, (Toronto: Canadian Tax Foundation, 1972) at 29 (contending that provincial succession duties could have applied to all amounts received by beneficiaries resident or domiciled in the province without violating the constitutional provision limiting provincial taxing powers). That provincial succession duties could also apply to amounts received by resident beneficiaries regardless of the domicile or residence of the deceased, was subsequently established in *Attorney-General of British Columbia v. Ellett Estate* [1980] CTC 338 (SCC).

[76] Carter, *supra* note 71 at 233.

[77] Smith, *supra* note 70 at 16; Philipps, *supra* note 9 at 91.

taxes to progressive direct taxes,[78] their primary rationale appears to have been to raise revenue.[79] In Australia, revenues from estate duties exceeded 30 percent of total State tax revenues in 1909/10,[80] and continued to account for a significant share of State tax revenues until the late 1960s.[81] In Canada, provincial succession duties accounted for almost 40 percent of provincial tax revenues in 1913,[82] and remained substantial contributors to provincial finances until 1946, when most provinces ceded occupancy of this field to the federal government.[83] In New Zealand, the estate tax accounted for 13.5 percent of government revenues in 1915, but declined thereafter.[84]

Revenue considerations were also central to the decision of the Commonwealth government in Australia to enact a national estate duty in 1914, and the decision of the federal government in Canada to enact a succession duty in 1941. In Australia, estate

[78] Smith, *supra* note 70 at 16; Philipps, *supra* note 9 at 93-94 (contending that political agitation for direct taxation was much more muted in Canada than in the United States).
[79] Smith, *supra* note 70 at 17 (referring to Australia); McKay, *supra* note 70 at 1 (referring to New Zealand); and Perry, *supra* note 71 at 109 (referring to Canada).
[80] Calculated from figures in R.L. Mathews and W.R.C. Jay, *Federal Finance: Intergovernmental Financial Relations in Australia since Federation*, (Melbourne: Thomas Nelson Australia Ltd., 1972) at 83 (Table 11).
[81] Although the contribution of estate duties to State tax revenues decreased to 15.1 percent in 1918/19, 12.0 percent in 1928/29 and 7.6 percent in 1938/39, this share increased to 24.1 percent in 1948/49 (after the states abandoned their income taxes to the Commonwealth government during the Second World War), and exceeded 18 percent in 1958/59 and 16 percent in 1968/69. Calculated from figures in *ibid.* at 100, 166, 194, 230, and 247 (Tables 14, 21, 24, 34, and 38). For a breakdown among different States in the years after the Second World War, see Saunders, *supra* note 72 at 398-99.
[82] Calculated from figures in Perry, *supra* note 71 at 123 (Table VII).
[83] The contribution of succession duties to provincial tax revenues was almost 30 percent in 1937 and over 20 percent in 1946, but declined thereafter to 6.9 percent in 1949, 4.8 percent in 1959, and 2.0 percent in 1969. Calculated from figures in Statistics Canada, *Historical Statistics of Canada*, H92-112. Provincial governments, net general revenue by major source, selected years, 1933 to 1969, available on the web at http://www.statcan.ca/english/freepub/11-516-XIE/sectionh.htm#Fed%20Gov%20Fin. While succession duties obviously accounted for a larger share of tax revenues in those provinces that collected their own taxes (Ontario and Quebec until 1963 and British Columbia thereafter), the relative role of these taxes also declined in the postwar period, falling to 9.2 percent in Ontario and 6.1 percent in Quebec in 1958/59 and 3.2 percent in British Columbia, 2.7 percent in Ontario, and 2.4 percent in Quebec in 1968/69. Calculated from figures in *Provincial Finances 1969*, (Toronto: Canadian Tax Foundation, 1969) at 207, 211, and 224 (Tables 53, 55, and 63).
[84] As a percentage of total government revenue, the estate tax declined to 9.1 percent in 1925, 8.8 percent in 1935, 4.6 percent in 1945, 4.0 percent in 1955, 2.5 percent in 1965, and 1.4 percent in 1975. McKay, *supra*

duty and income tax were enacted in order to help finance participation in the First World War, after revenues from customs and excise duties collapsed due to the disruption of trade.[85] In Canada, where a federal income tax was enacted primarily for revenue reasons during the First World War,[86] the main justification by Minister of Finance J.L. Ilsley for the introduction of a federal succession duty was "the compelling need for revenue" to fight the Second World War.[87] At the same time, he emphasized, since the provinces had "not fully occupied" the field, there was "room for an additional and independent dominion tax" as a permanent source of federal revenue.[88] As a percentage of total tax revenues, however, federal wealth transfer taxes in Australia and Canada were never very large, accounting for only 2 to 4 percent of federal tax revenues in Australia from 1914 to 1940 and no more than 1.4 percent of federal tax revenues in the post-war period,[89] and contributing no more than 1.7 percent of federal tax revenues in Canada.[90]

In Australia, the introduction of the national estate duty led to a lengthy period in which the Commonwealth and State governments jointly occupied the wealth transfer tax

note 70 at 21 (Table I). By 1985, the share of tax revenues represented by the estate tax fell to 0.2 percent. OECD, *supra* note 3.

[85] Mathews and Jay, *supra* note 80; and Smith, *supra* note 70 at 45. Although the estate duty included gifts made within a year of death, a separate gift tax was not enacted until 1942.

[86] On the origins of the federal income tax in Canada, see Richard Krever, "The Origin of Federal Income Taxation in Canada" (1981), 3 *Canadian Taxation* 170.

[87] Hon. J.L Isley, Minister of Finance, *Budget Speech*, 29 April 1941, (Ottawa: King's Printer, 1941) at 16 (adding that "[d]eath duties, in general, are a very good type of tax, second only to income tax in their essential fairness and the possibilities of adjusting them progressively to ability to pay"). The succession duty was based partly on the share of the estate received by each beneficiary, partly on the size of the estate, and partly on the relationship between the beneficiary and the deceased. In 1958, this tax was replaced by an estate tax with progressive rates based solely on the aggregate value of the estate. A gift tax had been introduced in 1935, primarily to discourage income-splitting under the federal income tax.

[88] *Ibid.*

[89] Saunders, *supra* note 72 at 398-99.

[90] Figures calculated from Statistic Canada, *Historical Statistics of Canada*, H75-91. Federal government, net general revenue by major source, selected years, 1933 to 1969, available on the web at http://www.statcan.ca/english/freepub/11-516-XIE/sectionh/sectionh.htm#All%20Gov.

field. Despite recurring proposals to allocate this revenue source solely to the States,[91] or solely to the Commonwealth government,[92] joint occupancy continued until the taxes were repealed at both levels of government in the 1970s and early 1980s. As a result, although the Commonwealth and State governments cooperated to some extent in the administration of these taxes,[93] Australia's "double or duplicative" wealth transfer tax system was a source of considerable complexity and high compliance and administration costs.[94]

In Canada, complete joint occupancy lasted only from 1942 to 1946, when all provinces but Ontario and Quebec agreed to withdraw from the collection of succession duties as well as personal and corporate income taxation in return for unconditional grants from the federal government.[95] In order to relieve the estates of decedents in Ontario and Quebec from the combined burden of federal and provincial taxes, the federal succession duty was amended to provide a credit for provincial succession duties

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[91] At the Premiers Conference in 1926, for example, the Commonwealth proposed to vacate the estate duty and other revenue sources to the States in exchange for the abolition of per capita grants. The States rejected the proposal for a number of reasons, including the absence of any guarantee that a subsequent Commonwealth Government would not re-enter the field. Mathews and Jay, *supra* note 81 at 120. Likewise in 1974, the Senate Standing Committee on Finance and Government Operations recommended that the Commonwealth government vacate the field of estate and gift duty, subject to the States agreeing on uniform legislation and rates of duty. Senate Standing Committee on Finance and Government Operations, *Report on Death Duties*, (Canberra: Australian Government Publishing Service, 1974).

[92] In 1975, for example, the Taxation Review Committee (Asprey Committee) recommended a single national estate and gift duty administered by the Commonwealth government, with a portion of revenues shared with the States based on "the domicile of deceased persons and donors domiciled within the State and property within the State of deceased persons and donors domiciled outside Australia." Taxation Review Committee, *Full Report*, (Canberra: Australian Government Publishing Service, 1975) at 24.74., available on the web at http://setis.library.usyd.edu.au/oztexts/parsons.html.

[93] Saunders, *supra* note 72 at 400.

[94] Willard H. Pedrick, "Oh, to Die Down Under! Abolition of Death and Gift Duties in Australia" (1981), 35 *Tax Lawyer* 113 at 119. See also Peter Groenewegen, "Options for the Taxation of Wealth" (1985), 2 *Australian. Tax Forum* 305 at 315 (attributing the unpopularity of death duties in Australia in part to "their high compliance costs for taxpayers, the size of which was strongly influenced by the fact that death duties were a major area of Federal-State duplication"); and Taxation Review Committee, *supra* note 92 at 24.71 (acknowledging criticism of the death duties then in force "on grounds of the complexity of separate Commonwealth and State taxes and the considerable costs in administration and compliance that result").

[95] Carter, *supra* note 71 at 235.

up to 50 percent of the federal tax otherwise payable.[96] In 1957, the unconditional grant system was replaced by a series of agreements under which most provinces continued to relinquish succession duties to the federal government in exchange for "rental payments" equal to 50 percent of federal collections of succession duties in each province.[97] In Ontario and Quebec, which refused to "rent" their succession duties to the federal government, the federal tax was reduced in the form of a 50 percent abatement that replaced the former tax credit.[98] In 1964, British Columbia withdrew from this "tax rental agreement" and began to collect its own succession duty, receiving the same abatement as was available in Ontario and Quebec.[99] The next year, federal rental payments for this revenue source were increased to 75 percent, with a corresponding increase in the abatement allowed under the federal tax.[100] While British Columbia increased its succession duty to take full advantage of this abatement, Ontario and Quebec left their succession duties unchanged, opting to receive rental payments equal to 25 percent of federal collections in their provinces.[101] As a result, while federal-provincial agreements simplified the collection of wealth transfer taxes in seven of ten Canadian provinces, the combination of federal and provincial taxes in the remaining three was as complicated and "duplicative" as the system in Australia. More importantly, perhaps, the federal government's agreement to return 75 percent of federal wealth transfer tax revenues to the province where the tax was collected (or to abate the federal tax by up to 75 percent

[96] *Ibid.* at 235-37 (explaining that the credit did not always relieve the combined burden of both taxes).
[97] *Ibid.* at 236 (adding that these revenues were supplemented by an equalization component designed to raise the per capita yields in each participating province up to the per capita yield in the two provinces having the highest per capita yields).
[98] *Ibid.* (emphasizing that the substitution of the abatement for the tax credit "amounted to a change merely in form, not in substance").
[99] *Ibid.*
[100] *Ibid.*
[101] *Ibid.*

where a province collected its own tax) might be expected to significantly weaken its commitment to the tax. As the following sections demonstrate, however, complexity and revenue yield are only two of many reasons why wealth transfer taxes were abolished in Canada, Australia and New Zealand.

A. The Abolition of Wealth Transfer Taxes in Canada

The specific events leading to the abolition of wealth transfer taxes in Canada began somewhat innocuously with the appointment of a Royal Commission on Taxation (the Carter Commission) in 1962, unfolded at the federal level between 1967 and 1971 as the federal government responded to the Report of the Carter Commission, and continued at the provincial level over the following fourteen years. This section examines each of these phases.

1. The Carter Commission: 1962- 1967

Promised by Progressive-Conservative Prime Minister John Diefenbaker in the opening speech of his 1962 election campaign,[102] an independent commission had long been favoured by tax professionals and business leaders as a vehicle to reduce progressive rates, simplify administration and enforcement, and address technical anomalies in the income tax.[103] When the Progressive-Conservative Party formed a minority government after the election, Diefenbaker announced the appointment of a Royal Commission comprising mainly professionals and businesspersons and chaired by

[102] "The Vital Pledge", *The Globe and Mail* (7 May 1962) at 6.

[103] See Les MacDonald, "Why the Carter Commission Had To Be Stopped," in Brooks, *supra* note 24, 351 at 351-53. The main technical issues involved the characterization of isolated transactions as taxable business income or non-taxable capital gains, and "surplus stripping" transactions designed to convert taxable dividends into non-taxable capital gains.

Toronto accountant Kenneth Carter.[104] The Carter Commission's terms of reference were extremely broad, involving a review of all aspects of federal taxation including "income, sales and excise taxes and estate duties".[105]

Given its origins and its membership, there was every reason to expect that the Commission would affirm the prevailing "tax orthodoxy" of business and professional commentators that taxes were too high, that indirect sales or value-added taxes should be considered as alternatives to high income taxes, and that wealth transfer taxes were causing Canadian family businesses to be sold to foreigners.[106] Indeed, submissions to the Commission, most of which were from the same business and professional interests which had pushed for its establishment,[107] tended to repeat these views in more technical form.[108] According to the Shoe Manufacturers' Association of Canada, for example, "[t]he unreasonably high level of succession duties has been the largest single factor both in encouraging the sellout of Canadian enterprises to foreign interests and in eliminating from the economic scene continuing independent family businesses."[109] The Canadian Bar Association decried the "excessive amount of property" that was tied up for long periods of time in trusts to avoid wealth transfer taxes, concluding that these

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[104] Of the six members of the Commission, three were "acknowledged authorities in tax circles, with impeccable professional and business connections", one was a lawyer and General Manager of the Nova Scotia Trust Company, another was Treasurer of the National Council of Women and had previously managed the western Canadian branch of an insurance firm, and the last was Manager of the British Columbia Federation of Agriculture and an Executive Director of the Canadian Federation of Agriculture. *Ibid.* at 353.

[105] Order in Council, P.C. 1962-1334 (25 September 1962), reproduced in Royal Commission on Taxation (Carter Commission), *Report*, (Ottawa: Queen's Printer, 1966), Vol. 1, at v.

[106] MacDonald, *supra* note 103 at 354.

[107] According to one commentator, over half of the submissions to the Commission came from business organizations while less than 5 percent were from labour and employee organizations. Robert Gardner, "Tax Reform and Class Interests: The Fate of Progressive Reform, 1967-72" (1981), 3 *Canadian Taxation* 245 at 246, n. 9. For a list of submissions received by the Commission, see Royal Commission on Taxation, *supra* note 105, Vol. 1, Appendix A, at 121-30.

[108] MacDonald, *supra* note 103 at 354.

[109] Reported in "Nation's Business: The dead hand of death duties," *Financial Post* (1 February 1964), p. 1.

arrangements "frequently restrict the company's proper development and expansion and may add to production costs."[110] On the basis of these and other submissions, Canada's leading financial newspaper concluded that "the economic damage" caused by these taxes was "staggering." [111]

As well as accepting submissions, the Commission embarked on an ambitious research programme, lasting four years and costing approximately $4 million.[112] Among 27 research studies, one found no evidence that the estate tax was a major factor in the sale of small businesses.[113] Others challenged the non-taxation of capital gains, which were traditionally excluded from the source concept of income that Canada had borrowed from the United Kingdom.[114] Another study examined the incidence of taxation Canada, concluding that the tax system as a whole was regressive for at least the poorest third of Canadian families and possibly more.[115] After much delay, and two intervening elections resulting in Liberal minority governments, the Commission's six-volume Report was finally released in February 1967.

Of the Commission's many recommendations, the most central was its conclusion that "taxes should be allocated according to the changes in the economic power of individuals and families."[116] Emphasizing that "[t]he first and most essential purpose of

[110] *Ibid.*
[111] *Ibid.*
[112] John G. Head, "Evolution of the Canadian Tax Reform" (1973), 1 *Dalhousie L.J.* 51.
[113] John G. Smith, D.B. Fields, and E.J. Mockler, *Death Taxes*, Studies of the Royal Commission on Taxation, Number 11 (December 1964) at 18-20.
[114] Geoffrey R. Conway and John G. Smith, *The Taxation of Capital Gains and the Law Concerning Capital Gains*, Studies of the Royal Commission on Taxation, Number 19 (1966); and Douglas J. Sherbaniuk, *The Concept of Income – The Receipts Side*, Studies of the Royal Commission on Taxation, Number 20 (February 1967).
[115] W. Irwin Gillespie, *The Incidence of Taxes and Public Expenditures in the Canadian Economy*, Studies of the Royal Commission on Taxation, Number 2 (1966).
[116] Royal Commission on Taxation, *supra* note 105, Vol. 1, at 9. See also ibid., Vol. 3, at 39 (suggesting that taxes should be based on "the sum of the market value of goods and services consumed or given away in the taxation year by the tax unit, plus the annual change in the market value of the assets held by the

taxation is to share the burden of the state fairly among all individuals and families",[117] a majority of the Commissioners rejected any distinction among different sources of changes to a taxpayer's economic power,[118] proposing a "comprehensive tax base" according to which the "all the net gains ... of each tax unit" should be subject to tax "on an annual basis".[119] Among the implications of this approach, gifts and inheritances would be included in the comprehensive tax base for the year in which they were received,[120] and capital gains and losses would be fully recognized on an accrual basis irrespective of any sale.[121] For administrative reasons, however, the Commission retreated from accrual treatment for capital gains and losses, recommending instead that these gains and losses should be recognized on a realization basis, as well as when property is transferred by way of gift or on death.[122] Since gifts and inheritances would be included in the recipient's income, the Commission also recommended that separate wealth transfer taxes should be repealed.[123] Other key recommendations included the introduction of a family tax unit (including dependent children),[124] a reduction in the top

unit"). In adopting this approach, the Commission was obviously inspired by the broad definitions of income formulated by U.S. economists Robert Haig and Henry Simons. See R.M. Haig, "The Concept of Income – Economic and Legal Aspects," in R.M. Haig, ed., *The Federal Income Tax*, (New York: Columbia University Press, 1920) 27 at 59 (defining income as "the money value of the net accretion to one's economic power between two points of time"); and Simons, *supra* note 14 at 50 (defining personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question").

[117] Royal Commission on Taxation, *supra* note 105, Vol. 1, at 4.

[118] *Ibid.* at 9 (emphasizing that if a person "obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property or was given it by a relative").

[119] *Ibid.*, Vol. 3, at 39. Two Commissioners (Beauvais and Grant) dissented from this recommendation. See *ibid.*, Vol. 1, at 51-111.

[120] *Ibid.*, Vol. 3, at 41.

[121] *Ibid.*

[122] *Ibid.* at 368-80.

[123] *Ibid.* at 473 and 513

[124] *Ibid.*, chapter 10.

marginal rate from 80 percent to 50 percent,[125] the complete integration of corporate and personal income taxes,[126] and a dramatic reduction in tax concessions for income from mineral and petroleum extraction.[127]

2. Federal Reform: 1967-1971

While the Commission's Report was hailed by leading tax academics as "a landmark in the annals of taxation",[128] affluent individuals and the business and professional interests that pushed for the Commission's formation were overwhelmingly negative.[129] Although a reduction in the top marginal rate and repeal of wealth transfer taxes would provide some benefit for affluent individuals, this would be more than offset by the full taxation of capital gains and the inclusion of gifts and inheritances in income. While the Report estimated that 64 percent of Canadian taxpayers would pay lower taxes under its proposals, these reductions averaged only about 5 percent of taxes otherwise payable and were generally limited to taxpayers with incomes of less than $35,000 in 1964.[130] In contrast, 27,000 taxpayers with incomes over $35,000 could have expected to pay an additional $1,000 on average, while an estimated 633 individuals with incomes over $300,000 could have expected to pay an average of more than $67,000 in additional taxes.[131] The mining industry stood to lose the most, as the Report's proposed withdrawal of net depletion allowance and a three-year tax holiday were expected to increase its taxes by more than 100 percent – most of which would have been paid by the 15 largest

[125] *Ibid.*, chapter 11.
[126] *Ibid.*, Vol. 4, chapter 19.
[127] *Ibid.*, chapter 23.
[128] Arnold C. Harberger, "A Landmark in the Annals of Taxation" (1968), *Can. J. Econ.*, Supplement No. 1, 183-94. See also Head, *supra* note 112 at 52.
[129] See, e.g., the detailed review in Gardner, *supra* note 107. See also Meyer Bucovetsky and Richard M. Bird, "Tax Reform in Canada: A Progress Report" (1972), 25 *Nat. Tax J.* 15 at 17-18; and Head, *supra* note 112 at 58-59.
[130] Royal Commission on Taxation, *supra* note 105, Vol. 6 at 62, Table 36-7.

companies.[132] Not surprisingly, therefore, mining companies led organized opposition to the Report, threatening the cessation of Canadian investments, and enlisting the support of premiers from Western provinces where the extraction industries predominated.[133]

At the end of April 1967, then Finance Minister Mitchell Sharp announced a timetable to deal with the Report, inviting comments on the major recommendations by September of that year, and promising a White Paper incorporating the government's proposals thereafter and draft legislation to be enacted by the end of 1968.[134] Within two weeks, however, Sharp responded to pressure from the mining industry by guaranteeing that the three year tax exemption for new mines would remain until the end of 1973, whatever decisions were made on the basis of the Report of the Royal Commission.[135] By autumn 1967, Sharp had received over a thousand responses, including 150 substantial submissions, mostly from corporations and business and professional organizations, and mostly critical.[136] While many of these submissions opposed the withdrawal of special tax preferences,[137] considerable criticism was also directed at the Commission's emphasis on fairness as "the first and most essential purpose of taxation" and at the comprehensive tax base in particular. Imperial Oil, for example, opposed the "sacrifice of economic

[131] MacDonald, *supra* note 103 at 360.
[132] Royal Commission on Taxation, *supra* note 105, Vol. 6 at 96 and 121.
[133] See, e.g., Bucovetsky and Bird, *supra* note 129 at 17-18; and Gardner, *supra* note 107 at 249.
[134] Hon. Mitchell Sharp, "Tax Reform – The Fiscal Context," Address at Banquet of the Nineteenth Tax Conference, 24-26 April 1967, in *Report of Proceedings of the Nineteenth Tax Conference*, (Toronto: Canadian Tax Foundation, 1967) 471 at 473.
[135] *House of Commons Debates* (11 May 1967) at 111 (Hon. Mitchell Sharp) (assuring that "should the government decide to propose the removal of this incentive, it would not do so in a manner that would remove the exemption with respect to income earned before January 1, 1974, nor would it in any essential manner change the method of application of that exemption before that date").
[136] Gardner, *supra* note 107 at 248.
[137] According to Graham Hodgson, "More than 100 oil industry briefs oppose recommendations of Carter tax report" *Globe and Mail* (26 September 1967) p. B1, for example, over 100 protesting submissions were made by the oil industry alone.

growth to the commission's concept of equity."[138] The Trust Companies Association warned that the inclusion of gifts and inheritances in the income tax base "would remove a major incentive for Canadians to work and produce for the benefit of their families" resulting in a "very large annual disappearance of private capital".[139]

The Government's first official response to the Report came on November 30, 1967, when the Minister of Finance tabled the federal budget. Identifying as common concerns in the submissions that he had received both the uncertain impact of such far-reaching reforms and the need to attract foreign capital, Sharp announced that whatever proposals the Government would "place before parliament and the public in the form of a White Paper and ultimately in draft legislation" would "undoubtedly be influenced" by the Report of the Commission, but "will be more in the nature of reforms to the existing tax structure rather than the adoption of a radically different approach."[140] In other words, the Government would adopt a more piecemeal approach to tax reform, rather than the comprehensive framework adopted by the Commission. Before any more specific proposals could be formulated, however, the Government was thrown into turmoil when then Prime Minister Lester Pearson announced his intention to resign in December 1967 and a leadership race and federal election intervened.[141]

[138] Imperial Oil Limited, "Submission to the Minister of Finance Regarding The Recommendations of the Royal Commission on Taxation," (September 1967), p. A-10, cited in Gardner, *supra* note 107 at 248.
[139] Trust Companies Association of Canada, "To: The Honourable Mitchell Sharp Minister of Finance. Re: Report o the Royal Commission on Taxation" (September 1967), p. 2, cited in Gardner, *supra* note 107 at 250.
[140] *House of Commons Debates* (30 November 1967) at 4906 (Mr. Mitchell Sharp).
[141] As a contender in the race for leadership of the Liberal Party, Sharp insisted that he was in no position to take a public stance on tax reform. Hartle, *supra* note 24 at 412. Before the leadership campaign came to an end, however, Sharp withdrew in favour of Pierre Trudeau, who became Liberal leader and Prime Minister on April 6, 1968. Under Trudeau, the Liberals called a federal election for June 25, 1968, which they won handily and formed a majority government.

With a new Liberal Government under Prime Minister Pierre Trudeau, the promised White Paper was predictably delayed. In April 1968, the new Finance Minister Edgar Benson announced a change in the government's tax reform schedule, explaining that major reforms would not be presented until some time in 1969.[142] In the interim, however, the Government signalled its rejection of the Commission's comprehensive tax base by introducing major revisions to the federal gift and estate taxes in the October 1968 federal budget: exempting inter-spousal transfers, integrating these taxes in the form of a cumulative progressive tax, and increasing rates on estates valued at less than $5 million.[143] Defending the continued existence of a separate gift and estate tax, the Finance Minister explained that he respected "the intellectual coherence and elegance" of the Commission's recommendation, but that "the overwhelming weight of Canadian opinion is against it now, and many Canadian practices and institutions would be seriously disrupted if we embraced this proposal."[144]

Not surprisingly, given the increased impact on small and medium-sized estates, the amendments to the gift and estate tax generated considerable political opposition, particularly from owners of small businesses and family farms who had played a relatively minor role in opposition to the Royal Commission Report.[145] In Western Canada, where farming interests were particularly strong, the provincial governments of Alberta and Saskatchewan acceded to this sector by refunding the provincial share of the

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[142] Head, supra note 112 at 61.

[143] *An Act to amend the Income Tax Act and the Estate Tax Act*, R.S. 1968-1969, c. 33. See, e.g., Michael B. Jameson, "Proposed Estate Tax Changes," in *Report of the Proceedings of the Twenty-First Tax Conference, 1968* (Toronto: Canadian Tax Foundation, 1969) 72.

[144] *House of Commons Debates* (22 October 1967), at 1685 (Mr. Edgar Benson).

[145] Gardner, *supra* note 107 at 251. See also Richard M. Bird, "Canada's Vanishing Death Taxes" (1978), 16 *Osgoode Hall L.J.* 133 at 137 (observing that the amendments to the federal gift and estate taxes "gave rise to considerable public outcry, to the point where it appears the whole experience may have made the

federal estate tax to estates from which it had been collected.[146] In these two provinces, therefore, estate taxes were effectively reduced by 75 percent.

In this context, the long-awaited White Paper was finally released on November 7, 1969.[147] Although explicitly rejecting the Commission's comprehensive tax base,[148] as well as several other proposals such as family taxation[149] and the elimination of all resource tax incentives,[150] the White Paper agreed with the Commission Report that, as a general rule, capital gains should be fully taxable at ordinary rates.[151] In order to prevent the concurrent application of capital gains tax and estate tax "at a most inconvenient time", however, the White Paper rejected the Commission's proposal that capital gains should be recognized when property is transferred at death, recommending instead that "the person who inherits the assets be treated as if he had purchased them at their cost to the deceased" plus "part of the death taxes paid on the assets in question – the part that relates to the capital gain."[152] In the case of gifts, though, the White Paper recommended that capital gains be taxable in the year of the gift and that the person receiving the

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government particularly cautious in this area when designing its major tax reform over the next few years").

[146] *Provincial Finances 1969*, (Toronto: Canadian Tax Foundation, 1969) at 58. In Alberta, this legislation came into effect on April 1, 1967. In Saskatchewan, refunds commenced on April 1, 1969. In its 1969 budget, the Government of Manitoba announced that it would also introduce legislation to refund the provincial share of the federal estate tax unless the federal government resolved the "competition for economic advantage" satisfactorily. Millie Goodman, "Checklist" (1969), 17 *Can. Tax J.* 155 at 161-62. The legislation, however, died on the Order Paper when a provincial election was called, and was not reintroduced by the social democratic New Democratic Party that came to power.

[147] Hon E.J. Benson, *Proposals for Tax Reform*, (Ottawa, 1969). For useful summaries of the White Paper's proposals, see Bucovetsky and Bird, *supra* note 129 at 18-20; and Head, *supra* note 112 at 61-67.

[148] Benson, *supra* note 147, para. 3.3, at 36 (stating that the government "rejects the proposition that every increase in economic power, no matter what its source, should be treated the same for tax purposes").

[149] *Ibid.*, para. 2.5, at 15 (noting that the Commission's proposed family unit would create a "tax on marriage").

[150] *Ibid.*, para. 5.24, at 64 (concluding that "special rules are still needed for the mineral industry").

[151] *Ibid.*, paras. 3.13-3.18, at 38 (proposing as well special rules to exempt gains on the sale of principal residences and to tax only half the gains of widely-held Canadian companies). In order to prevent retroactive application of the tax, the White Paper also proposed that tax should only apply to gains accruing after a stipulated "valuation day". *Ibid.*, para. 3.16, at 38.

[152] *Ibid.*, para. 3.42, at 42.

property be treated "as if he had purchased the asset for its fair market value."[153] Finally, and unexpectedly, the White Paper recommended that shareholders in widely-held Canadian corporations should be required to recognize accrued gains and losses every five years – though only half of these gains and losses would be recognized for tax purposes.[154]

In the White Paper itself, the Minister of Finance welcomed "public discussion of the proposals ... before Parliament is asked to approve a bill to implement tax reform."[155] For this purpose, the Government's preferred vehicle was the parliamentary hearings on the White Paper conducted by the House of Commons Standing Committee on Finance, Trade and Economic Affairs and the Standing Senate Committee on Banking, Trade and Commerce. Unlike Congressional Committees in the United States, these committees had limited staff and minimal technical knowledge, and were completely unprepared for the difficult task of reviewing and commenting upon detailed tax proposals.[156] The Commons committee alone received 524 briefs and 1,093 letters, and heard 211 oral presentations from 820 individuals.[157]

The vast majority of these submissions were from corporations and business associations,[158] most of which were highly critical of the proposals to tax capital gains at ordinary rates and to tax accrued gains on widely-held shares every five years.[159] Many organizations also objected to the taxation of capital gains as well as gifts and estates,

[153] *Ibid.*, para. 3.41, at 42.
[154] *Ibid.*, para. 3.33, at 40-41. This approach had been considered in the Commission's Report, but was not specifically recommended. Royal Commission on Taxation, *supra* note 105, Vol. 3, at 344 and 378-80.
[155] *Ibid.*, paras. 1.1 and 1.4, at 5.
[156] Bucovetsky and Bird, *supra* note 129 at 21.
[157] Standing Committee on Finance, Trade and Economic Affairs, *Eighteenth Report Respecting the White Paper on Tax Reform*, (Ottawa: Queen's Printer, 1970) at 5.
[158] Gardner, *supra* note 107 at 252.
[159] Bucovetsky and Bird, *supra* note 129 at 21; and Head, *supra* note 112 at 67-70.

notwithstanding the White Paper's proposal to defer the recognition of gains on bequests until the property is ultimately sold.[160] The Ontario Government released a set of counter-proposals in June 1970, recommending significantly lower capital gains tax rates, taxation of accrued gains at death, and a simultaneous and substantial reduction in wealth transfer taxes.[161] Small business owners organized a broader campaign of public advertisements, letters, speaking tours, and rallies under the banner of the Canadian Council for Fair Taxation, established in December 1969.[162] According to the group's founder and President, John Bulloch, the combination of capital gains tax and the estate tax amounted to "an attack on the middle-class values of hard work, thrift and initiative" and a "confiscation of the money and resources of the huge middle segment of the population".[163] At the height of the campaign, the Government was reported to be receiving protest letters at a rate of 7,000 each day.[164]

When the parliamentary committees reported in the fall of 1970, it was not surprising that they would "reflect in varying degrees the overwhelmingly hostile reaction of representatives of the business and professional organisations from whom the bulk of the brief and other submissions were received."[165] According to the Commons committee, the one-half inclusion rate for shares of widely-held corporations should be

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[160] R.M. Bird and M.W. Bucovetsky, *Canadian Tax Reform and Private Philanthropy*, Canadian Tax Paper No. 58, (Toronto: Canadian Tax Foundation, 1976) at 34. See also the summary of various submissions in Hartle, *supra* note 22 at 66-72.

[161] Hon Charles MacNaughton, *Ontario Proposals for Tax Reform in Canada*, (Toronto: Department of Treasury and Economics, 1970).

[162] See Gardner, *supra* note 107 at 252; and Philipps, *supra* note 9 at 133-34.

[163] Ronald Anderson, "Benson meets hostile response at public meetings on proposals" *Globe and Mail* (11 February 1970) p. 1.

[164] Ronald Anderson, "Tax reform fight found producing hysteria" *Globe and Mail* (21 February 1970) p. B1.

[165] Head, *supra* note 112 at 70. See also Bucovetsky and Bird, *supra* note 129 at 21 (concluding that their limited staff and minimal technical knowledge "meant that the two Committees were unlikely to serve as anything else than a sounding board for those segments of public opinion that were most vocal").

extended to all capital assets,[166] the five-year realization rule for these shares should be abandoned,[167] and the proposal to tax accrued gains at death should be restored in order to prevent indefinite deferral.[168] Since the last of these recommendations would, the committee noted, "magnif[y] the problem, brought to the committee's attention innumerable times, of the concurrent impact of the two taxes at the same time, at death," a further recommendation proposed a reduction of the federal estate tax "across the board, either by reducing the rates or by expanding the brackets."[169] The Senate committee went further, recommending a distinction between short-term and long-term gains and a rate of tax on the latter limited to the lesser of 25 percent or half the marginal income tax rate of the taxpayer,[170] and the postponement of tax on transfers of property by gift as well as at death, with a carryover of the donor's cost to the recipient.[171] In addition, the committee suggested, the government "might well consider abandoning the estate tax field to the provinces."[172]

The Government, which had given itself room to manoeuvre by presenting its response to the Commission Report in the form of a White Paper rather than a budget,[173] substantially revised its proposals in light of the parliamentary committee reports and the organized opposition, releasing its final tax reform package in the form of draft legislation accompanying the federal budget on June 18, 1971.[174] Following the

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[166] Standing Committee on Finance, Trade and Economic Affairs, *supra* note 157 at 26.
[167] *Ibid.*
[168] *Ibid.* at 33.
[169] *Ibid.* at 33 and 34.
[170] Standing Senate Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform Presented to the Senate of Canada*, (Ottawa, September 1970) at 59-60.
[171] *Ibid.* at 61.
[172] *Ibid.* at 45.
[173] Bucovetsky and Bird, *supra* note 129 at 21 (explaining that the defeat of a budget constitutes a "want of confidence" requiring the government's resignation, while a White Paper constitutes "an expression of the thrust of government thinking that nonetheless provides freedom for alteration or strategic retreat").
[174] Hon. E.J. Benson, *Summary of 1971 Tax Reform Legislation*, (Ottawa: Queen's Printer, 1971).

recommendations of the Commons committee, the draft legislation adopted a one-half inclusion rate for all capital gains and losses accruing after a designated valuation day,[175] dropped the White Paper proposal to tax accrued gains on widely-traded shares every five years,[176] and accepted the Carter Commission's original proposal to tax accrued gains when property is transferred on death as well as by gift.[177] Following the recommendation of the Senate committee, the Government decided to abandon the estate and gift tax field to the provinces.[178]

The reasons for the Government's decision were expressed in four short paragraphs in its *Summary of 1971 Tax Reform Legislation.* First, it explained, the combination of capital gains tax and estate tax at death "could in some instances result in substantial tax impact arising on the death of a taxpayer."[179] Second, it continued, "[a] reduction in federal estate taxes to the extent suggested by the Commons committee would result in a revenue loss of about half the $55 million now received by the federal government from this source" after payment of the provincial share to provincial governments.[180] Third, it concluded, "[t]wo provinces now return their entire share of estate taxes to estates and it is no longer possible to establish a uniform national system of death duties through federal legislation."[181] As a result, it concluded, "[i]n these circumstances, it has been decided that the federal government will vacate the estate and gift tax field on December 31, 1971."[182] Thus, it would seem, the introduction of capital gains tax at death, the low revenue yield for the federal government, and the disparate

[175] *Ibid.* at 30 and 32-33.
[176] *Ibid.* at 30.
[177] *Ibid.*
[178] *Ibid.* at 33.
[179] *Ibid.*
[180] *Ibid.*
[181] *Ibid.*

effects of federal and provincial joint occupancy of the field led to the repeal of the federal gift and estate tax. Unstated, of course, was the organized opposition to capital gains and wealth transfer taxes reflected in public campaigns and submissions to the parliamentary committees.

By sacrificing the federal gift and estate tax, the Government finally obtained the acquiescence of organized interest groups to the introduction of capital gains tax and the recognition of accrued gains at death. In a letter to the editor of the *Toronto Daily Star*, Canadian Council for Fair Taxation President John Bulloch praised the "highly nationalistic" tax legislation for abolishing wealth transfer taxes "that would, in combination with capital gains taxes, have forced the sale of family businesses, frequently to foreign interests."[183] The construction industry and the Canadian Real Estate Association welcomed the repeal of the federal gift and estate tax because "the small builder is still the backbone of the residential construction industry."[184] The business press was generally favourable, characterizing the tax reform legislation as "a far superior tax plan" to the White Paper.[185] Aside from a critical editorial in the *Toronto Daily Star*,[186] and unfavourable commentary from a few Canadian tax academics,[187] the predominant public response to the repeal of the federal gift and estate tax was silence.[188]

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[182] *Ibid.*
[183] John F. Bulloch, Letter to the Editor, *Toronto Daily Star* (22 June 1971), p. 7.
[184] Kenneth B. Smith, "Budget, Tax Reaction" *Globe and Mail* (19 June 1971), p. B13.
[185] I.H. Asper, "Benson Iceberg Becomes Benson Compromise and a Political Timebomb is Defused," *Globe and Mail*, (19 June 1971), p. B3.
[186] "Santa to the rich," Editorial, *Toronto Daily Star* (30 June 1971), p. 6 (arguing that the abolition of federal wealth transfer taxes "clearly violates a principle to which society should give some deference: equality of opportunity. And it overlooks without justification a perfectly good source of government revenue"). The editorial proceeded to describe the repeal of the federal gift and estate tax as "but one example of Mr. Benson's depressingly long march from Carter's central concern with tax equity", adding that: "The people who would have directly benefited from its implementation were not heard in Ottawa: their small voices ignorant, and poor, were submerged in the flood of glossy briefs that poured into the capital from all the vested interests."

In Parliament, where the Liberal Party held a comfortable majority, enactment of the draft legislation was never in doubt. While the Progressive-Conservative Leader of the Opposition criticized the Government for the inconsistency of amending the gift and estate tax in 1968 and repealing it three years later,[189] he and the members of his parliamentary caucus generally supported the decision to repeal the federal gift and estate tax. In fact, several complained that since provincial governments might continue to levy succession duties, the taxation of capital gains at death could create "extreme hardship" – particularly for family farms.[190] Only members of the social democratic New Democratic Party opposed abolition of the tax, criticizing the Government for abandoning the Prime

[187] See, e.g., Gordon Bale, Letter to the Editor, *Globe and Mail* (25 June 1971), p. 7 (describing repeal of the federal gift and estate tax as "tax regression rather than tax reform"). See also Richard M. Bird, "The Case for Taxing Personal Wealth" in *Report of the Proceedings of the Twenty-Third Tax Conference, 1971* (Toronto: Canadian Tax Foundation, 1972) 17 at 24 (defending wealth transfer taxes on "moral, social and economic grounds" and emphasizing the need for "a reaffirmation of the national interest in taxing wealth); and John Bossons, "Economic Overview of the Tax Reform Legislation" in *ibid.*, 45 at 54 (concluding that the repeal of the federal estate tax "would provide a substantial windfall for a relatively small number of present wealth holders" equivalent to "a lump-sum transfer of approximately $4.5 billion to individuals who currently own wealth that would be taxed in future years under the estate tax").

[188] Bird, *supra* note 145 at 133.

[189] See, e.g., *House of Commons Debates* (23 June 1971) at 7307 (Mr. Stanfield) (arguing that "the minister put the country through a lot of turmoil and trouble by an increase in estate taxes in an attempt to reduce the tax on very small estates. Now, with great fanfare the minister announces its abolition, also for the very best of reasons"); and *ibid.* (17 December 1971) at 10572 (Hon. Robert Stanfield) (contending that after the reform of the estate tax in 1968, the minister of finance was "doing away with all of what he put before the House two years previously and all that he had fought for in the House").

[190] *Ibid.* (8 November 1971) at 9447 (Mr. Gordon Ritchie) (suggesting that the federal capital gains tax in combination with provincial estate taxes "will create extreme hardship in agriculture and in the farm units as we know them today"). See also *ibid.* (22 June 1971) at 7226 (Hon. Marcel J.A. Lambert) (arguing that with the introduction of a federal capital gains tax, "[t]he people for whom this means another tax on top of other taxes are the farmers and ranchers, particularly those who live in provinces where the removal of the estate tax is meaningless"); *ibid.* (8 November 1971) at 9416 (Mr. Cliff Downey) (suggesting that despite the abolition of the federal estate tax, "really there will be no respite for many people in this country in respect of estate taxes, simply because there has not been sufficient consultation with the provinces"); *ibid.* (9 November 1971) at 9483 (Mr. A.P. Gleave) (arguing that "I really do not see how you can have an estate tax as well as a capital gains tax applied to the farming industry. You can have one or the other, but I doubt that you can have both. If you have both the result will be a tax jungle because a number of provinces have indicated they are going to retain and even increase estate taxes"); *ibid.* (15 November 1971) at 9568 (Mr. Wallace Bickford Nesbitt) (suggesting that following the repeal of the federal estate tax, "[u]ndoubtedly some of the provinces will move into the estate tax field, as a result of which Canadians in certain parts of Canada will, in effect, be taxed doubly as compared with Canadians in other places"); and *ibid.* (15 November 1971) at 9589 (Hon. Marcel J.A. Lambert) (suggesting that federal and provincial estate taxes

Minister's campaign promise of a "Just Society" by ignoring equality of opportunity and tax progressivity.[191] After minor technical amendments, the draft legislation was passed on December 17, 1971, and came into effect on January 1, 1972.

3. Provincial Aftermath: 1971-1985

At the provincial level, the federal government's decision to repeal the federal gift and estate tax was generally opposed.[192] Although the Province of Quebec had long favoured exclusive provincial jurisdiction of these taxes[193] and welcomed federal abandonment of the field,[194] most other provinces objected to the loss of revenue from federal rental payments and worried about the prospect of tax competition among provinces opting to collect their own succession duties.[195] Smaller provinces in particular complained about the lack of prior consultation and the absence of adequate notice to

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have contributed to foreign ownership of Canadian businesses, and are "the reason family businesses have been sold to strangers, whether they are from the United States or elsewhere").

[191] See, e.g., *ibid.* (14 September 1971) at 7803 (Mr. J. Edward Broadbent) (arguing that the abolition of the estate tax is detrimental to the principle of equality of opportunity, and that the Liberal party "which governs this country is the one which talks about equality of opportunity. This is the same party that is abolishing estate taxes. So much for justice in that area"); *ibid.* (15 September 1971) at 7840-41 (Mr. David Orlikow) (describing gift and estate taxes as "one of the basic features of every progressive tax system"); *ibid.* (17 September 1971) at 7955 (Mr. John Gilbert) (suggesting that the abolition of federal wealth transfer taxes "will further stratify the Canadian people into an economic caste system"); and *ibid.* (10 December 1971) at 10369 (Mr. John Burton) (arguing that "it is absolutely essential, if we are to have any sort of just society at all, to tax inherited wealth").

[192] Carter, *supra* note 71 at 239.

[193] See, e.g., *Report of the Proceedings of the Federal-Provincial Conference, 1963* (Ottawa: Queen's Printer, 1964) at 47; and Prime Minister Pierre Trudeau, *The Taxing Powers and the Constitution of Canada*, Government of Canada Working Paper on the Constitution, (Ottawa: Queen's Printer, 1969) at 34.

[194] Michel Bélanger, Secretary of the Treasury Board, Province of Quebec, addressing the Canadian Tax Foundation's Twenty-Third Tax Conference, in *Proceedings of the Twenty-Third Tax Conference, 1971*, *supra* note 190 at 267 (stating that "[t]here is some benefit in having at least one more field of taxation where there will no longer be joint occupancy").

[195] See, e.g., H. Ian Macdonald, Deputy Treasurer and Deputy Minister of Economics, Province of Ontario, addressing Canadian Tax Foundation's Twenty-Third Tax Conference, in *ibid.* at 260 (criticizing the federal government's decision as "a withdrawal from fiscal leadership, an invitation to tax avoidance, and an undermining of the equity considerations which loom so large in the federal tax reform program"). Although provincial governments would gain some revenue over time from the taxation of accrued gains at death, revenue estimates suggested that these were unlikely to exceed revenue losses from the abolition of the federal estate tax. Bossons, *supra* note 187 at 56 (projecting annual losses for all provincial governments of $16o million in 1972, growing to $451 million in 2002). For a similar conclusion, see Bird and Bucovetsky, *supra* note 160 at 54-55.

establish their own gift and succession duties, as well as the administration and collection costs that this would entail,[196] requesting the federal government to maintain the existing system of estate and gift taxation for at least a year from January 1, 1972, to give them time to address the implications of the federal proposal.[197] Although it refused to accede to this request, the federal government nonetheless offered to administer and collect provincially-imposed succession duties and gift taxes for a period of three years, provided that: (1) the agreements were entered into by at least four provinces; (2) that each participating province would agree to a model Act under which the base of the tax would be the same for all provinces; (3) that "some degree of uniformity of rates would be provided under the model Acts having regard to the rates now in effect in those provinces imposing their own succession duties;" and (4) that "it would be clear that the federal government's role is purely administrative and that the presentation to the public would make it clear that it is a provincial, not a federal tax."[198]

In Alberta, where the provincial share of the federal estate tax had been refunded since 1967, the provincial government made it clear that it had no intention to enter into any such agreement and would not introduce its own wealth transfer tax.[199] In Manitoba and Saskatchewan, however, where the social-democratic New Democratic Party

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[196] Carter, *supra* note 71 at 241.
[197] *The National Finances, 1971-72*, (Toronto: Canadian Tax Foundation, 1972) at 49.
[198] Hon. Patrick M. Mahoney, Parliamentary Secretary to the Minister of Finance, *House of Commons Debates*, (19 October 1971), p. 8851. See also Douglas H. Clark, Department of Finance, Ottawa, addressing Canadian Tax Foundation's Twenty-Third Tax Conference, in *Proceedings of the Twenty-Third Tax Conference, 1971*, *supra* note 187 at 275-76. The offer to collect provincial succession duties was extended only to the seven provinces (other than British Columbia, Ontario and Quebec) that did not collect their own succession duty at the time. The offer to collect provincial gift tax was extended to the nine provinces (other than Quebec) that had entered into federal-provincial tax collection agreements in the field of personal income taxation.
[199] Hon. Gordon Miniely, Provincial Treasurer, Alberta, *1972 Budget Address*, (Edmonton: Treasury Department, 1972) at 6 (stating that the provincial government "will not ... enter into an agreement for the collection on our behalf of succession duties, and estate and gift taxes, as we have no intention of imposing these taxes on citizens of Alberta").

(N.D.P.) had won provincial elections in 1969 and 1971, as well as the four Atlantic Provinces, provincial governments accepted the federal government's offer and introduced largely uniform succession duties and gift taxes.[200] In order to protect their succession duties, British Columbia and Ontario entered into agreements with the federal government for the collection of gift tax, and Quebec enacted its own gift tax which it collected as of January 1, 1972.[201] At the beginning of 1972, therefore, the federal government was collecting the uniform succession duty for six provinces and gift tax for eight provinces, the governments of British Columbia, Ontario and Quebec were collecting their own succession duties, Quebec was collecting its own gift tax, and Alberta levied no wealth transfer taxes. Not surprisingly, this situation did not last very long.

Of the six provinces accepting the federal government's offer to administer and collect provincial succession duties, Prince Edward Island was the first to repeal its succession duty legislation, which it did before any tax was even collected.[202] Estimating that total collections from the new tax over three years would amount to only $240,000,[203] the provincial government apparently concluded that the anticipated revenue was simply not worth the effort. In his Budget Speech in 1973, however, the Province's Minister of Finance proudly declared that "Alberta and Prince Edward Island are

[200] *Provincial and Municipal Finances 1975*, (Toronto: Canadian Tax Foundation, 1975) at 87. According to one commentator at the time, "revenue considerations were of primary concern to these six provinces; they concluded that they simply could not afford to give up this source of revenue." Wolfe D. Goodman, *The New Provincial Succession Duty System: An Examination of the Succession Duty Acts of the Atlantic Provinces, Manitoba and Saskatchewan*, Canadian Tax Paper No. 56, (Toronto: Canadian Tax Foundation, 1972) at 1.
[201] *Provincial and Municipal Finances 1975*, *supra* note 200 at 87.
[202] Bird and Bucovetsky, *supra* note 160 at 40.
[203] *Ibid.*, n. 122.

presently the only two provinces without some form of death duties."[204] Fearing the loss of investment to this "tax haven", the government of Nova Scotia announced on February 23, 1973 that it's succession duty and gift tax would expire by March 31, 1974.[205] A month later, New Brunswick's Minister of Finance blamed "tax policies in other provinces" when he announced the repeal of his province's succession duty and gift tax effective December 31, 1973.[206] Newfoundland concluded the abolition of wealth transfer taxes in Atlantic Canada by repealing its succession duty and gift tax effective April 9, 1974.[207]

In Western Canada, where Alberta became Canada's first "death tax haven" when it refused to enact a succession duty or gift tax in 1972,[208] provincial wealth transfer taxes lasted only a few more years. Although the Premier of British Columbia promised in June 1972 to repeal his province's succession duty and gift tax by 1 April 1973, [209] the election of a N.D.P. Government the next month put this policy on hold.[210] When the collection agreements with the federal government expired at the end of 1974, British Columbia assumed the administration of its own gift tax, and N.D.P. Governments in Manitoba and

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[204] Hon T.E. Hickey, Minister of Finance, Prince Edward Island, *Budget Speech* (Charlottetown: Department of Provincial Treasury, 1973) at 5.
[205] Nova Scotia, *Budget Address*, (23 February 1973). For references to the "tax haven" problem, see the exchange between the Nova Scotia Minister of Finance and an opposition member in Nova Scotia, House of Assembly, *Debates and Proceedings*, (23 February 1973), p. 936.
[206] Hon. Jean-Maurice Simard, Minister of Finance, New Brunswick, *Budget Speech*, 20 March 1973, (Fredericton: Finance Department, 1973) at 23. For family farms and fishing businesses, provincial succession duty ceased to apply from March 31, 1973.
[207] *Provincial and Municipal Finances 1975*, *supra* note 200 at 87.
[208] Hartle, *supra* note 22 at 75.
[209] "B.C. to cancel death duties and gift tax" *Globe and Mail*, (2 June 1972) p. B2.
[210] See British Columbia, *Debates of the Legislative Assembly* (24 October 1972) at 235-6 (Hon. D. Barrett), where Premier David Barrett defended the continuance of the provincial succession duty as follows: "If one rich man leaves because of this law or because of succession duty then I say let him go. And good riddance! We'd be far better off without him rather than having someone living around here who's trying to escape their social and financial responsibility to the people of British Columbia ... We say the rich are welcome, the capital we want it to stay, but it must pay its fair share."

Saskatchewan began collecting their own succession duties and gift taxes.[211] The election of the conservative Social Credit Party in British Columbia at the end of 1975, however, marked the beginning of the end of wealth transfer taxes in Western Canada. In his 1977 Budget Speech, British Columbia's Minister of Finance announced that the provincial succession duty and gift tax would be abolished in order to prevent the "forced" sale of family farms and businesses to "outsiders" and "to encourage the retention and accumulation of capital by residents of British Columbia."[212] Later that year, the N.D.P. Government in Saskatchewan announced that it would repeal the provincial succession duty and gift tax, notwithstanding the Government's conviction that "a tax on wealth is a fair tax" – attributing this decision to the abolition of these taxes in other provinces and "a widespread opinion that the successors of the average citizen will be subject to the tax" even though it applied to less than 3 percent of estates in Saskatchewan.[213] Although the N.D.P. Government in Manitoba maintained its commitment to provincial wealth transfer taxes in its 1977 budget,[214] a Conservative Government was elected later that year, and repealed these taxes in early 1978.[215]

By 1978, therefore, Ontario and Quebec were the only Canadian jurisdictions that continued to collect succession duties and gift taxes.[216] In each of these provinces, however, provincial governments had adopted a policy of gradually reducing these taxes

[211] *Provincial and Municipal Finances 1975*, *supra* note 200 at 87.
[212] Hon. Evan M. Wolfe, Minister of Finance, *British Columbia Budget*, (Victoria: Department of Finance, 1977) at 23.
[213] Hon. Walter E. Smishek, Minister of Finance, Saskatchewan, *Budget Speech*, (Regina: Treasury Department, 1977) at 30.
[214] Hon. Saul A. Miller, Minister of Finance, *1977 Manitoba Budget Address*, (Winnipeg: Department of Treasury, 1977) at 16. According to the Minister: "We believe the federal government belongs in the estate tax field, and we are prepared to vacate it, if and when Ottawa recognizes its responsibility. In the interim, we believe the provincial Succession Duty Act should be maintained."
[215] Bird, *supra* note 145 at 140.
[216] Like British Columbia, Ontario began collecting its own gift tax in 1975 after the collection agreement with the federal government expired.

over time as revenues from the taxation of post-1971 capital gains increased – regarding these taxes as temporary measures to maintain revenues until "the capital gains tax matures."[217] In Ontario, where succession duty rates were originally increased in 1972 in order to compensate for the loss of federal rental payments,[218] basic exemptions were increased from $100,000 to $150,000 in 1974,[219] $250,000 in 1975,[220] and $300,000 in 1977.[221] Making the perceived connection between succession duty and capital gains tax explicit, the 1977 Budget also made capital gains tax payable at death creditable against succession duties.[222] Two years later, the provincial Government repealed Ontario's succession duty and gift tax, declaring that "the continuation of this tax is hurting our economic performance and costing us jobs" and that "the present combination of other taxes provided government with an adequate return as wealth is accumulated."[223]

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[217] Hon. W. Darcy McKeough, Treasurer of Ontario, *1972 Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, Taxation and Fiscal Policy Branch, 1972) at 37. See also Ontario, *1973 Budget*, (Toronto, 1973) at 29 (emphasizing the "undesirable impact on small businesses, family farms and Canadian ownership" and noting that other provinces were vacating the field); and Mr. Raymond Garneau, Minister of Finance, Quebec, *Budget Speech* (18 April 1972) at 18 (promising "the gradual abolition of succession duties" with reductions "made in light of possible action on the part of the other provinces and the impact of the capital gains tax").

[218] Hon W. Darcy McKeough, *Introduction to Supplementary Estimates and Tax Legislation* (Toronto: Ontario Department of Treasury and Economics, Taxation and Fiscal Policy Branch, 1971) at 27.

[219] Hon. John White, Treasurer of Ontario, *1974 Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, Fiscal Policy Division, 1974) at 12.

[220] Hon. W. Darcy McKeough, Treasurer of Ontario, *1975 Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, Taxation and Fiscal Policy Branch, 1975) at 27.

[221] Hon. W. Darcy McKeough, Treasurer of Ontario, *Ontario Budget 1977* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, Fiscal Policy Division, 1977) at 18.

[222] *Ibid.* (explaining that "this credit mechanism will result in ever-increasing reductions in succession duty over time, as the value of capital assets increases and the Succession Duty Act is amended periodically to recognize the effect of inflation"). This approach had been recommended by a provincial advisory committee in 1973 in order to address the perceived "double tax burden" from succession duty and capital gains tax at death. Ontario Advisory Committee on Succession Duties, *Report* (23 February 1973) at v and 10-14.

[223] Hon. Frank S. Miller, Treasurer of Ontario, *Ontario Budget 1979*, (Toronto: Ministry of Treasury and Economics, Fiscal Policy Division, 1979) at 5 and 6.

In Quebec, succession duties were reduced by 20 percent in each year from 1974 to 1977, resulting in a total reduction in tax otherwise payable of 80 percent by 1977.[224] With the election of the sovereigntist and social democratic Parti Québecois (P.Q.) in November 1976, however, the final 20 percent reduction that had been scheduled for 1978 was cancelled in the new Government's first budget.[225] The next year, the P.Q. Government announced that the provincial succession duty would be retained but substantially amended, with rates based solely on amounts received by each beneficiary, the total exemption of bequests between spouses, and further exemptions for transfers to children and other dependents.[226] The legislation, which was introduced in Quebec's National Assembly in June 1978, was enacted on 22 December 1978, and came into effect immediately.[227] Over the next several years, the tax raised up to about $45 million per year,[228] but the Government faced continuing pressure to abolish provincial wealth

[224] Mr. Raymond Garneau, Minister of Finance, Quebec, *Budget Speech*, (28 March 1974) at 19; Mr. Raymond Garneau, Minister of Finance, Quebec, *Budget Speech*, (17 April 1975) at 19; and Mr. Raymond Garneau, Minister of Finance, Quebec, *Budget Speech*, (11 May 1976) at 35.
[225] Mr. Jacques Parizeau, Minister of Finance, Minister of Revenue, and Chairman of the Treasury Board, *1977-78 Budget Speech*, (12 April 1977) at 52 (noting that the Carter Commission had recommended the abolition of succession duties on the basis that inheritances should "be taxed as if they were income for those receiving them" and adding that "governments have not adopted this theory, but have used the partial taxation of capital gains as a reason for removing succession duties").
[226] Mr. Jacques Parizeau, Minister of Finance, ministre des Finances, ministre du Revenue, and président du Conseil du trésor, *1978-79 Budget*, (18 April 1978) at 50-51.
[227] *Succession Duty Act*, L.Q. 1978, c. 37. For a detailed review of the revised legislation, see Robert Raich, "An Overview of the New Quebec Succession Duty Act" in *Report of the Proceedings of the Thirtieth Tax Conference, 1978*, (Toronto: Canadian Tax Foundation, 1980) 725. Among the many revisions to the provincial succession duty, one of the most important was replacement of a "transmissions basis" whereby the tax applied to property situated outside the province only if the deceased was domiciled in the province and the beneficiary was resident or domiciled in the province with an "accessions basis" according to which the tax would apply to all property situated outside the province received by a person resident or domiciled in Quebec on the death of another person. Although the constitutionality of this approach was called into question by the British Columbia Court of Appeal in *A-G of British Columbia and the Canada Trust Company v. Ellett Estate*, [1979] C.T.C. 134 (B.C.C.A.) (ruling on a provision of the British Columbia succession duty enacted in 1972), it was accepted on appeal to the Supreme Court of Canada in *A-G of B.C. v. Ellett Estate*, [1980] C.T.C. 338 (S.C.C.).
[228] See the revenue figures reported in Mr. Gérard D. Levesque, Minister of Finance, Québec, *1986-1987 Budget*, (1 May, 1986) at 20.

transfer taxes "because such duties do not exist elsewhere in Canada".[229] With a new Minister of Finance, and a provincial election on the horizon (which it lost), the P.Q. Government repealed Quebec's succession duty and gift tax on 23 April 1985.[230]

B. The Abolition of Wealth Transfer Taxes in Australia

Unlike Canada, where the events leading to the repeal of federal and provincial wealth transfer taxes began with the appointment of a Royal Commission, the abolition of wealth transfer taxes in Australia originated in a popular protest movement initiated by a skilled carpenter and building contractor from Western Australia named Sydney Negus.[231] In 1970, after learning that estate duty could have a substantial impact on relatively modest amounts left to his wife, Negus launched a successful petition campaign calling for the abolition of estate duties, ran for public office, and was elected to the Federal Senate.[232] As Willard Pedrick observes, "the election of an Independent, whose only campaign issue had been abolition of death duties, was not lost on professional party leaders."[233] Little more than a decade later, Australian wealth transfer taxes had completely disappeared.

Three factors appear to have contributed to the strength of Australia's estate duty abolition movement in the early 1970s, particularly among farmers and small business owners.[234] First and foremost, exemptions had not been increased to account for inflation,

[229] Mr. Jacques Parizeau, ministre des Finances, Québec, *1983-84 Budget*, (10 May 1983) at 24.
[230] Mr. Yves L. Duhaime, ministre des Finances, Québec, *1985-86 Budget*, (23 April 1985) at 17 (stating erroneously that "Québec has ... been the only province to collect succession duties" since capital gains became partially taxable in 1972).
[231] See Pedrick, *supra* note 94 at 114.
[232] *Ibid.*
[233] *Ibid.*
[234] Smith, *supra* note 70 at 79-80.

causing Commonwealth and State taxes to apply to relatively modest estates.[235] At the federal level, for example, the Commonwealth estate duty at the time contained an exemption of only AU$10,000 for estates passing to a spouse, child or grandchild, and AU$5,000 for all other estates.[236] As a result, as the Taxation Review Committee (Asprey Committee) reported, over 55 percent of taxable estates in 1972-73 were valued at less than AU$40,000 and almost 83 percent were valued at less than AU$80,000.[237] At the State level, exemptions were generally lower, resulting in a larger number of taxable estates.[238] Farming interests consistently complained that farms had to be sold to pay the duties, though evidence to this effect was "sparse and mostly anecdotal."[239] Not surprisingly, therefore, it was political leaders with a rural political base who pushed the abolition agenda.[240]

In addition to the failure to adjust estate duties for inflation, a second factor contributing to the unpopularity of these taxes was the failure to integrate the Commonwealth and State duties.[241] While the existence of this "double or duplicative" system of wealth transfer taxes increased compliance costs for all taxable estates,[242] the relative burden was likely higher for small and medium-sized estates.[243] In addition, a study for the Asprey Committee concluded that the costs to comply with the Commonwealth and State taxes were larger for estates with small businesses than for

[235] *Ibid.* at 79. See also Pedrick, *supra* note 94 at 119-20; and Groenewegen, *supra* note 94 at 315.
[236] These figures resulted from the *Statute Law Revision (Decimal Currency) Act* 1966 (No. 93), which converted amounts in pounds to dollars by simply doubling the nominal amounts. Prior to 1966, the exemptions were £5,000 for estates passing to a spouse, child or grandchild, and £2,500 for all other estates. *Estate Duty Act* 1941 (No. 51) (Australia).
[237] Taxation Review Committee, *supra* note 92 at para. 24.1 (Table 24.B).
[238] Pedrick, *supra* note 94 at 119-20.
[239] *Ibid.* at 121.
[240] Groenewegen, *supra* note 94 at 311-12.
[241] Smith, *supra* note 70 at 80.
[242] Pedrick, *supra* note 94 at 119.
[243] Groenewegen, *supra* note 94 at 315.

most other estates.[244] Despite several recommendations to allocate this revenue source either solely to the states or solely to the Commonwealth government, however, joint occupancy remained until the taxes were finally repealed.[245]

A final explanation for the strength of Australia's estate duty abolition movement relates to the relative ease with which these taxes could be avoided.[246] Discretionary trusts, for example, could be used to transfer wealth from generation to generation without any tax.[247] At the federal level, gift tax was not integrated with estate duty, and gifts themselves were aggregated only over an eighteen month period.[248] Because of these and other deficiencies,[249] the tax was generally considered to be easily avoided by the most affluent and sophisticated taxpayers,[250] shifting the primary burden to small and medium-sized estates.[251] As a result, as one commentator explains, "[t]he extent of tax avoidance ... created public cynicism about the taxes."[252]

At the same time as the unpopularity of these taxes increased, their importance to Commonwealth and State revenues declined. In 1973, the Commonwealth government collected roughly AU$75 million from its gift and estate duties, representing only 0.7

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[244] B.L. Johns, W.C.D. Dunlop, and W.J. Sheehan, *Taxation and the Small Firm in Australia*, Taxation Review Committee Commissioned Studies (Canberra: Australian Government Publishing Service, 1975), chapter 8.
[245] See *supra* notes 91-94 and accompanying text.
[246] Smith, *supra* note 70 at 79.
[247] Hill, *Death and Gift Duties*, Taxation Review Committee Commissioned Studies (Canberra: Australian Government Publishing Service, 1975) at 75-76, cited in Pedrick, *supra* note 94 at 122.
[248] Hill, *supra* note 248 at 92 and 105-06, cited in Pedrick, *supra* note 94 at 122-232.
[249] For a detailed description, see Pedrick, *supra* note 94 at 122-24.
[250] See, e.g., Taxation Review Committee, *supra* note 92 at 115 (concluding that the Commonwealth estate duty "is certainly at present a tax which can be avoided by well-advised persons with ease, and which might almost be said to be paid principally from the estates of those who died unexpectedly or who had failed to attend to their affairs with proper skill").
[251] Smith, *supra* note 70 at 79-80.
[252] *Ibid.* at 79.

percent of total tax revenues – a lower percentage than at any time in their history.[253] While the States collected approximately $185 million from their wealth transfer taxes in 1973,[254] accounting for almost 9 percent of total tax revenues,[255] this percentage had declined substantially from only a few years earlier due to the transfer of the payroll tax field from the Commonwealth to the State governments in 1971,[256] and was lower than at any time since the end of the Second World War.[257] As inflation caused more and more small estates to become taxable, moreover, net revenues suffered because administrative costs were incurred to obtain relatively amounts of revenue from these estates.[258] In 1972-73, for example, the smallest 55.7 percent of estates subject to Commonwealth estate duty accounted for only 3.9 percent of revenue collected.[259] Joint occupancy by the Commonwealth and State governments also contributed to high administrative costs as both levels of government as well as all State governments were required to maintain the organizational apparatus to enforce and collect the taxes.

The abolition movement's first legislative victory was in Queensland, a "hotbed of agrarian resentment against death duties", where the Brisbane *Courier Mail* had run a series of articles highlighting the hardships caused by death duties and the growing campaign for abolition.[260] After exempting inter-spousal transfers from estate and gift duties in 1975,[261] the conservative Liberal-Country Party coalition government embraced

[253] Saunders, *supra* note 72 at 399 (Table 1). Income taxes, on the other hand, accounted for almost 70 percent of total tax revenues in 1973. Calculated from figures in O.E.C.D, *supra* note 2.
[254] Calculated from figures in Saunders, *supra* note 72 at 399 (Table 1).
[255] Calculated from figures in O.E.C.D., *supra* note 3.
[256] For an explanation of the events leading up to the transfer of this revenue source, see Mathews and Jay, *supra* note 81 at 248-54. In 1968/69, wealth transfer taxes had accounted for 16.6 percent of State tax revenues. Calculated from figures in *ibid.* at 247 (Table 38).
[257] Saunders, *supra* note 72 at 399 (Table 1).
[258] *Ibid.* at 400.
[259] Taxation Review Committee, *supra* note 92 at para. 24.1 (Table 24.B).
[260] Pedrick, *supra* note 94 at 114.
[261] *Gift Duty Act Amendment Act* 1975 (No. 63). See also Pedrick, *supra* note 94 at 114-15.

complete abolition in 1976 and repealed the taxes effective January 1, 1977.[262] Although the coalition's Liberal Party Treasurer Sir Gordon Chalk expressed misgivings about the budgetary implications of abolition, which would reduce State revenues by $25 to $30 million dollars per year,[263] Country Party Premier Joh Bjelke-Peterson apparently concluded that the loss in revenues would be more than offset by internal migrants attracted by the combination of a warm climate and tax-free bequests.[264] Indeed, before the repeal had even come into effect, the Gold Coast Visitor's Bureau prepared a pamphlet entitled "Legal Information on the Abolition of Death Duties in Queensland" reporting the duty payable in other States on an estate of $100,000 and detailing the ways in which death duties could be avoided by investment or domicile in Queensland.[265]

Not surprisingly, other States responded to this interstate tax competition by amending and then abolishing their own gift and estate duties. In 1976, inter-spousal transfers were exempted in New South Wales and South Australia,[266] and the State of Victoria enacted legislation exempting estates passing to spouses, children and grandchildren from duty in stages between 1976 and 1981.[267] Over the next three years, Tasmania introduced exemptions first for inter-spousal transfers and then all transfers.[268] In Western Australia, inter-spousal transfers were made exempt in 1977 and gift and

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[262] *Succession and Gift Duties Abolition Act* 1976 (No. 93) (Qld). See also Pedrick, *supra*, note 94 at 115.
[263] *Brisbane Courier Mail* (3 December 1976). For the fiscal year 1975-76, Queensland collected almost $27 million from succession and probate duty. Pedrick, *supra* note 94 at 115, n. 6.
[264] *Ibid.* at 115. Since 1980, in fact, over half a million Australians from other states have moved to Queensland, though the abolition of wealth transfer taxes in these other states suggests that climate was destined to play a bigger role than taxation!
[265] *Ibid.* at 115, n. 10.
[266] *Stamp Duties (Amendment) Act* 1977 (No. 13) (NSW); *Succession Duties Amendment* Act 1976 (No. 72) (SA).
[267] *Probate Duty Act* 1976 (No. 8936) (Vic), *Probate Duty Act* 1977 (No. 9056) (Vic), *Probate Duty Act* 1979 (No. 9334) (Vic), *Probate Duty Act* 1980 (No. 9441) (Vic), *Probate Duty Act* 1981 (No. 9618) (Vic). See also Saunders, *supra* note 72 at 398.

estate duties were abolished in 1980.[269] Finally, South Australia abolished its gift and estate duties in 1980 and New South Wales in 1981.[270] As a result, as one commentator has written, "by the early 1980s, the momentum against any death taxation in Queensland carried all other state death duties to the grave."[271]

At the Commonwealth level, interstate competition was obviously not an issue. Nonetheless, the political momentum of the estate duty abolition movement proved overwhelming. After Mr. Negus was elected, and before Queensland abolished its gift and estate duties, a Senate Committee examined the subject of wealth transfer taxes, recommending that the Commonwealth vacate the field, leaving the States to negotiate a uniform base and rates.[272] Of the eight Senators on the Committee, however, three filed a dissenting report recommending that the Commonwealth repeal its gift and estate duties and that the States be encouraged to reduce their taxes with a view to their eventual abolition.[273] Although the Asprey Committee affirmed an important role for wealth transfer taxation when it delivered its Report in January 1975,[274] recommending a national integrated gift and estate duty designed to reduce administration and compliance

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[268] *Deceased Persons' Estates Duties Act (No.2)* 1978 (No. 49) (Tas), *Deceased Persons' Estates Duties Amendment Act* 1982 (No. 49) (Tas). See also Pedrick, *supra* note 94 at 115-16; and Saunders, *supra* note 72 at 398.

[269] *Death Duty Act Amendment Act* 1977 (No. 3) (WA), *Death Duty Act Amendment Act* 1978 (No. 61) (WA). See also Pedrick, *supra* note 94 at 115-16.

[270] *Succession Duties Act Amendment Act* 1979 (No. 67) (SA); *Stamp Duties (Further Amendment) Act* 1980 (No. 161) (NSW). See also Saunders, *supra* note 72 at 398.

[271] Smith, *supra* note 72 at 79.

[272] Senate Standing Committee on Finance and Government Operations, *supra* note 93. Senator Negus was invited to chair the Committee for the purpose of this inquiry, but "declined on the ground that his commitment to death tax relief would disable him from performing as an impartial chairman." Pedrick, *supra* note 94 at 114, n. 2.

[273] Saunders, *supra* note 72 at 401.

[274] Taxation Review Committee, *supra* note 93 at para. 24.4 (emphasizing that these taxes "support the progressivity of the tax structure by the indirect means of a progressive levy on wealth once a generation" and "limit ... the growth of large inherited fortunes, a trend that most people would agree to have undesirable social consequences").

costs and to minimize opportunities for avoidance,[275] the effort to modernize these taxes appears to have been too late.[276] In the election that followed the Australian constitutional crisis later that year,[277] former Labor Prime Minister Gough Whitlam promised to abolish Commonwealth estate and gift duties in an unsuccessful effort to return to power.[278] During the 1977 election campaign, the incumbent Liberal Prime Minister Malcolm Fraser announced the immediate exemption of all transfers to a spouse or a child, and promised to abolish Commonwealth estate and gift duties altogether if re-elected.[279] After the Liberal-Country Coalition won a majority on 10 December 1977, the Government introduced legislation to repeal these taxes effective 1 July 1979.[280] Although the Labor Party moved to withdraw the legislation "until such time as an alternative form of tax on capital is introduced,"[281] the motion was defeated along party lines and the legislation was enacted in 1978.[282]

C. The Abolition of Wealth Transfer Taxes in New Zealand

Though separated from the Australian mainland by more than a thousand miles of water, New Zealand was not immune from the effects of estate and gift duty abolition in

[275] *Ibid.* at paras. 24.7-24.76.
[276] Smith, *supra* note 71 at 79-80 (attributing the abolition of these taxes to "tax policy inertia, which allowed popular support for these taxes to dwindle").
[277] On 11 November 11 1975, Australia's Governor-General Sir John Kerr dismissed the Labor Prime Minister Gough Whitlam after the Senate, in which the opposition Liberal-Country coalition had a majority, blocked a bill that appropriated funds for the payment of government expenditure. Kerr appointed the Opposition Leader Malcolm Fraser, who obtained passage of the bill and immediately requested the Governor-General to dissolve Parliament and call a general election. For a useful explanation of the 1975 constitutional crisis, see http://www.nationmaster.com/encyclopedia/Australian-constitutional-crisis-of-1975.
[278] Pedrick, *supra* note 94 at 116.
[279] "Fraser: reject Labor's 'recipe for disaster'" *Sydney Morning Herald* (22 November 1977) at 8 (quoting Fraser's statement that "[e]state duty has caused distress and hardship to thousands of Australian families, to small business, to farmers").
[280] *Estate Duty Amendment Act* 1978 (No. 23) (Australia), *Gift Duty Amendment Act* 1978 (No. 25) (Australia). See also Pedrick, *supra* note 94 at 116-17.
[281] Australia did not tax capital gains at the time.
[282] Pedrick, *supra* note 94 at 116-17.

Australia. Under pressure from farming interests, who complained that increased land values resulted in a larger estate tax burden,[283] the New Zealand Government amended the estate and gift duties in 1979 by significantly increasing the basic exemption in stages from $25,000 to $250,000 in 1982.[284] Little more than a decade later, the estate tax was effectively abolished by reducing to zero the rate of tax on persons dying on or after 17 December 1992.[285] In 1999, further legislation formally repealed New Zealand's estate tax, though its gift tax remains in place.[286]

Although less than one percent of decedents were subject to the tax in 1992,[287] abolition of estate duty was welcomed by New Zealand's leading agricultural organization, Federated Farmers of New Zealand, which praised the legislation as a "victor[y] for rural business and communities."[288] From the government's perspective, while the tax raised approximately NZ$80 million in 1992, this accounted for less than 0.3 percent of total tax revenues.[289] Finally, as Cedric Sandford has suggested, New Zealand's estate duty "may also owe its demise, at least in part, to what happened in Australia, because of the free movement of nationals between New Zealand and Australia".[290] As an estate-type tax based on the estates of persons dying while domiciled

[283] See R.A. Green and Lindsay McKay, "The Estate and Gift Duties Amendment Act 1979: The Demise of Wealth Transfer Taxation" (1980), 10 *Vict. U. Wellington L. Rev.* 227 at 240-42.
[284] *Financial Statement to the House of* Representatives, (Wellington, 21 June 1979) 33. For a critical assessment of this amendment, see Green and McKay, *supra* note 283.
[285] *Estate Duty Abolition Act* 1993 (No. 13) (New Zealand). See the brief discussion of this amendment in Asa Gunnarson, "Ability to Pay in New Zealand's Tax System" (1997), 27 *Vict. U. Wellington L. Rev.* 697 at 711.
[286] *Estate Duty Repeal Act 1999* (New Zealand).
[287] According to a story in the *Daily News* (3 December 1998), of 55,000 persons who died while domiciled in New Zealand in 1992, only 453 estates were subject to estate duty.
[288] "Stamp Duty Cut Applauded," *Christchurch Press* (27 May 1999).
[289] O.E.C.D., *supra* note 3.
[290] Cedric Sandford, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation*, (Fersfield: Fiscal Publications, 2000) at 100.

in New Zealand, New Zealand's tax, like that of the Australian States, was particularly vulnerable to tax-motivated emigration by affluent retirees.

D. Public Choice Theory and the Abolition of Wealth Transfer Taxes

Writing in 1978, Canadian economist Richard Bird characterized the disappearance of Canada's wealth transfer taxes as "strange".[291] Writing in 1983, Australian economist John Head described the abolition of Australia's federal estate and gift duty as "totally incomprehensible".[292] More recently, Cedric Sandford argued that the abolition of wealth transfer taxes in both countries "had an accidental element about it".[293] While there is certainly a large element of contingency to the events culminating in the abolition of these taxes in Canada, Australia and New Zealand, public choice theory suggests that the outcome in each of these cases is neither "strange", nor "incomprehensible", nor entirely "accidental". On the contrary, the abolition of wealth transfer taxes in these countries was in many respects a predictable response to the shifting political costs of these and other taxes.

In Canada, the Carter Commission's proposals to tax gifts and inheritances as income and capital gains at death significantly increased the political costs of the federal gift and estate tax as well as provincial succession duties – taxes for which the political costs were already high given their application to a relatively narrow group of people. While the 1968 amendments to the federal gift and estate tax might have lowered political costs by rejecting the Carter Commission's proposal to tax gifts and inheritances as income and exempting inter-spousal transfers, political costs were clearly increased by

[291] Bird, *supra* note 145 at 133.
[292] Head, *supra* note 72 at 14.
[293] Sandford, *supra* note 290 at 105.

integrating the gift and estate taxes and increasing federal rates on estates valued at less than $5 million. Not surprisingly, these amendments galvanized farming and small business interests, increasing further the political costs of Canadian wealth transfer taxes and federal tax reform more generally.

Although the White Paper attempted to contain these political costs by rejecting the taxation of accrued gains at death, the proposals to tax capital gains at ordinary rates and widely-held shares every five years were politically very costly, since these measures would "impose obvious and substantial new burdens on a relatively small but affluent, articulate and well organised section of the community which could hardly be expected to stand idly by", resulting in benefits that "would be widely dispersed over the relatively unorganised mass of taxpayers at the bottom of the income scale."[294] Clearly expecting opposition from organized interest groups, the Government attempted to manage the tax reform process by referring its proposals to parliamentary committees. These committees, however, were completely unprepared for this task and served mostly as "sounding board[s] for those segments of public opinion that were most vocal"[295] – namely, the organized interest groups that had opposed the Carter Commission's proposals from the outset. Predictably, the parliamentary committee reports "reflect[ed] in varying degrees the overwhelmingly hostile reaction of representatives of the business and professional organizations from whom the bulk of the briefs and other submissions were received."[296] Finally, confronting the prospect of substantial revenues from the introduction of capital gains tax versus minimal revenues from the gift and estate tax (75 percent of which was transferred to provincial governments or abated in the case of provinces collecting their

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[294] Head, *supra* note 112 at 69 and 70.
[295] Bucovetsky and Bird, *supra* note 129 at 21.

own succession duties), the federal government opted to withdraw from the wealth transfer tax field, enacting a capital gains tax on half the amount of the gain with accrued gains taxable at death.

At the provincial level, several governments endeavoured to maintain wealth transfer taxes, though the eventual abolition of these taxes was probably inevitable when Alberta refused to enact a provincial succession duty and gift tax in 1972. With low revenues, high administrative costs, and the risk of inter-provincial migration, wealth transfer taxes were abolished in Atlantic Canada by 1974, Western Canada by 1978, and Ontario in 1979. While Quebec held out, substantially amending its succession duty in 1978, even it succumbed to the pressures of horizontal tax competition, repealing its succession duty and gift tax in 1985.

In Australia, the political costs of estate and gift duties collected by Commonwealth and State governments increased significantly in the late 1960s and early 1970s as inflation eroded the real value of exemptions, increasing the number of taxable estates. Even before then, the political costs of these taxes were probably high, given their relatively narrow application and the high administrative and compliance costs resulting from joint occupancy by both levels of government. Not surprisingly, those who were subject to the tax established an organized movement pressing for abolition of the taxes. As the political costs of these taxes increased and government reliance on estate and gift duties as a source of revenue decreased, these governments looked at other less politically costly sources of revenue as alternatives to these taxes. When Queensland abolished its estate and gift duties effective 1 January 1977, horizontal tax competition quickly led to the abolition of these taxes in all other States. At the federal level,

[296] Head, *supra* note 112 at 70.

Committees made recommendations for major reform, but the political momentum of the abolition movement carried the day and Commonwealth gift and estate duties were repealed effective 1 July 1979. New Zealand held out for a little more than a decade, but the combination of political opposition, low revenues and horizontal tax competition proved fatal there as well as the estate tax was repealed effective 17 December 1992.

IV. Conclusion

Opponents of wealth transfer taxes are apt to take comfort both from their abolition in Canada, Australia and New Zealand and from public choice explanations for these events, and proponents may despair. As an advocate of these taxes myself,[297] this is obviously not what I intend. Although wealth transfer taxes were abolished in Canada, Australia, and New Zealand, are under pressure in the United Kingdom, and are scheduled to be phased out in the United States, they appear to have retained their vitality in several other countries,[298] a few of which rely on these taxes more today than they did in the early 1970s.[299] While political costs and benefits may influence the choices that governments make among different revenue sources, these are clearly not the only factors

[297] Duff, *supra* note 5.

[298] In Norway, for example, wealth transfer taxes accounted for 0.21 percent of tax revenue and 0.08 percent of GDP in 1971 and 0.2 percent of tax revenue and 0.09 percent of GDP in 2001. Similarly in Japan, wealth transfer taxes accounted for 1.27 percent of tax revenue and 0.26 percent of GDP in 1971 and 1.22 percent of tax revenue and 0.35 percent of GDP in 2001. OECD, *supra* note 3.

[299] In France and Germany, for example, wealth transfer taxes accounted for larger percentages of tax revenues and GDP in 2001 than they did in 1971: increasing in France from 0.52 percent of tax revenue and 0.18 percent of GDP in 1971 to 1.23 percent of tax revenue and 0.6 percent of GDP in 2001, and increasing in Germany from 0.2 percent of tax revenues and 0.06 percent of GDP in 1971 to 0.4 percent of tax revenues and 0.15 percent of GDP in 2001. *Ibid.*

as political values and ideologies as well as the structure of state institutions can also play an important role.[300]

Nonetheless, it is important to be realistic about the considerable political challenges that are apt to make the retention or reintroduction of wealth transfer taxes especially difficult. As experience in Canada, Australia and New Zealand suggests, the political costs of these taxes tend to be much higher than those of broad-based income, consumption, or payroll taxes, and can increase significantly if tax reforms (Canada) or tax policy inertia (Australia) increase the burden on small and medium-sized estates.[301] In federal systems, moreover, the political costs of wealth transfer taxes are greatly increased by joint occupancy by both levels of government (vertical tax competition) and mobility among sub-national jurisdictions (horizontal tax competition). Although the costs of horizontal tax competition in this field can be reduced by applying the tax to inheritances received by beneficiaries who are resident or domiciled in the taxing jurisdiction, since these persons are likely to be less mobile than affluent retirees, the example of Quebec (where this "accessions basis" was adopted in 1978 but provincial succession duty and gift tax were repealed in 1985), suggests that wealth transfer taxes in a federal jurisdiction should be collected by the federal government.

For those who wish to preserve and restore the taxation of wealth transfers, then, what lessons can be drawn from the abolition of these taxes in Canada, Australia and New Zealand? Reflecting on public choice accounts of tax policy and the historical experience in these countries, three conclusions seem evident. First, if wealth transfer

[300] See, e.g., Banting, *supra* note 9 at 352-55 (considering literature on the politics of redistribution as well as public choice theory, and concluding that these approaches should be understood as complementary, not contradictory).

taxes are to be maintained or reintroduced, the political costs of these taxes cannot be allowed to increase beyond a level that is necessary to their essential purposes. Basic exemptions, for example, must exclude small and medium-sized estates, and special rules must minimize the burden on family-owned enterprises and principal residences – ideally by deferring the collection of tax until these assets are sold rather than exempting these transfers from tax altogether. Capital gains taxes must be adjusted to lessen the combined impact of two taxes when property is transferred by gift or on death, for example by permitting the donor's cost to carryover to the recipient. Administrative and compliance costs must be minimized by integrating federal and sub-national taxes or abolishing the latter, by eliminating complex rate structures based on the size of an estate and the shares received by different classes of beneficiaries, and by statutory rules designed to minimize opportunities for avoidance. Horizontal tax competition must be discouraged by ensuring that wealth transfer taxes are collected by federal governments in federal systems and by applying these taxes to gifts and inheritances received by beneficiaries who are resident or domiciled in the taxing jurisdiction in addition to property situated in the taxing jurisdiction and transfers of property by persons domiciled in the taxing jurisdiction.

Second, if governments are to enact the legislative measures necessary to preserve or re-establish wealth transfer taxes, methods must be devised in order to protect public decision-making processes from the influence of organized interest groups who can be expected to oppose these measures. In Canada, for example, the Carter Commission was able to produce a Report that was hailed as "a landmark in the annals of taxation" because it had both the institutional mandate and the financial resources to engage in a

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[301] This appears to have been a factor in the U.S. as well, where inflation and increased real estate values eroded the effectiveness of the integrated gift and estate tax credit in the 1990s.

thorough and non-partisan analysis of tax policy. In contrast, the parliamentary committees that considered the federal government's White Paper proposals in 1970 were thrust into a highly political exercise without the knowledge or resources to withstand the pressure exerted by organized interest groups that dominated the process. Although this was only one of many factors that led to the eventual abolition of wealth transfer taxes in Canada, its impact at the time may have been decisive.

Finally, if these taxes are to retain and attract public support, efforts must also be made to increase their perceived benefits. One strategy for this purpose might be to earmark the revenues from these taxes to a particular expenditure program, especially a program that complements the redistributive objectives of the tax such as early childhood education for children from low-income families. More generally, a greater "tax preference" for wealth transfer taxes might result from less emphasis on the revenues raised from these taxes, which are bound to be less than taxes on income, consumption or payrolls, and more explicit acknowledgement of their symbolic and social function to lessen inequalities and unequal opportunities.[302] Public support for these taxes might also be improved by applying these taxes to amounts received by living beneficiaries rather than the aggregate amount of a decedent's estate, demonstrating that the tax is intended not to punish those who have succeeded in life or to compound the misery of death, but to regulate the distribution of wealth and opportunities among beneficiaries for whom a gift

[302] In this respect, see Ontario Committee on Taxation, *Report*, (Toronto: Ontario Printer, 1967), Vol. III at 136 (emphasizing the social purpose of wealth transfer taxes "to control the growth in this country of an economically powerful minority whose influence is based upon inherited wealth"); and Taxation Review Committee, *supra* note 92 at para. 24.4 (recognizing role of wealth transfer taxes to "limit ... the growth of large inherited fortunes, a trend that most people would agree to have undesirable social consequences"). See also McKay, supra note 70 (noting the rare emphasis on the social purposes of wealth transfer taxes in New Zealand); and Bird, *supra* note 145 at 138 (suggesting that public support for the wealth transfer taxes in Canada was weak because "revenue was clearly the main purpose of [these] taxes so far as most Canadians and Canadian governments were concerned").

or inheritance is largely undeserved.[303] In fact is interesting to note that the decline in wealth transfer taxes in O.E.C.D. countries has been much greater among countries with estate-type taxes that fall on the estates of persons dying domiciled in the jurisdiction than countries with inheritance-type taxes that apply to amounts received by beneficiaries living in a particular jurisdiction. In addition to any lessons from the history of abolition in Canada, Australia and New Zealand, wealth transfer tax advocates might also look to the experience of these countries where wealth transfer taxes appear to have been more resilient.

[303] See, e.g., Graetz and Shapiro, *supra* note 2 at 233-36 and 256.

Statement by U.S. Representative Tim Mahoney
"Alternatives to the Current Federal Estate Tax System"
United States Senate Committee on Finance
March 12, 2008

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this hearing on estate tax reform, and for allowing me to submit my testimony to the Committee. I appreciate your leadership on this issue, which is important to family farmers and small business owners in my district.

In high growth states or in expanding metropolitan areas, such as Florida, land values appreciate due to the value of the land for commercial or home development. Unfortunately, this creates a situation where a family may be forced to sell the family farm to pay the estate tax, as agricultural income is insufficient to cover the liability.

The sale of property for development reduces America's capacity to be an independent producer of a safe food supply. The Centers for Disease Control and Prevention (CDC) estimates that each year in the United States, 76 million people get sick, 325,000 are hospitalized, and 5,000 die from food-related illnesses. While these illnesses are the result of a variety of factors, increased attention has been paid to the safety of imported foods.

Following revelations that pet food imported from China sickened or killed an unknown number of dogs and cats, Congress focused on the more than $4 billion worth of food we import from China. While the U.S. food supply, including imported food, is among the safest in the world, a challenge is emerging – how do we keep our food supply safe in the face of rapidly rising imports.

Finally, the sale of agricultural property reduces the green space we have and development puts greater pressure on our environment.

As you may know, last year, I joined Representatives John Salazar and Baron Hill in introducing H.R. 1929, the Save the Family Farm and Ranch Act of 2007. This bill will defer the payment of the estate tax on family farms and ranches as long as the land is used for agricultural or conservation purposes. Specifically, the legislation would apply to those who receive more than 50 percent of their gross income from farm or ranch operations. As long as their heirs keep the estate in accordance with the Internal Revenue Services' definition of farmland, the estate tax is deferred until the family decides to sell it or at such time as the family income drops below 50 percent. At that time the sale of the estate would be subject to the estate tax currently in law on the full value of the estate.

The Save the Family Farm and Ranch Act of 2007 protects family farms, maintains farm production, lessens urban development in rural areas, and conserves or environment.

This legislation is similar to S. 1994, which was introduced by Senator Ken Salazar.

As the Senate Finance Committee continues to examine alternatives to the current federal estate tax system, I would urge you to consider the provisions contained in the Save the Family Farm and Ranch Act.

Again, thank you Chairman Baucus, Ranking Member Grassley, and Members of the Committee for your work on estate tax reform, and for providing me with the opportunity to testify before you today.

Senate Finance Committee
Statement for the Record
Senator Pat Roberts
Alternatives to the Current Federal Estate Tax System
March 12, 2008

Thank you, Mr. Chairman, for scheduling this hearing.

This is the second estate tax hearing we've had in recent months, and I hope that this reflects a commitment by the committee to move toward reform, or repeal, of the estate tax. We all know that we have one year, in 2010, when the estate tax is permanently repealed and then the tax returns with full force to its pre-2001 levels, with a tax rate of at least 55 percent and an exemption level reduced down to one million dollars.

One of the repeated concerns that Kansas small businesses, family farmers, and ranchers share with me is that the burden of the estate tax limits their ability to pass on their business, farm or ranch to their children or grandchildren.

In Kansas, as in many states, small businesses are the leaders in job creation and the drivers of local economies. And, yes, there are family farms in Kansas where the children hope to take over the farm from their parents. However, when the estate tax hits, these younger generations are too often placed in the difficult position of having to sell the business or the farm just to pay their tax bill to Uncle Sam. It is an unfortunate reality that this frequently results in the kids packing up and leaving their rural community to earn a living elsewhere.

Absent Congressional action, in 2011 and beyond, more and more family farms and small businesses will be impacted and generations-old farms and family businesses will cease to exist.

Several years ago, the Senate came close to reaching a compromise on a reform of the estate tax. As the witnesses here today have pointed out, there are a number of options to reform the estate tax. Whatever approach we ultimately take, we need to act sooner rather than wait until 2010, so that taxpayers who are subject to the estate tax can have certainty with respect to how they plan for the future of their small businesses or the family farm.

COMMUNICATIONS

Dick Patten
President
American Family Business Institute
1920 L Street NW, Suite 200
Washington, DC 20036

Testimony to:

The U.S. Senate Finance Committee
Hearing on "Alternatives to the Current Federal Estate Tax System"
March 12, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Committee: I am honored to present testimony on behalf of the American Family Business Institute and the family-businesses and farms we represent. I want to explain why the inheritance tax is no "alternative" to the existing federal estate (or rather, death) tax.

This hearing, though thought-provoking, may miss the point. Any alternative to the existing system should reduce the overall burden placed on family businesses and farms. The inheritance tax, as I will explain, would increase the overall burden. Moreover, the arguments for this proposal are predicated on the same wrong notions about earned wealth as those of the arguments for maintaining our existing death tax. Family-businesses and farms create economic opportunity for all and should not be punished as though their success came at the expense of other Americans. Abolishing the death tax is the policy most in the interest of America's family-business owners, farmers and the economy as a whole.

I. Problems with the Inheritance Tax

There are three specific problems with the inheritance tax in her proposal as proposed by panelist Lily Batchelder, who made the clearest case in support of such a tax. Taken together, these problems make the inheritance tax an unacceptable "alternative" for the existing estate tax.

First, the effective rate of the inheritance tax would be somewhere between 65% and 69.6%, much higher than the current rate of 45%[1] and even the scheduled 2011 rate of 55%[2]. Ms. Batchelder recommends using the income tax to establish the base level of taxation, the highest rate of which is currently 35% (but slated to increase to 39.6% in 2011 when the 2001 tax relief expires).[3] Next she would add a "surtax" of 15%[4],

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[1] Tax Law Changes for Gifts and Estates and Trusts, *Internal Revenue Service,* December 1, 2007, http://www.irs.gov/formspubs/article/0,,id=112782,00.html.

[2] Brian G. Raub, Recent changes in the Estate Tax Exemption level and Filing Population, *Internal Revenue Service,* http://www.irs.gov/pub/irs-soi/05estate.pdf.

bringing the current total to 50% and the 2011 total to 54.6%. Finally, she implies that stepped-up basis for capital gains should be eliminated, resulting in yet another 15%.

When today, farms and family-businesses are already facing financial ruin due to a rate of 45%, what sense does it make to increase it by 50%?

Second, the Batchelder inheritance tax would encourage the disintegration of family-farms and businesses through fragmented ownership. The inheritance tax provides an exemption on the basis of inheritances received, meaning the only way around the onerous rate is to bequest to enough owners as to take advantage of the full exemption amount (Ms. Batchelder recommended an exemption of $2 million[5]). For many family-business and farmers, this would mean making bequests to non-children and even non-relatives, who may or may not have an interest in the business's long-term viability.

For instance, if the owner of a farm valued at $10 million dies and has no cash to pay the inheritance tax, he would be encouraged to make 5 bequests (each at the $2 million exemption rate). However, if he does not have 5 children or other suitable heirs, then he would have to bequest a fifth of the ownership (or more) of his farm to an outside heir. This person may very well have more interest in immediate cash rather than preserving the farm's character and viability. Giving this person ownership of the farm would place the rest of the family in conflict, rather than ensuring the long-term sustainability of the farm.

Proponents of the inheritance tax claim that it would make tax-planning less complex, but the incentive for disintegration of family-enterprises will make tax-planning only more difficult.

Third, the inheritance tax as proposed by Batchelder would provide a "deferred" payment plan[6] for family-businesses and farms, which in reality, would only shackle them with burdensome debt. Under this plan, heirs who receive illiquid assets such as a business or farm and lack cash, could defer the tax indefinitely until the asset is sold. On face value, it almost sounds like a plausible solution to the problem faced by family businesses and farms.

However, there are two very important problems posed by this "solution" which make it untenable. First, annual interest would accrue on the amount of the tax owed by the heir.[7]

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[3] Effective Tax Rates Under Current Law: 2001-2014, *Congressional Budget Office*, August 2004, http://www.cbo.gov/ftpdoc.cfm?index=5746&type=0&sequence=1.

[4] Lily Batchelder, "Reform Options for the Estate Tax System: Targeting Unearned Income," *Testimony Before the United States Senate Committee on Finance*, March 12, 2008, page 10.

[5] Batchelder, page 2.

[6] Ibid., 15.

[7] Ibid., 16.

This means that within a number of years, a family inheriting a business or farm could theoretically owe 100% of the value of their enterprise to the government in taxes.

Moreover – as with any federal debt – until the tax is paid, the business would become a "borrower" of the federal government, making the IRS a silent partner in the business's operations, secured by an IRS lien. As any executive is aware, the complications of nonproductive loans can wreak havoc with a business's ability to borrow money for growth. This "deferment" plan does not work on paper and it would ruin family-businesses in real life.

I know of many business-owners and farmers who are strained by the burdens of the 10-year loan plan offered for the current death tax. Congress would not accomplish much for them by simply offering infinite debt and the consequent financial strains. Business-owners and farmers who have worked hard do not deserve an IRS loan-shark as the "compromise" to immediate confiscation.

II. Ideological misconceptions common to both the death tax and the inheritance tax

The reasons for an inheritance tax, based on its proponents own words, are very similar to those used in support of the current death, or estate tax. This belies the notion that the proponents of the inheritance tax are actually interested in dealing with the problems created by the current death tax. The reality, as explained below, is that these individuals are looking for a more aggressive way to accomplish their goal: the redistribution of wealth in America.

The primary misconception is the notion that income inequality in America is an undeniable crisis of moral proportions. Certainly, no just society can tolerate the subjugation of any class. However, there is nothing wrong with discrepancy in economic net-worth, insofar as that discrepancy is not static. And the evidence from a recent Treasury Department study finds that income in America is incredibly dynamic.[8]

This study found that over the last 10 years, income mobility has not been static, but instead incredibly dynamic. In fact, more than half of the lowest income earners have moved into a higher income bracket in the 10-year span and nearly a quarter of the lowest income earners have moved into middle or upper-middle income brackets. The only income bracket to see a drop in real income over the last ten years was the top 1%.

Not only is wealth dynamic, but it is particularly so among those in the lowest wealth brackets. A study in 2003 found that within five years, one-third of households in the bottom wealth quintile move up to a higher quintile.[9]

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[8] "Income Mobility in the U.S. from 1996 to 2005," *Department of the Treasury,* November 13, 2007, http://useu.usmission.gov/Dossiers/Economic_Relations/Nov1307_Income_Mobility_Study.pdf.

[9] Ana Castaneda, Javier Diaz-Gimenez and Jose-Victorrios-Rull, "Accounting for the U.S. Earnings and Wealth Inequality" *Journal of Political Economy* 111, no. 4 (August 2003): 848.

Moreover, the notion that wealth between generations in a family is static stands in stark comparison to the evidence. A paper published in the *Journal of Political Economy* found that two thirds of children of parents in the poorest wealth quintile ended up in higher quintile than their parents. And the children of parents in the wealthiest quintile? They had a 64% chance of being in a different (lower) wealth quintile than their parents.[10]

Only those who are ideologically committed to Marxist egalitarianism can find fault with these trends. Real humanitarians are interested in improving the lot of all Americans, and have no problem with a "wealth divide" so long as there is nothing preventing anyone from moving up. And leading economists have found that inheritances have little impact on such inequality.

Alan Blinder, a former member of President Bill Clinton's Council of Economic Advisers, stated that only 2 percent of inequality is due to the unequal distribution of inherited wealth.[11] Joseph Stiglitz, chairman of President Clinton's CEA, stated inheritances might actually reduce income inequality.[12]

Supporters of death tax repeal know that inheritances do not hold anyone back. In fact, they allow everyone to move forward faster than they would otherwise. Beyond helping the heirs move into higher income brackets, inheritances enable economic growth which brings better jobs for everyone, particularly in the case of family businesses. A death tax hampers this growth and slows the economy, holding everyone back.

III. The Truth about the Family Farm

Ms. Batchelder repeated the oft-cited but patently false claim that the death tax has not resulted in the sale (or destruction) of any family-farms. This common lie holds continued weight only due to the shallow analysis with which most policy-experts and academics approach it. You see, it is unlikely that any farms have been sold the day after the death tax levy, or any time close to it. However, there are plenty of instances of farms which have been sold in advance of the tax, as the aging owners realized that their children would be burdened with a major tax liability and subsequent fire-sale if it was not addressed sooner. Selling the farm provides liquidity to pay for the tax, and leaves some inheritance for the children, though hardly in the form that the family intended.

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[10] Kerwin Kofi Charles and Erik Hurst, "The Correlation of Wealth across Generations," *Journal of Political Economy* 111, no 6 (December 2003): 1155-1182.

[11] Alan S. Blinder, *Toward an Economic Theory of Income Distribution* (Cambridge, MA: MIT Press, 1974).

[12] Joseph E. Stiglitz, "Equality, Taxation and Inheritance," in *Personal Income Distribution: Proceedings of a Conference Held by the International Economic Association, Noordwijk aan Zee, Netherlands, April 18-23, 1977,* eds. Wilhelm Krelle and Anthony F. Shorrocks, 283 (New York, NY): North-Holland Publishing Company, 1978).

In other cases, family farms are forced to take on burdensome loans in order to pay for the tax. In these cases, it often is just a matter of time before the debt loan becomes an unmanageable loss, and the farm is sold. Allow me to share with you a few examples of both scenarios.

For instance, consider the story of Lex McCorvey a resident of Santa Rosa, CA.[13]

> In the late 1800's my Swiss born grandfather Antonio Ghisletta immigrated to the United States in search of new opportunities. It was the classical story of him arriving with no money in a new land where hope and hard work would somehow fulfill a life's dream
>
> My grandfather Antonio was a dairyman, as his family before him was in the old country. Through his hard work and determination he saved and borrowed money to purchase a dairy farm in the Chileno Valley of Petaluma, California. My mother Lorraine was born on the ranch in 1914 and milked cows by hand before and after school, harvested hay, potatoes and grains and did other routine chores. Antonio even donated land on the ranch to create Laguna School, a new rural one room elementary schoolhouse so the three children could be closer to the farm.
>
> With over 70 years of a farming legacy in the community, Antonio passed away in the mid 1960's. His children and their families faced the daunting task of dealing with his estate. What took a lifetime for my grandfather Antonio to build disappeared as his children were forced to sell both farms to simply pay the inheritance taxes. The family farm was no more. Even more damaging was that the properties had to be sold quickly to meet the inheritance tax obligations. As a result, both farms brought less than the market value adding insult to injury for the heirs as they saw there family farming legacy swept away in a few short months.
>
> To this day, those farms would still be in the family had it not been for an injustice that is served by unfair inheritance laws in this country. It is difficult enough for generations of new or aspiring farmers to buy or even rent land for agriculture. I hope that Congress will act soon to repeal the death tax before more farm families suffer the same fate.

Another sad case is that of Tim Koopman, whose family has operated a ranching operation in two locations since 1889.[14] Tim had long planned to be the fourth generation of his family to run the farm. However, with this grandfather's unexpected and unprepared death at the age of 80, his plans quickly changed:

> As a simple hardworking man, he had prepared just a simple Last Will and Testament. After several years of meetings with accountants, appraisers, IRS officials and attorneys, the IRS prevailed in establishing a non-agricultural appraised value on the Sunol ranch [one of two ranches owned by the Koopmann family]. The result was an inheritance tax liability of over $125,000…
>
> …In 1973, in order to generate sufficient cash to settle the death tax liability, the family had to sell the Turlock ranch. The family ranching operation was reduced in scale to adapt to the loss of the Turlock ranch, additionally, at that time 150 acres of the leased share crop farm ground was lost due to residential development. As a result of the death tax liability and the costs associated with attorneys and appraisers, cash reserves were reduced to nothing. The reduced scale of operations, in conjunction with increasing expenses, provided for meager income flow. To compound an

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[13] Lex McCorvey, "Letter to Members of Congress," *Living Through the Death tax: Personal Stories from Farm and Ranch Families in California,* California Farm Bureau Federation, September 9, 2005.
[14] Tim Koopmann, "Koopmann Ranch," *Living Through the Death tax: Personal Stories from Farm and Ranch Families in California,* California Farm Bureau Federation, July 13, 2005.

already dismal economic condition, came the weather conditions of 1975 through 1977. The lack of rainfall for these two years was classified as the most severe drought in over 100 years in northern California....

...As my college agricultural education tenure neared its end, my hopes of entering into a family agricultural partnership were dashed....I thus became the first Koopmann family member from four generations of California agriculturalists to be "off the land"...

Though unable to make a living as a full-time rancher, Tim continued to be an active participant in the family agricultural operation, and looked for ways to keep the remaining land from being sold. Unfortunately, this ultimately proved to be a futile effort:

In April of 1991, we accomplished a small goal by establishing a family trust for the ranch. It was a beginning to estate planning that we all hoped could be further enhanced. Unexpectedly, my father died of a massive heart attack on July 1, 1991. The family trust that had been established to re-structure ownership proved to be of some benefit. My mother's health had been poor prior to my fathers' death and further deterioration occurred. In November 1994, after months of suffering, my mother was hospitalized. After emergency lifesaving surgery due to a cancerous colon rupture, she remained in the hospital until February. On Easter Sunday she passed away.

Following the death's of my parents I completely utilized all available cash reserves and liquidated assets in order to meet the alleged obligation imposed upon my family by the IRS and state of California for their death taxes. Appraisals, attorney fees, and accounting costs have amounted to thousands upon thousands of dollars. Initially we paid $76,000+ to the state of California for death taxes that the state claims technically not to have. The IRS received $49,000+ as a down payment on our "obligation" of over $300,000.

Following our final estate tax return submission, that we assumed would finalize our term payment plan, we received notice of the IRS intent to audit. Additional legal and accounting fees were needed in order to prepare documentation and respond to the IRS audit. As a result of the audit, it was determined that the ranch had been appraised at below market value at the time of my fathers' death. The IRS demanded an additional $11,700+ up front (not to be added to the term obligation) and the state of California required an additional $8,000+....

...At the time, I was left with absolutely no alternative than to engage in a sale of real estate. The only buyers that presented themselves were developers and speculators who maintained no desire for operating an agricultural business or maintaining the open space provided by this working landscape. Each January, from 1996 to 2000, I made the required payment in the amount $16,500+ to the IRS for the interest only installment on my "obligation". In the year 2000, I was invoiced for $36,000 as the amortized payment schedule began. Gross agricultural product sales of $50,000 to $60,000 were not sufficient to service this debt, thus borrowing money was required, pending real estate sales. The sale of two conservation easements on portions of the ranch were finally completed in 2002 and 2005 which allowed the payoff of the loan and estate taxes, however, there remains a capital gains obligation due in April of 2006 estimated at 220,000+. Following the payment of this capital gains tax, there will be a total depletion of the sales proceeds from the conservation easements.

Given this family narrative, how can the Federal Estate Tax be considered fair and equitable treatment?

My grandfather purchased this ranch in 1918 and every payment due to purchase the ranch was made as agreed. Every property tax bill ever presented was paid as agreed and every dime of income tax due for ranch-generated income was paid as agreed. Multi-generational land ownership, the American dream for generations of future farmers and ranchers is officially dead.

Even when the farm isn't sold, the death tax often results in drastic changes to its composition. These changes are almost always deleterious for the local ecology. Hannah Tangeman-Cheney's experience[15] is indicative:

> Mrs. Tangeman-Cheney's ranch has been owned by her family since 1862, and run by women since 1914. Hannah's mother passed away in 1990. Immediately, Hannah found herself working with the IRS, attorneys and appraisers, while her grieving got pushed aside. Her mother had a will and a trust, but there was a still a significant tax burden placed on Hannah and her sister.
>
> It took two years for Hannah and the IRS to come to an agreement on the appraised land value of the ranch since their appraisers came up with different numbers. Mrs. Tangeman-Cheney entered an agreement with the IRS to pay the taxes off over a ten-year period. As part of the agreement, the IRS placed a lien on her ranch until the amount was paid off in full.
>
> With the weight of the IRS lien on her shoulders, Hannah and her sister made a tough decision: they harvested thousands of trees that they didn't plan on harvesting. 13,157 trees were cut – far more trees than they ever conceived of harvesting under any other circumstances. These trees took over 100 years to grow, and the property had not been harvested since the 1950s. But the burden on the ranch was too much, so they consulted with their local forester to create a timber harvest plan that would have the least environmental impact on the local wildlife and habitat. Moreover, they had to pay capital gains tax on the trees, then turn the rest of the revenue over to the IRS.
>
> This was extremely frustrating for Hannah and her sister because they are environmentally conscious; in fact, the ranch has since been certified as part of the "Green Building" program with the Forest Stewardship Council. Now, Hannah and her sister have the IRS debt paid off, and they have life insurance policies on each other to help with estate taxes in the future. However, if her mother passed away today, Hannah argues they would never be able to pay off the tax burden due to the increased land values.

These stories speak for themselves, and put to rest the lie that the death tax does not affect family farms.

Today's hearing to consider an inheritance tax is far removed from legislative reality. I know as well as the members present that it is unlikely the Committee would mark up legislation to actually replace the death tax with an inheritance tax. Instead of wasting time on what is a foolish idea and a distraction, Congress return to the work of marking-up legislation to actually repeal or substantially reduce the death tax. While this committee delays, farmers and business owners across America wait in the balance.

[15] Hannah Tangeman-Cheney, "Involuntary Harvesting to Pay the Death Tax," *Living Through the Death tax: Personal Stories from Farm and Ranch Families in California,* California Farm Bureau Federation, 2005.

Statement of the American Farm Bureau Federation

Submitted for the Hearing Record

Alternatives to the Current Federal Estate Tax System

United States Senate Committee on Finance

March 12, 2008

600 Maryland Ave. SW | Suite 1000W | Washington, DC 20024 | p. 202.406.3600 | f. 202.406.3606 | www.fb.org

The American Farm Bureau Federation is a general farm organization with producer members who grow every commodity commercially marketed in this country. They do this on farm and ranch operations in 2,800 counties in all 50 states and Puerto Rico.

Federal estate taxes have long been a concern to American farmers and ranchers because of the potential for the tax to force liquidation and hamper or prevent the intergenerational transfer of farm operations after the death of an owner.

While other sectors of the economy have similar concerns, farmers and ranchers are particularly sensitive to the estate tax issue for several reasons. First and foremost, farm operations typically require substantially more in capital assets to generate $1 in income than other sectors of the economy. Hence, a more modest-sized farm operation can pay higher estate tax rates compared to non-farm businesses, even if the non-farm estate generated comparable income while its owners were alive.

In addition to carrying a larger capital burden while operating and a high estate tax burden in death, the typical farm estate has more capital tied up in fixed assets that are difficult to liquidate. Hence, farm estates typically face greater difficulty making the death tax payment.

This disparate estate tax burden has broadened over the last five years due to a combination of rising inflation in asset values and increasing scale economies forcing farmers to get bigger or get out of business. Appreciation in land values, increased costs and more mechanization have worked to increase the size of the average farm operation over time. Hence, farmers and ranchers typically bequeath larger businesses subject to sharply graduated tax rates that translate into big enough tax bills to disrupt larger-sized operations. In many cases, state estate taxes and the cost of complex estate management add to this federal tax burden.

Replacing the estate tax with an inheritance tax or other tax due at the death of a business owner will do little to resolve the issues that plague farmers and ranchers under the current death tax regime. Taxes still will be owed by surviving sons and daughters who want to continue to farm and many will be forced to sell off parts of their business to settle the debt. The forced sell-off of assets can not only destroy the economic viability of the business but can result in "fire sale" returns that further exacerbate a strained cash flow situation.

Over time, Congress has included a number of provisions in the federal tax code to ease the burden of estate taxes. These include provisions that are applicable to all estates as well as provisions applicable only to farm estates. For example, a general unified credit is built into the law, allowing for a sizeable exemption before any tax is collected. In 2007, the exemption from the tax is set at $2 million. Special provisions applicable only to farms and other small businesses include items such as pricing land at its use value rather than its generally higher market value and paying estate taxes over 14 years rather than over the nine months applicable to other estates. These special provisions have historically cut the number of farm estates paying taxes and the taxes they paid by roughly half, but often at the cost of investing considerable time and money in farm estate planning and administration.

Congress wisely moved in 1997 and 2001 to further ease and ultimately to eliminate the estate tax. Estate taxes are being phased down through 2009 and eliminated completely in 2010. Given their estate tax exposure, farmers and ranchers are a major beneficiary of the 1997 and 2001 initiatives. However, the 2001 legislation included sunset language that provides for the reinstatement of estate taxes (a reversion to the 2001 tax structure) in 2011. As a result of this lack of certainty in the law, the cost of estate planning has multiplied while the confidence that farmers place in their plans' ability to protect their farm and ranch businesses has diminished.

Replacing the estate tax with an inheritance tax or other tax due at the death of a business owner will do little to reduce estate tax planning costs plus a transition to a different system will add even more complexity and uncertainty to what is already an estate planning nightmare. The cost of life insurance and attorneys fees is already out of reach for some farm business owners and those that can afford to plan have no assurance that the plan developed will save their farms and ranches from the ravages of taxes collected at death.

For these reasons the American Farm Bureau Federation remains committed to the permanent repeal of estate taxes. Until permanent repeal is achieved Farm Bureau believes that the exemption should be increased to $10 million a person and be indexed to inflation; full stepped-up basis must be maintained; the gift tax exemption should be increased to $20,000 and indexed; and there should be no limits on the amount that property values can be adjusted under IRS code section 2032A special use valuation.

John Ed Anthony
Owner
Anthony Timberlands
1906 Highway 290
Hot Springs, AR 71913

Written Testimony prepared for the U.S. Senate Finance Committee
Hearing on "Alternatives to the Current Federal Estate Tax"
March 12, 2007

Chairman Baucus, Ranking Member Grassley, and members of the Committee: I am making this contribution to the hearing record specifically in response to the claim of panelist Lily Batchelder that "no family farms have been sold due to the death tax." She is wrong and as a tree-farmer in Arkansas, I know it.

At age 69 I serve as Chairman of Anthony Timberlands Inc., a Sub-S Corporation which I own with my two sons and a daughter. My son Steven, now 47 with two sons of his own now in college, is President.

Our company was formed in 1907 by my grandfather and operates manufacturing facilities and owns timberland in South Arkansas in 7 communities employing over 1000 people in the plants and in support of our operations.

We paid the Death Tax when my father died in 1961 and again when my grandfather died in 1980. It is hopeless for my heirs to pay the tax at my death and the company will have to be sold to one of several corporate suitors either at my death or prior, which is more likely, since the handwriting is on the wall unless the tax is repealed. We are one of the last privately owned forest products company of significance remaining in the state and one of only a few remaining in the South, all sold to pay the tax. Allow me to briefly explain why.

Only a fool sits on the track waiting for the train the run over them. The reason it appears to Ms. Batchelder that no family farms have been lost is that the owners of those farms, in anticipation of the inevitable catastrophe of the Death Tax, have all sold the farm prior to the train wreck.

In the process of a lifetime of accumulating assets, bought with after tax dollars, and particularly with regard to farm, range and timberland, many efforts are made by entrepreneurs to jump through countless hoops to deal with the Death Tax. These include the purchase of insurance at enormous cost, legal fees for tax attorneys involving often illogical business plans and formation of complicated trusts, gifts and spin-offs. This almost always results in there coming a time when, at the end of the day, they see that it was a hopeless effort. They then conclude that the only course of action is to liquidate the asset, sell out to the corporate entity, and dissolve the family business.

That's why there are no private companies of consequence, particularly in manufacturing, remaining. It's also the reason no family farms have been sold on the courthouse steps. Innovators and good managers are too prudent to allow their families to be bushwhacked in their final days, so they salvage what they can by selling out, usually to corporate interests, and most often to the detriment of the communities and regions which they have helped develop and nurture. That's why rural America is slowing going away. All the assets once held privately in the small towns of America have been acquired by the multinational corporations, which are never exposed to the tax.

The case for death tax repeal has long been established. It is time for the committee to support legislation which actually ends this unfair and pernicious tax.

Warren I. Blum
7916 Melrose Avenue, #5
Los Angeles, California 90046
STATEMENT FOR THE RECORD
COMMITTEE ON FINANCE
WASHINGTON, DC 20510

February 6, 2008

Chairman Baucus, Ranking Member Grassley, and members of the Committee;
It is my honor to share my concerns about the death tax, and reasons for repeal:

In the late 1940's, my mother and father traveled across the country from New York on their honeymoon to visit Los Angeles. They loved it and decided to stay. They rented a small storefront and opened a Television store in the front, and lived in the back. I am told that I was conceived in that small living quarter.

Eventually, the little store grew into a thriving business selling Televisions and Stereo equipment. My parents were able to acquire two properties within a few blocks of the store containing retail and residential space. Later they bought a house, and then a larger one. In the early 1950's property in Los Angeles was much lower and affordable.

I was born, and a few years later, my sister was born. Those happy years for our family came to an abrupt end when at age 47, my father died of a heart attack.

The TV and Stereo business was sold, and under new management closed down soon thereafter due lack of success. What was left for our family were the properties that my parents had acquired, which consisted of my parents' residence, a three unit residential property, and the two commercial properties. My mother lived in the residence, and the other properties provided her with a modest income.

After I graduated college and law school, I worked in various business, but eventually settled on helping my mother to manage the properties. Today we manage the properties together. My office is in one of the buildings we own, a block away from where my parents started and from where I was conceived. I have spent most of my life in this neighborhood. I have seen people come and go. I see a lot of familiar faces and longtime acquaintances. This neighborhood is in my blood.

Now, property values have increased significantly to the point where, even though there are only a few buildings, when my mother passes on, I may be forced to sell the properties to pay the estate tax. The current exemption amount will be insufficient to protect us. Not only will I will lose my dear mother, and my management job, but I may have to move away from the neighborhood I was born, raised, and worked in, and go somewhere where property values are lower. This is not a happy prospect.

I realize that the death tax is the law, but it is an unfair and immoral law. It confiscates the fruits of a lifetime of hard work by someone like my mother to pass something on the future generations of our family. It penalizes my mother for keeping her capital invested, rather than depleting her estate by spending on luxuries. It discourages sons and daughters from participating in a family business. For instance, since I don't have an ownership interest in the business yet, the fruits of my labor will also be subject to the death tax. It also causes interfamily conflict, as the overwhelming financial burden on the business caused by the tax makes it difficult to provide a continuation of livelihood for all members of the next generation.

The death tax is now 45%, and in a few years, it is scheduled to go back up to 55%. Because of the cost of money to borrow such a large percentage of our capital investment value, and the need to pay back principal, it appears that it would be impossible to keep our family business intact.

I urge you to repeal the death tax immediately.

Thank you for this opportunity to provide a statement.

Warren I. Blum

BEEF USA

NATIONAL CATTLEMEN'S BEEF ASSOCIATION

1301 Pennsylvania Ave., NW, Suite #300 • Washington, DC 20004 • 202-347-0228 • Fax 202-638-0607

March 12, 2008

The Honorable Max Baucus Chairman U.S. Senate Finance Committee 219 Dirksen Senate Office Building Washington, DC 20510	The Honorable Charles Grassley Ranking Member U.S. Senate Finance Committee 219 Dirksen Senate Office Building Washington, DC 20510

Dear Chairman Baucus and Ranking Member Grassley:

The National Cattlemen's Beef Association (NCBA) appreciates your continuing efforts to address the immense logistical and financial burden placed upon farmers, ranchers and small businesses by the current estate tax. We recognize the Finance Committee's hearing entitled "Alternatives to the Current Federal Estate Tax System" as a step towards meaningful action on this important issue, and I appreciate this opportunity to offer our thoughts.

Producer-directed and consumer-focused, NCBA is the largest and oldest organization representing America's cattlemen and women, and it is dedicated to preserving and advancing the beef industry. Tax policy is a key factor impacting American cattle producers, particularly in today's difficult business climate. Additionally, the long-term viability of our industry is dependent upon the ability to pass on a farm or ranch to the next generation without exhausting resources for arduous planning, or being forced to break apart economically viable operations. The current tax structure for addressing the transfer of assets at the time of death fails in both of these regards.

Under current law, farmers and ranchers have no choice but to direct monetary resources to costly estate planning given that major components of the Death Tax shift from year to year. Furthermore, the financial worth of farmers and ranchers is rarely derived from liquid assets such as cash, but rather from the value of their land and equipment. Thus, they are faced with the very real threat of being forced to break-up and sell-off portions of the operation in order to obtain the funds necessary to meet liabilities imposed by the Death Tax. It is unacceptable that farming and ranching families, who have succeeded in building a successful business and who have a sincere interest in seeing it continue on with the next generation, are burdened in this manner.

It is absolutely essential that any legislative effort to eliminate or reform the Death Tax addresses these fundamental issues. However, our assessment indicates that replacing the current law with an inheritance tax will do nothing to remedy these problems. First, the inheritance tax merely shifts the burden of the tax to the next generation. For families seeking to keep their farm, ranch or business intact, this will do nothing to preserve or protect the value of the business.

Secondly, dividing the operation into smaller offerings in order to accommodate the inheritance structure may not be an option for every producer. If a farmer or rancher wants to pass their operation along to the next generation and he/she has only one child, the concept of dividing up the tax liability may not be possible because the value of the business is in the assets. Again, the inheritance tax would fail to reduce or eliminate the burden relative to the current Death Tax.

In addition, replacing the current tax structure with an inheritance-based mechanism will do nothing to address the inherent disparity between different sectors with regards to planning for the tax. Wealthy individuals will continue to be able to pay teams of highly specialized accountants and planners to help them navigate the new law and evade tax liability; that won't be the case for small businesses. Instead, farmers and ranchers who have invested in prudent estate planning will not only be left with a useless estate plan, but they will also be faced with the challenge and significant cost of planning for a completely new tax.

Cattle producers understand and appreciate the role of taxes in maintaining and improving our nation, but they also believe that the most effective tax code is a fair one. For this reason, NCBA members fundamentally disagree with the taxing of assets that have already been taxed, sometimes two and three times over. In the eyes of American farmers and ranchers, death should not be a taxable event for either the estate or its heirs.

NCBA members have long been fervent supporters of full and permanent repeal of the Death Tax. Our commitment to that outcome is unwavering, even though we understand it may not be politically possible at this time. The reality is that regardless of all political beliefs and budgetary constraints, the Death Tax continues to be a significant burden to farmers and ranchers. Therefore, it is with a complete dedication to bringing about meaningful relief for these families, that we stand ready to work with you to address this issue.

NCBA appreciates the Senate Finance Committee holding this hearing on the "Alternatives to the Current Federal Estate Tax System." Congress must take steps to address the challenge facing cattle producers as they struggle to plan for the transfer of their livelihood from one generation to the next. It is imperative, however, that as Congress contemplates legislative action, careful attention be paid to the impacts of various ideas on planning costs and the ability of farmers and ranchers to meet tax liabilities without dissolving their operations. In applying these standards to the topic at hand, for the reasons outlined above, NCBA does not support replacing the estate tax with an inheritance tax. U.S. cattle producers need your leadership to bring about certainty and relief from the Death Tax, and I look forward to a continuing dialogue on this important issue.

Sincerely,

Andy Groseta

Andy Groseta
President, National Cattlemen's Beef Association
Arizona Cattle Producer

John R. Woloshen
Owner
RATA Associates, LLC
1916 Boothe Circle
Longwood, FL 32750

Written Statement for the U.S. Senate Finance Committee
Hearing on March 12, 2008
"Alternatives to the Current Federal Estate Tax System"

Chairman Baucus and Members of the Committee: I simply find it hard to believe how short-sighted some policymakers and interest groups are. The inheritance tax presented today as an "alternative" to the current death tax will affect no change in the tax burden experienced by small-businesses such as my own.

Any form of death taxation will, without a doubt in my mind, eat up my entire estate since I own a small but very successful business. Regardless of whether the tax is applied to my children or to me, the burden of the tax will fall on the business and its 14 employees. When I die, my business will undoubtedly have a tax bill greater than all of my other assets combined based on the money it generates, even though it is so specialized that it has a very low, possibly 'zero' market value. My two grown children who have been running it and making it grow for more than 10 years without my help will not inherit anything and the business will go down the tubes, putting both of them out of work along with 14 high-paid technical employees.

My business, RATA Associates was founded in 1989 to provide software support for compliance with certain federal housing regulations. I believed in my ability to make this business successful, and initially worked 70-80 hours a week to get it going. My effort was rewarded, as the service turned out to be a profitable niche market and provided substantial revenue, most of which was reinvested in software improvements. However, the same boutique specialty that makes the business successful has also made it effectively worthless as market value is concerned. My main "assets" are the minds of the employees who understand the complexities of our software, the regulations of the Home Mortgage Disclosure Act, Fair Lending, and Community Reinvestment Act, and the proprietary services that we have developed to help banks and lending institutions achieve compliance with these regulations. As a result, the IRS most likely will value the business very high based on past and expected future profits, but there is not enough tangible assets or property which could be sold to raise the cash needed.

An inheritance tax which taxes the individual bequests to my son and daughter, rather than my estate, would still leave my children in a bind. After taking a small exemption, perhaps $2 million a piece, they would still be forced to pay over half of the value of the business in taxes. This could easily come to $10 to $20 million. The only way to pay this would be to sell the business, or take out a loan that would make running the business more of a chore than those two bright individuals deserve. In fact, it is likely that the highest loan I could take out would be $1 million, which would not be enough to cover the likely death tax levy.

The federal government will possibly have a short term tax windfall by taking everything I own and/or forcing the sale of houses and office building at 'fire sale' prices to make them sell quickly. However, in about 5 years time or less, it will have taken in less than it would have if the business were to keep running and growing, just from the income taxes paid by my two children and the 14 (possibly more by the time I pass away) employees.

My employees are some of the most intelligent, hard-working and loyal individuals I have ever known. Many of them have been with me from the start, and they have stuck with the company through slow periods and rough patches. They do not deserve to have their employment – and for that matter, retirement – security, thrown into a tail-spin due to a tax which neither I nor my children will be able to afford.

Honorable Senators, I am very frustrated. I am also somewhat angry that this insidious tax is still with us when simple 'COMMON SENSE' says it should have been repealed long ago. The IRS has already taken 30-40% of my business's earnings through the income tax. Is it too much to ask that my children be allowed to keep running the business, preserving my employees' jobs and providing long-term income tax revenue?

I realize that some people think that all businesses possess the liquidity of Bill Gates or Warren Buffett, and therefore face no serious burden with the death tax. Unfortunately, this is not the case for me. I cannot set up foundations, hire a legal team specifically for the purpose of rearranging my assets, or otherwise take advantage of the many benefits open to individuals such as Gates and Buffett. When I die, absent a repeal or significant reduction of the existing death tax, my children will definitely be forced to try to sell the business.

Right now, it seems the prospects for positive legislation are low. I fear we will go into 2010 with a 'recipe for murder' in place, and come out in 2011 with what we have now or worse. Members of the Senate Finance Committee, I ask that you prevent this from happening by supporting legislation to repeal the death tax or substantially reduce its rate. This is the only appropriate "alternative" to an unfair and destructive tax.

I'm sure that my situation is not unique. There are tens of thousands of small businesses who face the same problem. This tax is a nightmare for people like me who are trying to live the American dream. Thank you for your time and for your efforts to deal with this threat to my livelihood and that of my family.

Duane Shumaker
Owner
Schumaker Trucking and Excavating
3501 Havre Hwy
Great Falls, MT 59404

Testimony to the U.S. Senate Finance Committee
"Alternatives to the Current U.S. Estate Tax System"
March 12, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Committee: I am honored to present testimony on today's hearing, "Alternatives to the Current Federal Estate Tax System". As a family-business owner, I want to explain why Congress should repeal, not replace, the federal estate tax, or death tax. Any "alternative" which leaves a large confiscatory tax in place will damage, if not destroy, Shumaker Trucking and Excavating.

Shumaker Trucking and Excavating was born out of the cold war arms race, as the military needed contractor support for missile silo installation. We were hired by the military to transport site materials and provide labor for digging and constructing the silos that would house the ballistic missiles. When we first started, our only assets were a few dump-trucks and basic construction equipment. Over time, we have grown into a moderate-sized full-service contractor. We now serve a variety of projects, most of which are government related.

Like many family-owned businesses, Shumaker Trucking and Excavating is asset rich but cash poor. In order to maintain a competitive edge, we plow the majority of our profits back into the business. We have no mythical slush fund of cash. This family's American dream requires constant reinvestment in order to stay afloat.

The result of this lack of cash is that the future obligation of paying the death tax – currently at a rate of 45% but slated to return to a much higher rate of 55% - would entail selling of considerable assets in order to raise sufficient cash. We cannot afford to sell off 10% of our existing assets without the business becoming unsustainable and likely folding – let alone 55%. Yet this is just what the law would require us to do.

Of course, the IRS in its generosity also extends the option of a 10-year deferred payment plan. This may be workable for families with liquid assets, but few cash-strapped businesses are prepared for an unprofitable tax burden. 10-years of payout to Uncle Sam, depending on my business's valuation, could cost more than the business can reasonably sustain. Even if the business is kept viable, such a loan would certainly hamstring future growth and could result in payroll cuts to some of my 60-employees.

Like most family business owners, I have taken out life-insurance in order to provide some liquidity when I die, but it will not be close to enough. The harsh reality is that my family will face very harsh choices when I die. My wishes are to pass the operation on to one of my two sons, both of which have shown interest in the business. Of course, they are too young now to decide their future, but I think it is absolutely unjust that the death tax could remove this opportunity from consideration.

I understand that the Senate Finance Committee has heard a panel of witnesses propose "alternatives" to the death tax, most prominently a proposed "inheritance tax". Having read through the panelists' remarks, I have trouble understanding how this "inheritance tax" would be any improvement over the current estate tax.

As explained by panelist Lily Batchelder, the inheritance tax would be designed to fall more on the heir rather than the deceased. Specifically, heirs would be able to inherit a certain amount – perhaps $2 million – exempt from the tax. Above that, they would be subject to the current rate of income tax (35%) plus a "surtax" of 15%. Currently, that would come to 50%, slightly more than the 2008 death tax rate of 45%. And if Congress does not make the 2001 tax relief permanent, then the income tax rate will rise to 39.6%, making the total inheritance tax come to 54.6%, just below the 2011 death tax rate. Finally, this assumes that stepped-up basis for capital gains is retained, which I've been told Ms. Batchelder wants to eliminate. Without stepped-up basis, the full inheritance tax burden could come to almost 70%.

The effect of this tax will be to place family-owned enterprises such as mine between a rock and a hard place. Of course, one option is simply to bequest all of the company's ownership to one or both of my sons' and let them deal with paying 50% of the company's value in tax. My prior remarks should make clear why this is not acceptable.

The other option would be to split up the family enterprise between enough heirs that each receives no more than $2 million of total income. The problem with this is that I have only 2 sons, and my company is valued well over $4 million. In order to take advantage of the proposed exemption, I would have to bequest shares of my company to individuals' who lack long-term interest in maintaining the business's viability.

I do understand that Ms. Batchelder has some understandings of how her proposal would fall on family-owned businesses, and has suggested a sort of "deferral" plan. According to her, this deferral would allow those who lack liquid assets to defer paying the tax until they sold the business. Though this may seem benign at first blush, it comes with a host of complications. First, Ms. Batchelder made it clear that until the tax is paid, interest would accrue on the amount of deferred tax. This means that the total amount due will climb even higher than the total rate. Second, it is assumed that the IRS would place a lien on the property for amount of tax owed as long as it is deferred. I can tell you that it would be very hard, if not impossible, for my company to continue to grow while subjected to an IRS lien.

There is no way to "improve" on the death tax. Business owners such as myself will continue to face harsh decisions about the future of their company as long as it exists. Some proposals may shift the technical burden on paper, but the final effect will be the same. Any redistributionist tax will punish those who have worked hard and invested themselves and their profits in a viable company.

I recommend that the Senate Finance Committee get back to the work of crafting legislation to permanently and substantially reduce, if not repeal, the existing death tax. Thank you for hearing my remarks.

Bill Simkins
Vice-President
Simkins-Hallin
326 North Broadway
Bozeman, MT 59715

Statement for the Record to the:
U.S. Senate Finance Committee
March 12, 2008 hearing

"Alternatives to the Current Federal Estate Tax System"

Chairman Baucus, Ranking Member Grassley, and members of the committee: I am pleased to present testimony about "Alternatives to the Current Federal Estate Tax System." As the Vice-President of a family-owned business in the state of Montana, I have a particularly strong interest in permanent repeal of the death tax.

Simkins-Hallin was originally started as a lumber yard by my father and grandfather in 1946. In the last 61 years, we have become very successful, employing over 170 individuals and providing considerable economic growth for the local community. Though lumber remains the primary operation of the business, we also are very invested in local development. In fact, our current project is development of real estate around the Big Sky ski resort. A recent economic development study found that big sky is responsible for $1 billion in Montana's economy. Our development will help Big Sky become a premiere vacation spot and will result in increased economic growth and tax revenues for the state of Montana.

With that in mind, it is hard for me to understand why Congress refuses to repeal the death tax, a tax that hampers my business's growth and is going to make it very difficult to pass it on to the next generation of the family.

You see, the family business is very "cash poor." Our capital is in the form of hard assets such as property, machinery, lumber and payroll. Simkins-Hallin relies upon constant reinvestment of profits. The management team takes very small salaries in order to plow the majority of our resources into growing the business. This is common of many businesses and stands in stark contrast to the fallacy that a $10 million business has $10 million in liquid assets.

This lack of cash means that when the principal owners of the company die, the heirs will be forced to sell existing assets and likely take on expensive loans in order to pay the 55% death tax. It is very possible that we may have to sell the business entirely, rather than passing it on to the next generation of the family. For Simkins-Hallin, the death tax is a large and troubling unknown.

In fact, last December my family met to try to find a way to pay for the future death tax levy. Our options are less than optimal. Unlike billionaires such as Warren Buffett, most small business owners do not have the time or money to make use of expensive tax-planning measures.

We currently are paying for life-insurance, which is already a drain on the business and will only become increasingly so as the owners become older. Other options include deferring the tax and taking out large loans. However, we cannot sustain a high amount of debt and still stay in business over the long term– particularly loans which will not provide future profits. Honestly, it doesn't make economic sense that we should have to waste our precious resources in order to prepare for the death tax. My family left the December meeting frustrated with lack of a solution to dealing with the death tax.

I am very bothered that Congress thinks replacing the death tax with an inheritance tax counts as reform. Of course, I would rather that Congress simply repeal the tax. Short of that, the rate should be substantially reduced. The inheritance tax "alternative" discussed at the hearing will not effectively change the burden of the death tax for my family or other family-business owners.

As I understand it, the inheritance tax rate would be equal to, if not larger than, the current death tax when considered in full. Apparently the tax will allow for an exemption, likely in the realm of $2 million, for each heir. Unfortunately, our business is worth considerably more than we have suitable heirs to bequest it. In order to fully take advantage of the exemption, we would be forced to bequest shares of the business to relatives who have little interest supporting the long-term growth of the business. As a result, the exemption would be of little use to us, leaving the family in the same place as the current death tax.

As for the proposed "deferred payment plan" for family-businesses who lack cash, it is important to keep in mind that any debt – whether due immediately or far in the future – comes with immediate consideration. Even assuming we are never to sell the business, which of course is our hope, a perpetually deferred debt would undoubtedly be secured with an IRS lien. This would likely hamper the business's ability to obtain further loans, which it depends on for development projects such as Big Sky.

Moreover, I understand that interest would accrue on the amount of the tax as long as it is deferred. Every year my family will face the reality of an even higher tax should they choose to sell for lack of heirs to run it, or need the cash to deal with an emergency or start a new business. With all due respect, whoever proposed this idea does not understand that putting off a future obligation does not make it go away.

Congress should refocus efforts on actually dealing with the tax in a way that takes into consideration the burdens it places on businesses like Simkins-Hallin. Though the Senate certainly is within its rights to hear proposals for such concepts as the inheritance tax, it has little import for family-business owners throughout the nation. We need a real solution and we need it soon. I respectfully ask that the Senate Finance Committee quickly draft legislation to repeal or substantially reduce the death tax.

SMALL BUSINESS COUNCIL OF AMERICA

Comments Submitted to the United States Senate Committee on Finance

Hearing on
Alternatives to the Current Federal Estate Tax System

March 25, 2008

Prepared by Paula A. Calimafde Esq.
Chair of the Small Business Council of America

The Small Business Council of America (SBCA) appreciates the opportunity to submit our comments to the Senate Finance Committee's March 12, 2008, hearing titled "Alternatives to the Current Federal Estate Tax System."

The SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Advisory Boards, many of whom are the leading experts in the estate tax law and how that law impacts small and family-owned businesses.

Background

The 2001 Tax Act created a legal landscape that makes it impossible for small business owners and other taxpayers to plan their estates with any predictability. Over the next four years, the amount exempt from estate taxes will vary from $3.5 million to $1 million and in one year (2010), the entire estate tax system is repealed! This unpredictability has undermined taxpayer confidence in the estate tax system.

The estate tax system was developed to avoid the problems that occur when a very small elite of the country is able to amass great wealth and pass this wealth down to the next generation; it was not intended to cut in half the estates of working Americans who had built up a family business or a small business based on their own hard work.

Estate Tax Certainty and Reform Needed Now for Small Business Owners

Small businesses need certainty in the estate tax area. In order to assist small businesses, the estate tax exemption should be increased to the $3.5 million dollar level this year - not in 2009. The SBCA is in favor of reforming the existing estate tax system and does not support repealing the estate tax law in 2010 and beyond. We believe the following reforms are needed:

- Increase the estate tax exemption amount *immediately* to $3.5 million and then increase it gradually over a number of years until it reaches *at least* $5 million and thereafter have it increase by COLA

- Preserve the step-up in basis at death for simplicity

- Reunify the estate and gift tax exemptions, increasing the gift tax exemption to immediately equal the estate tax exemption, for simplicity and flexibility

- Exempt retirement plan assets from the estate tax in an amount up to an additional $1 million if assets are going to a surviving spouse and up to an additional $500,000 if the assets are going to other heirs

By implementing these steps, small business owners who have worked a lifetime to build their companies will, in most cases, be exempt from the estate tax system.

The SBCA is opposed to the proposed repeal scheduled to take place in 2010. This is because total repeal would be accompanied with a loss of the step-up in basis and a continuing $1 million cap on the gift tax exemption. Unfortunately, many small businesses will actually end up paying more taxes under the proposed repeal in 2010 than they would with the increased exemption proposed to be in effect in 2009 because of the loss of the step-up in basis.

To understand the repeal proposal and our pro-small business reform proposal, there are a few basic concepts to our estate tax system that should be discussed.

<u>Step-Up in Basis</u>

Under our current estate tax system, any assets that a person receives from another person's estate receive a "step-up" in basis - this means that the person receiving them gets them with a tax basis increased to fair market value as of date of death. Thus, when a person decides to sell the property, he would be taxed on the difference between the sales price and the date of death fair market value (this gain would be subject to either income tax or capital gains tax depending upon the asset).

Upon the full repeal of the estate tax in 2010, the current rule providing for a fair market value basis in property acquired from a decedent (i.e., the step-up in basis) is repealed. In lieu of this rule, the recipient of property acquired from a decedent will have basis in such property equal to the lesser of the decedent's adjusted basis in the property or the property's fair market value at the time of the decedent's death. However, recipients of property from a decedent will be entitled to an aggregate basis increase of $1.3 million (adjusted for inflation after 2010). In addition, the decedent's surviving spouse will be entitled to an additional aggregate basis increase of $3 million (adjusted for inflation after 2010). Accordingly, if a decedent is survived by the decedent's spouse and the value of the decedent's estate is $4.3 million, the full amount of the estate will pass to the spouse free of any estate tax and the surviving spouse will have a stepped-up basis for the entire estate. If there is no surviving spouse, then only $1.3 million of assets will receive the step-up in basis.

<u>"Exemption Level" (formerly the "Unified Credit")</u>

Any assets that a person owns up to the estate tax exemption level - $2 million this year, can be given away at death, free of estate taxes. This is referred to as the estate tax exemption or exclusion amount and it is scheduled to increase in 2009 to $3.5 million. This means a couple could leave $7 million to their heirs without the imposition of estate tax and with a step-up in basis on the entire $7 million of assets, *if* they did some basic estate planning. If they did not do any estate planning, then only $3.5 million would be exempt from estate taxes. Assets in excess of $3.5 (or with proper estate planning done for a married couple, $7 million) in 2009 would be subject to the maximum estate tax rate of 45%.

In the 2001 Act, Congress was concerned that once the estate tax was repealed, taxpayers would refocus their efforts on shifting assets to lower income tax bracket taxpayers (such as their children or grandchildren). Accordingly, Congress capped the gift tax exemption (which had for a long time been "unified" [or in lockstep] with the estate tax exemption) at $1 million. Thus, although a person can pass up to $2 million estate tax free today (scheduled to increase to $3.5 million in 2009), only $1 million can be passed during lifetime.

Many estate planners have found that this artificial cap on giving has caused the senior generation owners of small businesses to not be able to pass ownership of the family business to the next generation.

Example – Why Making The Law in 2009 Permanent Rather Than Repeal Is Advantageous for Small Businesses

Assume there is a small business owner who has $3.5 million of assets and no surviving spouse.

<u>Under total repeal</u>: $1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining $2.2 million of assets will have the basis that the decedent had in those assets.

As an aside, imagine if the decedent were an 85 year old man who acquired many of these assets more than 40 years ago... how anyone is even going to be able to figure out the carry over basis of those assets is beyond us.

The burden is on the heirs to prove any basis, and many will fail to have enough records, resulting in a zero basis. The step-up in basis was repealed back in 1976 and was then reinstated in 1980, though the carry-over rules never became applicable during that period, because Congress learned from attorneys and accountants who handled the probate process that the carry-over basis rules were unworkable because it was almost impossible to determine the carry-over basis for many assets.

Now when the heirs of this decedent sell this $2.2 million of assets, they will be subject to income tax on the difference between the then fair market value of the assets and any basis they can prove the decedent had in those assets. For example, let's assume that the heirs are able to prove that the carry-over basis in the assets is $1 million - then the heirs will be taxed on $1.2 million (assuming the fair market value of the assets was still $2.2 million).

With a $3.5 million exemption:

All $3.5 million of assets receive a step-up in basis to the $3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets (assuming the fair market value of the assets was still $3.5 million), there would be *no* income tax and *no* estate tax.

A single person with assets greater than $1.3 million up to $3.5 million is better off under the estate law as it stands in 2009 and in most cases ends up in a worse tax position under repeal of the estate tax. Similarly, a decedent who is married with assets greater than $4.3 million up to $7 million does better under the law as it would stand in 2009 than he/she would under total repeal. This covers a significant amount of taxpayers based on the data that illustrates how many taxpayers drop off of the estate tax rolls as the exemption amount increases. Based on data set forth in a March 16, 2005, issue paper from the Center on Budget and Policy Priorities[1]:

- If the estate tax exemption were $1 million in 2011, then 53,800 estates would be subject to the estate tax. Of the 53,800 estates that would be taxable, nearly half

[1] This paper is entitled, "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options with Low Tax Rates Raise Very Little Revenue" by Joel Friedman and Ruth Carlitz.

(46%) would have assets of less than $2 million and nearly three-fourths would be valued at less than $3.5 million.

- If the exemption level in 2011 were $2 million instead of $1 million, then the number of taxable estates would shrink to 21,000. This is a reduction of 61% in the number of estates that would face the estate tax.

- If the exemption amount in 2011 were $3.5 million instead of $2 million, then the number of taxable estates would drop to 8,500 (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were $1 million in 2011).

These numbers demonstrate how many small business owners would be worse off under total repeal than if the law were frozen at 2009 (with the $3.5 million exemption and the step-up in basis). Unfortunately, many small businesses owners do not understand the negative impact of repeal because they do not understand the carry over basis and the ultimate imposition of income tax on those assets which do not receive a step up in basis.

If the SBCA represented the interests of the wealthiest individuals in America, our suggestions would be entirely different. We would *not* suggest increasing the exemption amount because when one's estate is a billion dollars it does not matter at all if the exemption amount if $1 million or $3.5 million – the impact is negligible. What does matter is the tax rate. Thus, a tax rate of 45% is incredibly significant when a billion dollars is involved. Contrast this to the small business owner whose entire estate is $3.8 million. If the exemption amount is a $1 million or $3.5 will make a huge difference to the heirs and an estate tax rate of 45% on $300,000 does not appear to be overwhelming. A recent CRS Report ("Estate and Gift Tax Revenues: Past and Projected in 2008, March 19, 2008"), set forth the following query: "What explains the persistence of revenues despite a dramatic drop in the number of taxable estates?" The answer is:

> While large in number, the smallest estates as a group contributed relatively little in estate taxes. Although the two lowest gross estate size classes accounted for 33,179 or 64% of the 51,736 taxable returns filed in 2001, they contributed only $2.7 billion or 11% of the $23.5 billion in estate taxes paid. The large decrease in the total number of taxable returns between 2001 and 2005 can be explained by the elimination from taxability of the large number of estates in the two lowest gross estate size categories (under $1 million and $1 million up to $1.5 million) after the prevailing exemption rose to $1 million in filing year 2003. There was a further large decrease in the number of taxable returns in the $1 million to $1.5 million category and a smaller decrease in the $1.5 million to $2 million category in filing year 2005, when the prevailing exemption rose to $1.5 million.
>
> Between 2004 and 2005, the $1.4 billion loss in estate taxes paid by these two smallest size classes plus a $0.7 billion loss in the $2 million to $3.5 million gross estate size class, was more than offset by the $2.1 billion

> increase in taxes collected from the largest size class, with gross estates of \$20 million or more. (at p.10)

For years the SBCA has tried to come up with an effective reduction in tax rates for small business and we have not been successful. When one takes into accounts that among our advisory boards and board of directors, we have many of the leading estate planning advisors in the country for small business and we have been unable to come up with an effective exclusion, our guess is that none exists that will a) work correctly and b) not be subject to abuse.

We know that such an exemption should not bear any resemblance to the Qualified Family Owned Business Interest (QFOBI) exemption that came into law a few years back (and would spring back into existence in 2011, if the law is not changed). This rule was not only absurdly complicated, but suffered from the most severe planning defect - a business owner would not be able to know if he qualified for the exemption until death occurred.

Promote Retirement Savings

The SBCA believes that giving an exemption for up to $1 million in retirement plan assets that are left to a surviving spouse and up to $500,000 for retirement plan assets that are left to others would go a long way towards promoting retirement plan savings by small business owners and others. This estate tax exemption on retirement plan assets is also important because these assets can be subject to estate tax and income tax when distributed to the deceased plan participant's beneficiary. Currently, the incentive for contributing money to a retirement plan (and thereby locking it up until retirement) is being diminished by the lower tax rates on capital gains and dividends that do not apply to funds coming out of a retirement plan.

Example of the Small Business Nightmare under the Current Federal Estate Tax Landscape

Imagine Mr. Entrepreneur is the sole proprietor of a small business, Innovative Inc., which, together with his home, totals $3.5 million in assets. Mr. Entrepreneur's wife has passed away and his single heir is his daughter, who may or may not want to take over the business, once her father passes away. Mr. Entrepreneur wants to provide the best that he can for his daughter, Ms. Smart, upon his passing and he is currently seeking out the best plan. Unfortunately, in the current federal estate tax landscape, the next 4 years are almost too volatile to do any planning unless he was able to decide what year to die!

Let's say that Mr. Entrepreneur's assets will be valued the following way upon his death:

Asset	Decedent's Basis	Fair Market Value at Death
Innovative Inc.	$100,000	$2,600,000
Residence	$500,000	$900,000

Without Congress Acting:

If Mr. Entrepreneur were to pass away in the next five years, the following will occur:

- In 2008, Ms. Smart would owe $675,000 in federal estate tax.
- In 2009, (when the exemption level is $3.5 million), Ms. Smart will owe no federal estate tax.
- In 2010, the federal estate tax will have been repealed and the step-up in basis is significantly changed. Ms. Smart will have the burden to find the documentation of her father's basis in his property (which could have been purchased decades ago). In 2010, the law provides that Ms. Smart will receive $1.3 million in assets with a stepped-up basis to fair market value. The remaining $2.2 million in assets will have the same basis that her father had in those assets. Assuming Ms. Smart were to allocate all of the step-up basis to Innovative, Inc. and a capital gains tax of 15%, Ms. Smart would pay $255,000 in capital gains tax, if she chose to sell the business and the house. That is $195,000 for Innovative Corp (15% of $2.6 million minus the $1.3 million in step-up basis and $60,000 for the residence (15% of $900,000 minus $500,000). Depending on what documentation can be provided, Ms. Smart can pay as much as $330,000 (15% of $2.2 million) or as low as $255,000. Note that these taxes will not be due until Ms. Smart chooses to sell the house and the business.
- In 2011, the federal estate tax will be $1,220,000, because the exemption reappears at $1 million, which, in effect, would be devastating for Ms. Smart since she could not even cover the cost by selling the residence so she would be forced to sell all or a portion of the business, even if she wanted to keep running it. It is possible that some portion of the $1,220,000 will be paid to a state government depending upon the state's estate tax law.

How can Mr. Entrepreneur plan properly for an estate tax which in the next 4 years can fluctuate between zero and over a million dollars on a relatively modest estate!

With Congress Acting:

If Congress enacts a $3.5 million exemption immediately, all of Mr. Entrepreneur's assets would receive a step-up in basis of $3.5 million, assuring that there would be no federal estate tax and no income tax. If Congress reunited the estate and gift tax systems, Mr. Entrepreneur could gift his business to his daughter during his lifetime, if that made business sense. Furthermore, if a gradual increase to $5 million exemption were enacted, Mr. Entrepreneur would not be disincentivized to grow his business which in turn would keep our economy growing. In effect, Congress would have repealed the federal estate tax for Mr. Entrepreneur and most other small business owners who were never intended to be punished for their hard work.

Recommendation

To protect small business owners, Congress should increase the exemption amount immediately up to $3.5 million and then increasing the exemption amount over the next several years, retain the step-up in basis and reunify the gift and estate tax exemptions. Retirement plan assets should be exempt from the estate tax in an amount up to an additional $1 million if assets are going to a surviving spouse and up to an additional $500,000 if the assets are going to other heirs

By enactment of these reforms, most small businesses will be removed from the reach of the estate tax.

Ms. Calimafde is the current Chair, past President and a member of the Board of Directors of the Small Business Council of America, Inc., the only national non-profit organization which has represented the interests of privately owned businesses exclusively in the Federal tax, retirement, health care and employee benefits areas for the past twenty-five years. She received her B.A. from Swarthmore College and her J.D. from Catholic University.

She is a partner in the Bethesda, Maryland law firm, Paley Rothman, where she chairs the firm's Retirement Plans Practice Area and the Employee Benefits Practice Area. Ms. Calimafde has nearly 30 years of experience advising small businesses and closely held businesses in tax areas and estate planning. For nearly 30 years, she has been a legislative advocate for small and closely held businesses in the Federal tax, health care and employee benefits arena.

In 1986, Ms. Calimafde was elected at the Maryland State Conference to serve as a delegate to the White House Conference on Small Business. She was subsequently appointed by the White House Conference to serve as one of eleven National Commissioners of the 1986 White House Conference on Small Business. As such, she chaired the Payroll Costs Session at the National Conference, which covered qualified retirement plans, employee benefits and social security, among other issues. In 1995, Ms. Calimafde was appointed by the White House to serve as a Presidential Delegate at the 1995 White House Conference on Small Business.

She is also a member of the Board of Directors of the Small Business Legislative Council (1992-), Past Chair (1988-1990) and Vice Chair (1986-1988) of the Closely Held Committee of the ABA Tax Section, Advisory Board of the Journal of S Corporation Taxation, 1989-1994, Employee Benefits Council, Chamber of Commerce of the United States, 1986-1994, 1996-, and Small Business Council of the U. S. Chamber, 1995-1998 and the Washington, D.C. Estate Planning Council, 1994-. She is a fellow of the American College of Tax Counsel, the American College of Trust and Estate Counsel and a charter fellow of the American College of Employee Benefits Counsel.

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