

REFORM OPTIONS FOR THE ESTATE TAX SYSTEM: TARGETING UNEARNED INCOME

Lily L. Batchelder¹

Associate Professor of Law & Public Policy, NYU School of Law

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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

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

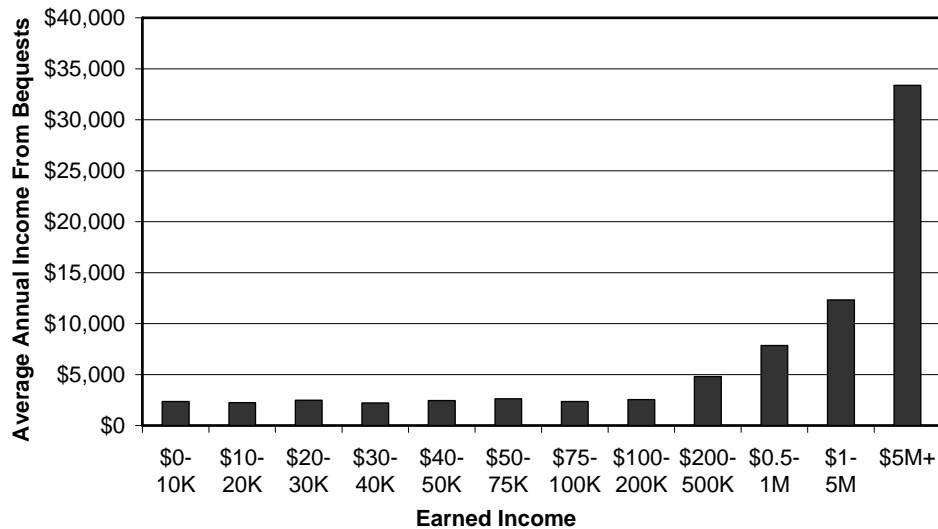
³ Unless otherwise noted, all estimates in this testimony are based on 2009 law and data, and are derived from Batchelder and Khitatrakun, *supra* note 1, or Batchelder (2008), *supra* note 1. These estimates are very rough because of data limitations that require multiple levels of imputation and because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



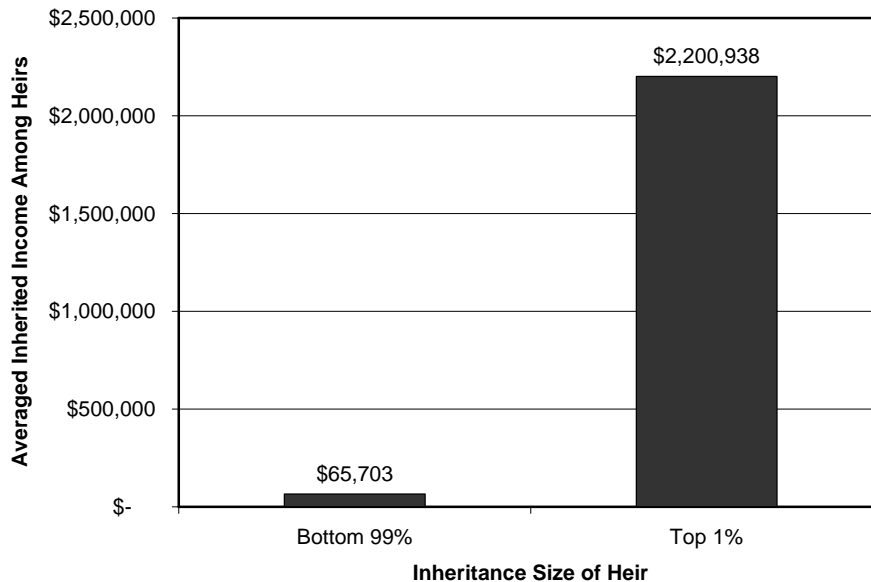
In addition, inheritances are perhaps the most important barrier to intergenerational economic mobility, or the ability of a child to achieve a different standard of living than that of his parents. The income that a child earns over his lifetime continues to be heavily influenced by the income of his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

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.

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

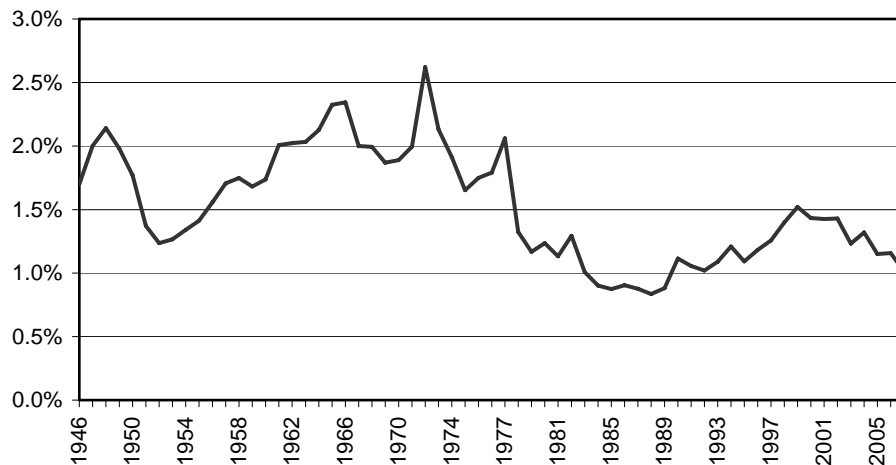
In 2008, the estate tax system operates as follows. An individual can transfer \$2 million in gifts and bequests (\$4 million in the case of a couple) tax-free. Any portion of a bequest above this threshold is taxed at a 45 percent rate under the estate tax.

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, 1946-2007⁹



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

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

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).

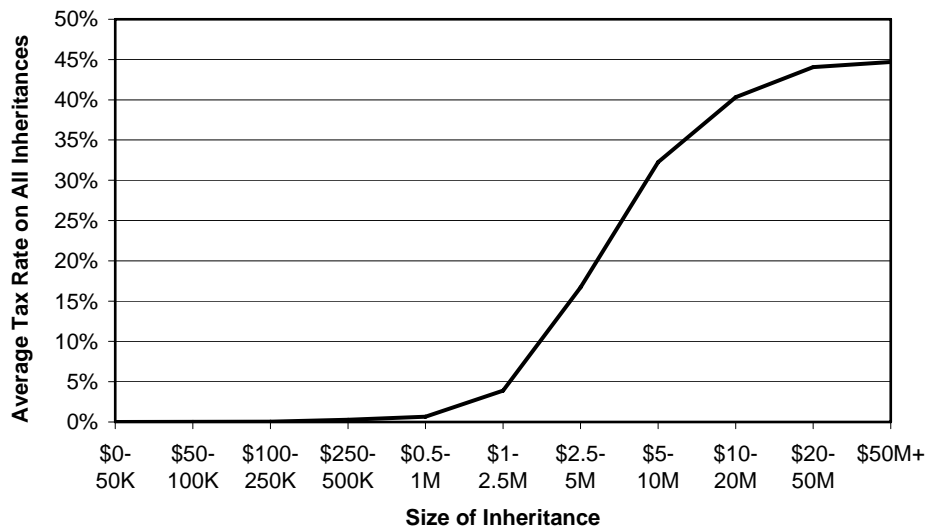
¹³ Even if all donors respond to wealth transfer taxes by increasing their consumption, they may still bear some burden to the extent they value the after-tax amount their heirs receive. However, a surprisingly large share of wealth transfers appear to stem from the donor saving for reasons unrelated 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



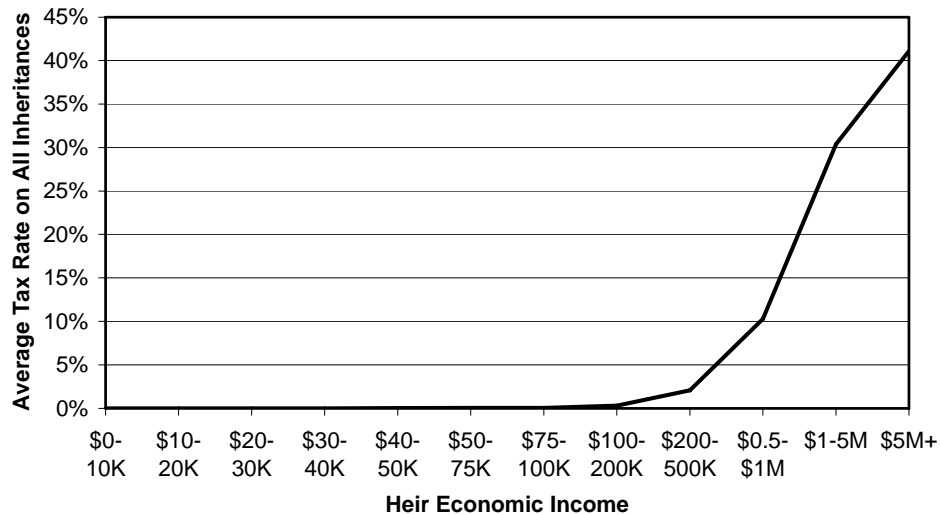
Under the current estate tax system, the tax rate does not directly turn on, or rise with, the amount the heir receives, but rather with the amount the donor transfers. In practice, estate tax burdens do, on average, rise steeply with the amount the heir inherits and his economic income, as illustrated 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

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.

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

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

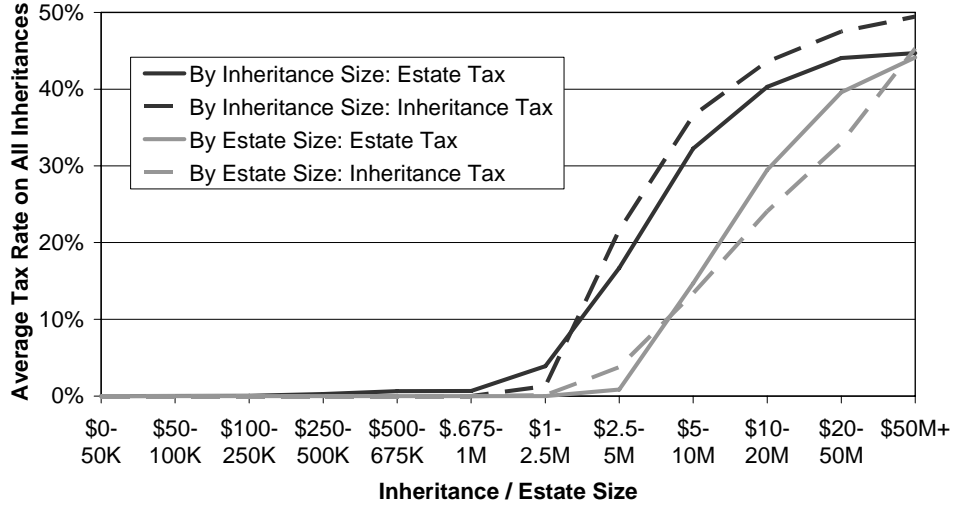
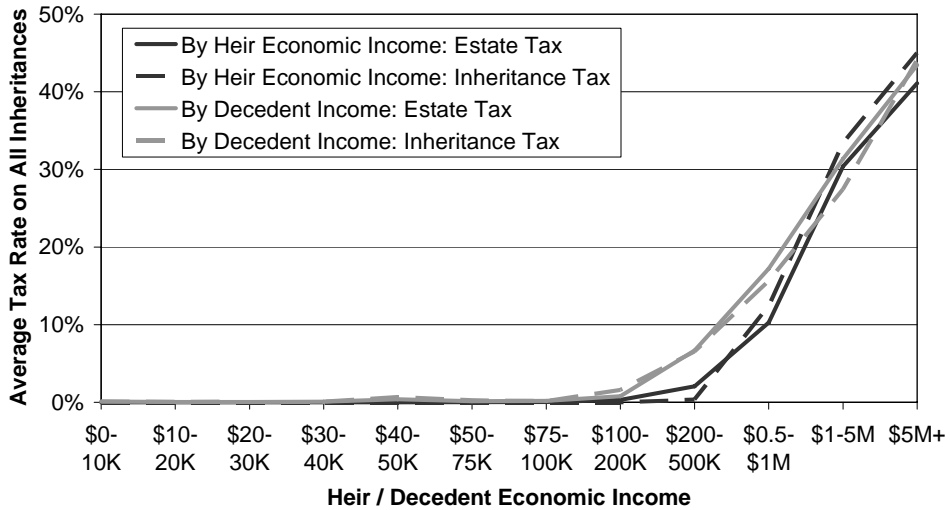
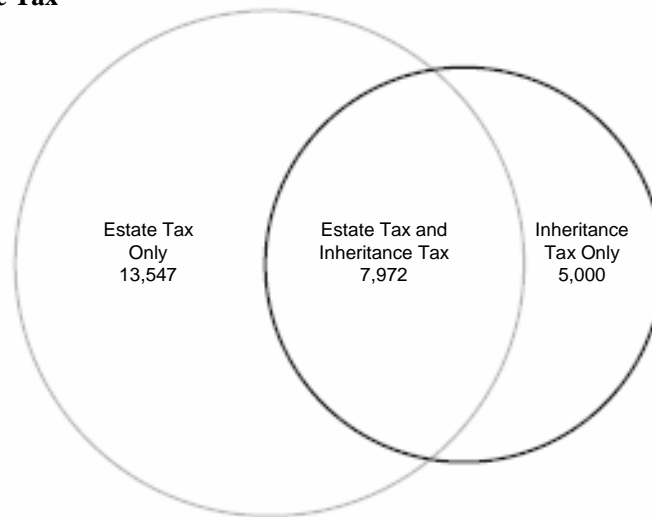


Figure 7: Estimated Average Tax Burden on All Inheritances under 2009 Estate Tax and Revenue-Neutral Comprehensive Inheritance Tax by Heir and Decedent Economic Income



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

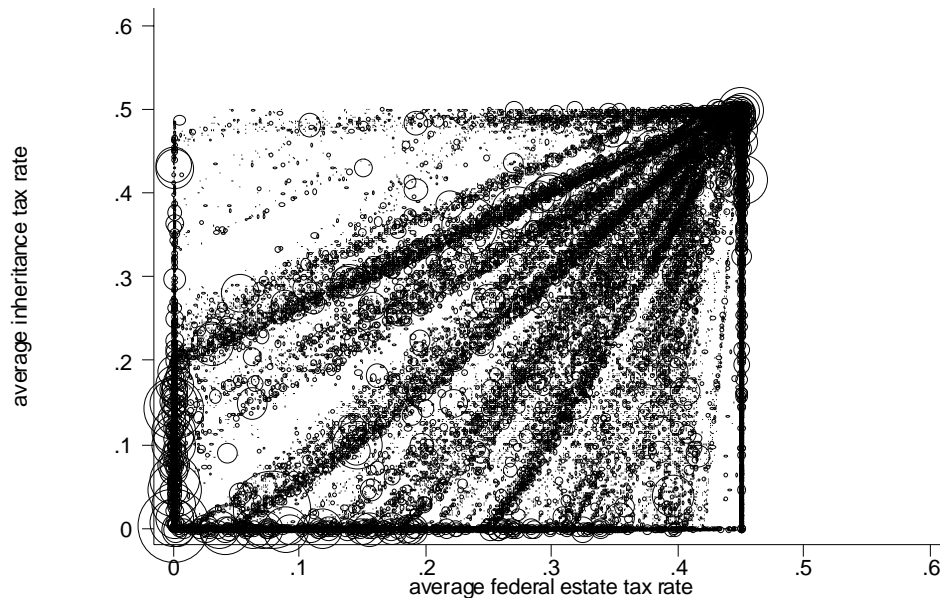


The differences between the estate tax system and this new tax can be understood still further by considering heirs who would be burdened by both taxes. These heirs do account for the lion's share of revenue raised under either tax (about 90 percent). However, many would be subject to a very different 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)



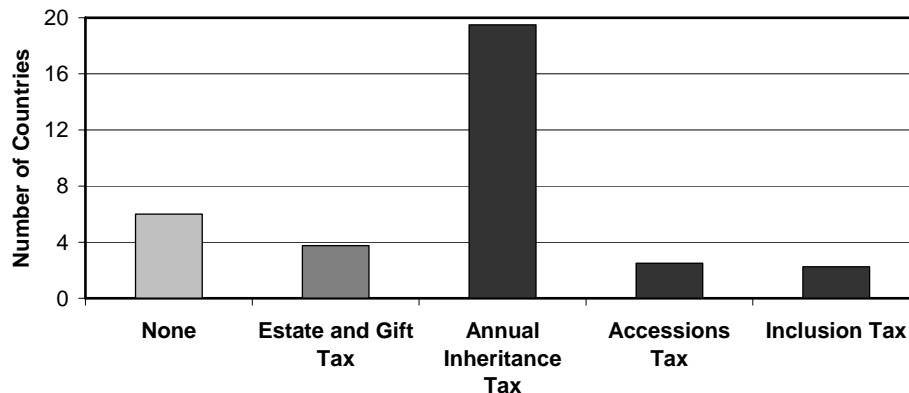
A comprehensive inheritance tax is only one of several alternatives to an estate tax system. As illustrated in Figure 10, jurisdictions currently apply five general approaches to taxing wealth transfers. Some, like the United States, have an estate and gift tax. Others have no wealth transfer tax and 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,

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 Countries²⁶



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

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

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

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.

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).