Restructuring Estate and Gift Taxes

Abstract - Most observers agree that restructuring the current transfer tax system (encompassing the estate, gift and generation skipping transfer taxes) is warranted and appropriate. However, the debate in Congress and the press centers on exactly how the system should be changed. In this paper, I analyze and compare outright repeal of the transfer tax to two alternatives—significant modifications of the current transfer tax system and a tax on appreciation at death—and conclude that a combination of an increased exclusion amount, reduced tax rates, broad tax payment deferral relief for all estates, and modifications to the generation skipping transfer tax would satisfy many of the critics of the current system.

INTRODUCTION

As more details of the Administration’s proposal to phase out the death tax have become public, the advantages and disadvantages of repeal compared to other methods of restructuring estate and gift taxes have been the subject of debate in the tax and popular press as well as in Congress. Although the House Ways and Means Committee approved a $193 billion repeal bill similar to the Administration’s proposal, there remains strong Democratic support in both the House and the Senate for other alternatives, including relief targeted primarily at small businesses and farms and other more substantial modifications to the current system.

In this paper, I analyze and compare repeal to two alternatives: (1) significant modifications to the current transfer tax system and (2) a tax on appreciation at death.1 Much of the analysis and comparison is taken from the American Institute of Certified Public Accountants (AICPA)’s Study on Reform of the Estate and Gift Tax System, published by the AICPA in February 2001. However, the AICPA report has been updated to include newly released statistical data, discussion of the Bush Administration’s proposal to phase out the death tax (U.S. Treasury Department, 2001) and H.R. 8 of the 107th Congress. The recommendations made in the paper are solely my own and have not been approved by the AICPA.

1 The American Institute of Certified Public Accountants (AICPA) report (2001) also analyzed a comprehensive income tax and an accessions tax.
BACKGROUND

The transfer tax system consists of a set of complex laws that apply to estates, gifts, and generation-skipping transfers. These laws are separate and distinct from our income tax system. However, the transfer tax and income tax systems interact in an attempt to achieve overall fairness and congruity in a system of taxation designed both to raise revenue and achieve social goals. As a result of this interaction, significant reform of the transfer tax system necessitates an examination of the impact of any proposed changes on the income tax system, as well as an examination of the overall affect on both systems in terms of complexity, taxpayer compliance burdens, ease of administration, and revenue.

While the transfer tax applies to relatively few estates (42,901 taxable estate tax returns were filed in 1997, representing less than 2 percent of the total estimated deaths), and while the tax is primarily paid by the wealthy (almost half of all estate tax payments in 1997 were made by 2,335 estates with a gross value of over $5 million; Johnson and Mikow, 1999, p. 107), evidence suggests that the tax may encompass a much larger number and percentage of taxpayers in the future. Without changes in the current transfer tax system, the combination of an aging population and increases in household net worth, fueled by unprecedented growth in the stock market and in the value of real estate, likely will result in significant increases in the number of taxpayers required to file estate tax returns and pay estate taxes. Furthermore, huge increases in the value of retirement assets, personal residences, real estate, stock options, and other forms of illiquid or inaccessible wealth have exacerbated the liquidity problems traditionally considered to affect only small businesses and farmers. These factors and others have caused most observers to agree that repeal or some sort of modification to the current system is appropriate. The debate centers on how the system should be changed.

ARGUMENTS FOR KEEPING THE CURRENT TRANSFER TAX SYSTEM

Supporters of the current system of taxing wealth at death argue that the estate tax is an important and growing source of revenue for the government. Between 1983 and 1998, transfer tax revenue increased 282 percent to an estimated $27.7 billion in 1999 (Repetti, 2000). The Joint Committee on Taxation (2001a) estimates that receipts from transfer taxes will exceed $409 billion over the ten years from 2002 to 2011.

Supporters also argue that the transfer tax makes a significant contribution to the overall progressivity of the nation’s tax system. Graetz (1983) concluded that about one-third of the progressivity in our tax system is due to the estate tax. However, his comments are now almost 20 years old. The observable trend suggests that the very wealthy pay less estate tax (as a percentage of the net estate) than those of moderate wealth (see Table 1). For returns filed in 1997, the estate tax as a percentage of the net estate averaged only 3.5 percent for gross estates of less than $1 million, increasing to 24.3 percent for estates between $10 and $20 million. However, for gross estates in excess of $20 million, the tax as a percentage of the net estate drops to 16.9 percent (Gravelle and Maguire, 2000). This likely is a result of effective planning and large charitable gifts.

2 To put the dollars in perspective, Repetti notes that the estimated $27.7 billion in 1999 equals the entire 1997 individual income tax liability of taxpayers with an adjusted gross income under $15,000 and all the corporate income tax collected in 1996 from corporations with assets under $100 million.
Restructuring Estate and Gift Taxes

Related to the progressivity argument is the argument that the transfer tax serves as a backstop to the income tax. Wealthy individuals generally realize more income from capital appreciation than individuals with more moderate wealth. Much of the income of wealthy individuals is accrued, but unrealized, capital gains. Thus, the transfer tax serves as a “backstop” to the income tax system by taxing these unrealized capital gains.3

Supporters also argue that the transfer tax provides an important tool for redistributing wealth in society and prevents unlimited wealth from being passed down from generation to generation. In 1891, Andrew Carnegie speculated that “the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would” (Carnegie, 1962, p. 56). In fact, there seems to be some truth to the “Carnegie conjecture.” In a research study, Holtz–Eakin et al. (1993, p. 432) found that “the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received.”

Proponents of the transfer tax also suggest that the tax provides a powerful incentive to make charitable contributions at death.4 However, due to the difficulty of separating wealth and price effects, the impact on charitable giving is not as clear as one might think. As tax rates increase, the cost or price of charitable giving goes down, increasing the incentive to make charitable contributions. For example, assuming a marginal estate tax rate of 40 percent, an individual with a taxable estate of $1,000,000 faces a tax liability of $400,000. If this individual donates $500,000 to charity, the tax decreases by $200,000 ($500,000 × 40 percent). Every $1 given to charity costs only 60 cents because 40 cents are saved in taxes. However, as tax rates increase, wealth decreases (due to the increased amount of taxes paid), reducing the incentive to make charitable contributions.

These conflicting forces can be seen in a recent study of the very wealthy conducted for Bankers Trust Private Banking by the Boston College Social Welfare Research Institute and the University of Massachusetts Boston Center for Survey Research (2000).5 While 74 percent of respondents indicated that increased tax

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3 If the estate tax is to serve as a backstop to the income tax, one must question the rationale of replacing a capital gains tax that has a maximum rate of 20 percent with an estate tax that has a maximum rate of 55 percent. Of course, the estate tax also does not allow a deduction for basis in determining the amount of asset value to be taxed.

4 Some criticize the use of tax incentives for charitable giving in the first place, arguing that the electorate as a whole, not individual donors, should make decisions about which activities deserve taxpayer support.

5 The average level of wealth in the study was $38 million, with almost 16 percent of respondents reporting family net worth of $100 million or more.
benefits likely would increase their charitable giving, 88 percent indicated that increasing their net worth would increase their giving. The impact of transfer tax rates on charitable giving is also confounded by the income tax and income tax rates. The income tax deduction for charitable contributions encourages making lifetime gifts rather than testamentary gifts.  

Most academic studies have concluded that the transfer tax does promote charitable giving. However, the strength of the relationship is questionable. Some studies indicate that tax rates are an important motivating force (Clotfelter, 1985; Auten and Joulfaian, 1996). Joulfaian (2000) estimates that charitable giving through bequests would decrease 12 percent if the estate tax were eliminated. Other research indicates that tax rates play little, if any, role in encouraging giving (Barthold and Plotnick, 1984).

While the total amount donated to charity at death is impressive, charitable bequests amount to only a small portion of total charitable giving. For returns filed in 1997, charitable deductions of over $14 billion were taken on 15,575 estate tax returns, compared to over $105 billion of charitable deductions on individual income tax returns in 1998 (IRS, 2000). As is shown in Table 1, the percentage of the estate donated to charity ranged from 3.1 percent for gross estates under $1 million to 28.4 percent for estates with assets exceeding $20 million (Johnson and Mikow, 1999, p. 105). However, the $9.3 billion of charitable bequests on 1994 returns represented less than 1.5 percent of the total revenue of charitable groups and less than 8 percent of total charitable giving by individuals (Joint Committee on Taxation, 1997, p. 40; Joint Economic Committee, 1998, p. 10).

ARGUMENTS AGAINST THE CURRENT TRANSFER TAX SYSTEM

The current system of taxing wealth at death has been criticized for a number of reasons. One study argues that repeal of the estate tax would result in sizable economic gains, including larger Gross Domestic Product (GDP), more jobs, and lower interest rates that would increase Federal tax revenues above the current baseline and thus offset the transfer tax revenue losses (Robbins and Robbins, 1999).

The wealth transfer tax system has traditionally been seen as a particular burden to farmers and small business owners. However, this burden also extends to taxpayers with a substantial portion of their wealth tied up in retirement assets, real estate, personal residences, and other forms of illiquid or otherwise inaccessible assets. The need to pay estate taxes may force heirs to liquidate family businesses and farms, sell the family home, or take other drastic steps in order to pay the estate tax. In a recent survey conducted by the AICPA (2001), over 80 percent of respondents said that the transfer of a closely held business or farm was a major issue faced by their clients (second only to providing for a spouse). In addition, almost 13 percent of respondents said that one or more of their clients had been

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6 A number of extremely wealthy individuals, including Bill Gates, have publicly announced their intentions to leave a significant amount of their wealth to charity. However, as noted by Abbin (2000), much of this giving appears to be directed towards private foundations established by the donors to benefit special needs of their choosing rather than to public charities.
7 In this paper, illiquid assets are considered to include assets like retirement plans that might require liquidation during unfavorable market conditions and that often cannot be accessed without incurring substantial income tax costs that otherwise would not be necessary.
8 While farm assets were reported on “only” 5.7 percent of taxable estate tax returns filed in 1997, this amounts to almost 2,500 individual farms (Johnson and Mikow, 1999).
forced to sell a closely held business or family farm to pay estate tax. Davenport and Soled (1999) point out that liquidity problems are often the result of the need to pay off multiple heirs rather than to pay the estate tax. While the transfer tax makes liquidity problems worse, its overall impact may be exaggerated.

The transfer tax is also criticized as having a negative impact on the investment and savings activities of taxpayers by encouraging greater consumption of wealth during lifetime. However, due to offsetting income and substitution effects, most economists would argue that the impact of the transfer tax is not clear. The Joint Committee on Taxation (1999, p. 251) concludes that “it is an open question whether the estate and gift taxes encourage or discourage saving.”

Additionally, the transfer tax is often criticized as being highly complex. The vast majority of gift and estate tax returns require professional assistance. Taxpayers spend billions of dollars annually on complex planning to reduce or avoid the tax. A number of provisions and components, including the generation–skipping transfer (GST) tax, are so complex that even experienced tax professionals often have difficulty interpreting the law. The complexity of the system results in significant problems for taxpayers.

Finally, the transfer tax is criticized as being “inefficient,” resulting in excessive administrative, planning, and compliance costs. However, the estimates of the total costs vary greatly. Munnell (1988) estimates that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised. On the other hand, Davenport and Soled (1999) estimate total annual compliance costs of between $1.6 and $2 billion, about 6 to 9 percent of expected tax revenue. This consists of over $150 million per year incurred by the Internal Revenue Service (IRS) in processing and examining transfer tax returns, over $1 billion in taxpayer planning costs, and another $550 to $800 million in administration costs. Practitioners have indicated that the costs are significantly more than estimated above.

**ESTATE TAX REPEAL**

Complete repeal of the estate tax has been proposed by the new Administration and some members of Congress. Most proposals would accomplish the repeal through a long–term reduction of tax rates occurring over seven or more years, and delay full repeal to the end of the phase–out period. Most proposals would implement a partial carryover basis regime for inherited assets, effectively increasing income taxes for many taxpayers.

The Administration’s proposal (U.S. Treasury Department, 2001) would phase out estate, gift and generation skipping transfer taxes over seven years (beginning in 2002), followed by full repeal and a partial carryover basis regime in the eighth year. The phase–out would be accomplished by reducing each tax rate by 5 percentage points in 2002, 10 percentage points in 2004, 15 percentage points in 2005, 20 percentage points in 2006, 30 percentage points in 2007, and 40 percentage points in 2008. However, no estate tax rate would fall below the highest individual income tax rate generally applicable to long–term capital gains (20 percent). Along with the reduction in rates, the exemption equivalent would be increased to $1.3 million in 2008.

After the estate tax is repealed on December 31, 2008, the Administration’s proposal would replace the unlimited step–up in income tax basis allowed under current law with a limited step–up. Although the basis of property acquired from a decedent would generally be equal to the lower of the fair market value on the date of the decedent’s death or the adjusted basis of the property immediately before death, each estate would receive a limited
ANALYSIS OF ESTATE TAX REPEAL

The Impact on Behavior

The current transfer tax law encourages the transfer of fractional interests in assets, regardless of whether the assets are active operating businesses or passive financial assets. The elimination of the estate tax likely would lead to the creation of fewer entities. In addition, the types of entities (i.e., trusts, partnerships) created to hold financial assets likely would change, with more emphasis being placed on maintaining control of the assets and the income tax characteristics of the entities. The consideration given to types of entities for operating businesses are typically more a function of control or management, legal liability, and income tax than estate tax.

Without an estate tax, families at marginal levels of wealth (i.e., near the current and projected applicable exclusion amounts) would be less likely to transfer wealth during their lifetime. However, families with income producing assets might still transfer assets to family members in lower income tax brackets or family members living in other countries in order to reduce income taxes.

A repeal of the estate tax that is accompanied by carryover basis would eliminate much of the incentive for retaining until death property that has substantially appreciated. The “lock-in” effect is a result of the current step–up in income tax basis accompanying assets passing at death. However, the elimination of the estate tax accompanied by carryover basis also reduces the incentive to sell property that has lost value before death. Under current law, if loss property is retained, an unrealized loss at death does not generate tax benefits. A pure carryover basis for inherited assets would allow

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9 Other provisions of the plan include new basis reporting requirements for donors and executors, technical changes to the GST tax, repealing the 5 percent surtax in 2002, and reducing state death tax credit rates to maintain the current relationship between the credit rates and the federal tax rates.
heirs to use unrealized losses when the property is sold.\textsuperscript{10}

The current estate and income tax regimes provide an incentive for investors to hold onto appreciated assets that may escape capital gains taxation due to the stepped-up income tax basis at death. On the other hand, a carryover basis regime might result in less incentive for investors to hold onto assets that generate capital gains (at least for large estates), and thus, might alter the types of assets taxpayers hold in their portfolios.

Eliminating the estate tax also allows more flexible investment decisions regarding purchases of life insurance products. Under our current tax structure, life insurance is frequently purchased to fund estate tax liabilities and is a tax-favored asset that can be the subject of a gift, usually in trust, that escapes estate tax. Eliminating the estate tax would allow the decision to purchase life insurance to be made based on factors other than estate tax needs.

Eliminating the estate tax may have a negative impact on charitable giving. Wealthy individuals who, under our current regime, transfer a significant portion of their assets to charity as a method of minimizing estate taxes might reduce their charitable transfers. However, as discussed previously, the impact of the estate tax on charitable giving is not known with certainty.

\textit{The Impact on Complexity and Compliance}

Although compliance costs related to the current transfer tax system are significant, these costs relate to more than estate tax. “Even without the estate tax, assets must be marshaled, debts must be paid, heirs must be pacified, property must be valued, special orders must be sought, asset schedules must be prepared, claims and debts must be listed, income and expenses must be tracked”\textsuperscript{(Davenport and Soled, 1999). Administrative costs would remain significant even if the estate tax were repealed. Elimination of transfer taxes would eventually eliminate the administrative expenditures that the IRS makes in this area. However, a phase-out accomplished by gradually reducing tax rates would do nothing to reduce administrative burdens during the phase-out period.

Repeal of the estate tax accompanied by a partial carryover basis regime may increase complexity for some taxpayers.\textsuperscript{11} While computerization of records relating to stock and mutual fund purchases and real estate investments has made basis determination easier, determining carryover basis of these and other assets still may cause problems. For example, although some mutual fund companies provide basis information to owners, the practice is not uniform. It can still be difficult and time consuming to determine carryover basis for a stock or mutual fund that has been held for decades with reinvested dividends, stock splits, and perhaps additional purchases and sales.

Although taxpayers must cope with carryover basis in many cases under current law (transfers to trusts, outright gifts, installment sales to grantor trusts, grantor retained annuity trusts (GRATS), the formation of family limited partnerships, etc.), carryover basis issues can be largely ignored if property is held until death.

\textsuperscript{10} Under the Administration’s proposal, assets with a fair market value below basis at death would receive a fair market value basis to heirs. However, heirs would be able to step up the basis of other assets by the amount of this unrealized loss. This would basically put heirs in the same position as had the decedent sold the asset before death and had an unused capital loss carryforward at death. Under the Administration’s proposal, this unused capital loss carryforward would increase the allowable step-up.

\textsuperscript{11} What is not clear is how many taxpayers will be required to determine carryover basis.
The $1.3 million step–up in income tax basis, plus the additional $3 million step–up in income tax basis for assets passing to a surviving spouse, proposed by the Bush Administration would exempt some taxpayers from a carryover regime. Still, as the AICPA pointed out in testimony before the Senate Finance Committee over 20 years ago, a young person, regardless of his or her present circumstances, would be foolish to decide today that over his or her lifetime, he or she will not accumulate enough assets for carryover basis to present a serious problem for his or her family. The duty of maintaining records of purchase dates and prices of all of one’s assets—of every variety—would be imposed upon an enormous segment of the population. In addition, for those taxpayers affected by carryover basis, allocating the step–up exemption among assets would be a new and complex task.

AICPA survey results (AICPA, 2001) suggest that many CPAs are concerned about the impact of carryover basis. Absent any step–up in income tax basis for assets passing to heirs, over half of the respondents indicated that calculating carryover basis would “definitely” or “probably” cause significant problems for their clients for collectibles, other personal property and household goods, mutual funds, and listed securities. Calculating carryover basis for a personal residence or other real estate was viewed to be less problematic, but still viewed as causing significant problems for clients by over 40 percent of respondents.

However, concerns about collectibles and other personal assets should be tempered by the fact that these assets make up a very small percentage of total assets in most estates. As can be seen in Table 2, regardless of the size of the estate, collectibles and other personal property make up an average of less than 4 percent of total assets. Likewise, regardless of estate size, stock and bond mutual funds make up less than 2.2 percent of total assets. The proportion of other asset categories varies greatly with estate size. For example, a personal residence and other real estate (for which determining carryover basis is less problematic) constitute an average of over 30 percent of smaller estates and just over 10 percent of the largest estates. Likewise, closely–held stock and other stock vary from a low of less than 18 percent of total assets in small estates to over 57 percent of total assets in the largest estates.

### Table 2

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>$0.6 to $1</th>
<th>$1 to $2.5</th>
<th>$2.5 to $5</th>
<th>$5 to $10</th>
<th>$10 to $20</th>
<th>Over $20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Residence</td>
<td>13.94%</td>
<td>10.00%</td>
<td>7.15%</td>
<td>5.62%</td>
<td>3.71%</td>
<td>1.52%</td>
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<tr>
<td>Other Real Estate</td>
<td>17.43</td>
<td>17.53</td>
<td>16.58</td>
<td>14.68</td>
<td>13.64</td>
<td>8.96</td>
</tr>
<tr>
<td>Closely–Held Stock</td>
<td>4.43</td>
<td>8.70</td>
<td>12.51</td>
<td>16.13</td>
<td>21.56</td>
<td>26.42</td>
</tr>
<tr>
<td>Other Stock</td>
<td>13.42</td>
<td>15.30</td>
<td>19.19</td>
<td>21.23</td>
<td>22.99</td>
<td>30.77</td>
</tr>
<tr>
<td>Tax Exempt Bonds</td>
<td>5.29</td>
<td>7.70</td>
<td>9.52</td>
<td>10.50</td>
<td>10.17</td>
<td>9.36</td>
</tr>
<tr>
<td>Government Bonds</td>
<td>3.33</td>
<td>2.75</td>
<td>2.48</td>
<td>2.63</td>
<td>2.38</td>
<td>2.00</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>0.64</td>
<td>0.47</td>
<td>0.82</td>
<td>0.47</td>
<td>0.71</td>
<td>0.54</td>
</tr>
<tr>
<td>Bond Mutual Funds</td>
<td>0.40</td>
<td>0.37</td>
<td>0.19</td>
<td>0.21</td>
<td>0.24</td>
<td>0.09</td>
</tr>
<tr>
<td>Stock Mutual Funds</td>
<td>1.75</td>
<td>1.47</td>
<td>0.96</td>
<td>0.70</td>
<td>0.53</td>
<td>0.17</td>
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<tr>
<td>Cash/Money Market</td>
<td>9.17</td>
<td>6.83</td>
<td>4.46</td>
<td>3.76</td>
<td>2.60</td>
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<td>Mortgage Notes</td>
<td>2.84</td>
<td>2.91</td>
<td>3.35</td>
<td>3.15</td>
<td>2.94</td>
<td>2.63</td>
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<td>Equity &amp; Life Insurance</td>
<td>2.52</td>
<td>1.94</td>
<td>1.15</td>
<td>0.86</td>
<td>0.63</td>
<td>0.16</td>
</tr>
<tr>
<td>Non–Corporate Business</td>
<td>2.91</td>
<td>2.72</td>
<td>2.75</td>
<td>3.58</td>
<td>4.96</td>
<td>4.25</td>
</tr>
<tr>
<td>Limited Partnerships</td>
<td>0.74</td>
<td>1.11</td>
<td>1.70</td>
<td>2.78</td>
<td>2.81</td>
<td>4.91</td>
</tr>
<tr>
<td>Retirement Assets</td>
<td>14.09</td>
<td>13.33</td>
<td>10.31</td>
<td>7.09</td>
<td>3.62</td>
<td>1.28</td>
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<tr>
<td>Other (Personal/collectibles)</td>
<td>3.96</td>
<td>3.58</td>
<td>3.80</td>
<td>3.75</td>
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<td>3.88</td>
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</table>
The imposition of carryover basis would result in substantial new responsibilities (and potential penalties) for executors, even those of modest estates, which might negatively impact the choice of executors, their agreeing to serve, and the fees they charge. Executors would have to determine how to allocate the limited basis step-up for estate assets. It is likely that additional reporting rules would be needed, requiring the executor to provide basis information to heirs. Executors likely would turn to CPAs, attorneys, and other professionals in order to determine carryover basis. In some cases, a decedent’s family may need to retain professionals to review a lifetime’s accumulation of bills, checks, insurance policies, and other records to determine the acquisition dates and prices of a multitude of assets and then make detailed time-consuming computations of their bases. This would increase fees paid to administer estates. However, fees related to the preparation of estate and gift tax returns would be eliminated12 so the impact on total fees is difficult to estimate.

Federal repeal of the transfer tax, whether immediate or accomplished through a phase-out, may result in additional complexity for taxpayers if states are forced to change their revenue collection infrastructure to supplant their lost revenue. A number of different transfer tax systems in each state would be complex and costly for taxpayers and their advisers, as well as difficult and costly for the states to implement and administer. Repeal would also add complexity to income tax planning as taxpayers change the focus of their planning from estate tax to income tax avoidance.

**The Impact on Liquidity**

Although liquidity issues created by the need to pay estate taxes would be alleviated with full repeal, significant problems with illiquid assets would still exist during any phase-out period. If the tax is phased out through a gradual reduction of rates, smaller estates would receive very little relief from the estate tax during the phase-out period. After repeal, by postponing taxation until property and businesses are sold, the need for complex and expensive administrative remedies targeted at farmers, small business owners, and ranchers, such as special use valuation provisions, deferred payments of death taxes, etc., would be eliminated.

**The Impact on the Redistribution of Wealth**

The distributional impact of a repeal of the current transfer tax regime is not clear. If Congress imposes new taxes to make up the revenue lost from the repeal of the estate tax, the tax burden currently borne by the wealthiest taxpayers may be shifted to those of moderate or lesser wealth.

After repeal (and without the imposition of new taxes), a proposal like the Administration’s would essentially be tax-neutral or provide a net tax advantage for individuals with assets below $1.3 million by allowing a full step-up in income tax basis for those assets. For the same reason, it would provide a net advantage for those individuals who pass less than $1.3 million to any heir and an additional $3 million to a surviving spouse. Likewise, a similar repeal proposal likely would provide a tax benefit for individuals and married couples with larger estates by eliminating an estate tax on property held at death (at a maximum rate of 55 percent) and replacing it with an income tax on appreciation when (and if) property is sold. If property has not appreciated in value, the taxation is eliminated altogether. Income tax on the sale of appreciated assets could be as high as 39.6 percent.

12 As discussed above, it may still be necessary to prepare basis-reporting information returns.
cent of the gain, although a substantial amount of gain would likely be taxed at capital gains rates of 20 percent.

It should be noted that estate planning techniques undertaken under current law might eliminate or reduce a substantial portion of estate tax. Consequently, the tax impact of repeal with carryover basis on high wealth individuals is difficult to judge.

**The Impact on Tax and Succession Planning**

The repeal of the estate tax likely would move wealth transfer planning to the “back burner,” although phase-outs might increase planning costs over the phase-out period. While potentially reducing estate planning costs for taxpayers, final repeal of the estate tax likely would shift the emphasis of tax planning for wealthy taxpayers from estate planning to income tax planning. It is likely that the use of techniques to defer the payment of income tax (like-kind exchanges, tax-free reorganizations, borrowing against assets, etc.) will increase.

The ultimate repeal of the estate tax would eliminate the need for bypass trusts, QTIP trusts, and other trust arrangements created solely for estate tax planning purposes. This type of planning is often used by those with moderate wealth. Repeal of the estate tax would also reduce the use of partnerships, LLCs, and other entities created primarily for estate tax planning purposes. Use of these entities would be relegated to mainly non-tax reasons, including the management of assets and control of distributions. Estate tax repeal would eliminate the advantage that very wealthy taxpayers have in using generation-skipping trusts and dynasty trusts to mitigate or eliminate estate taxes and would reduce the use of expatriation activities and offshore entities for estate planning purposes.

Repealing the estate tax may have an adverse effect on taxpayers who have effectively planned their estates under current law to minimize transfer tax payments. For example, taxpayers who have made taxable gifts, purchased substantial life insurance policies to provide liquidity, transferred assets to irrevocable trusts, transferred a personal residence to a qualified personal residence trust, or utilized family limited partnerships to transfer assets might believe they were worse off.

Estate tax repeal accompanied by carryover basis with a limited step-up in income tax basis would make planning difficult for taxpayers with estates close to the current applicable exclusion amount. Those taxpayers would face a great deal of uncertainty caused by not knowing whether only the stepped-up basis or both carryover basis and stepped-up income tax basis rules would apply to assets held in their estates.

The preparation of wills and trusts would remain complicated by non-tax factors such as evolving family structures due to the frequency of divorce and remarriage. Despite the fact that documents may not be significantly different, clients may be less willing to pay for planning services where tax savings are not at issue (Davenport and Soled, 1999).

**The Impact on Revenue**

A phase-out of the estate tax (instead of immediate repeal) would reduce the revenue impact to the government. Due to the large increases in the equity markets over the last several years, and the

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13 Davenport and Soled (1999) suggest that wealth transfer planning has many positives including: avoiding family squabbles, protecting assets from creditors, and the orderly management of business assets. “Planning is a positive benefit to society although it may well reduce estate tax receipts, and . . . estate taxes may sensitize people to the need for planning the disposition of assets at death.”
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deaths of many surviving spouses over the next ten years, substantial revenue would still be generated over the phase-out period. The cost of the phase-out proposed by the Administration is estimated to be $57 billion over the five-year period from 2001–2006 and $267 billion over the ten-year window from 2001 to 2011 (U.S. Treasury Department 2001). The slower phase out of the House Ways and Means Committee alternative reduces its ten-year cost to $193 billion (Joint Committee on Taxation, 2001b). In the ten–year period between 2012 and 2021, the estimated cost skyrockets to $1.3 trillion (Friedman, 2001).

However, the long–term impact of repeal and carryover basis on total tax receipts is difficult to ascertain. Income tax revenues may be accelerated when taxpayers do not have an incentive to hold assets until death for a step–up in income tax basis. However, tax revenues may also be deferred if heirs choose to hold onto property to avoid the income tax. Also, a decrease in transfer tax revenue may be offset in part by a decrease in administration costs incurred by the IRS and increases in income and other taxes.

The lack of a gift tax would increase the incentive for taxpayers to make gifts to family members in lower income tax brackets and family members living outside the country to reduce their income tax liability. Without special rules, taxpayers could simply make gifts of appreciated assets to family members in lower tax brackets (or family members living outside the country) who would then sell the assets and give the after–tax proceeds back to the original donor. Based on projections made by the Joint Committee on Taxation, Sullivan (2001) estimates that income tax evasion will increase revenue loss estimates by as much as 80 percent.

Unless state inheritance and estate taxes are abolished or changed, repeal of the Federal estate tax may not reduce such state taxes. Recent estimates suggest that in the aggregate, states would lose almost $9 billion annually by the time the Federal estate tax would be fully repealed in 2009 (McNichol et. al., 2000). It is unclear what impact eliminating the Federal transfer tax would have on changing individual states’ inheritance and estate tax provisions. At a minimum, the change would create confusion with a number of states due to the interplay of current state and Federal statutes. Changes in the states’ revenue collection infrastructure that might be necessary to supplant this revenue would be complex and costly for taxpayers, their advisers, and the states.

Transition Issues

Phase–outs are likely to result in significant transition issues and complexities for both taxpayers and the IRS. Transition issues may be substantial and include the administrative costs of educating taxpayers each year and planning costs incurred by taxpayers forced to update and revise their estate plans on an annual basis. Other alternatives and options may be less disruptive to taxpayers and may be easier to implement than phased–out repeal.

Suggestions

Should Congress and the Administration agree to repeal the transfer tax in stages over a period of years, the phase–out should be undertaken in a way that provides needed relief to the largest number of taxpayers during the transition period. Greater attention should also be given during the transition period to identifying and implementing those changes
necessary to the income tax system before final repeal takes effect. Specific suggestions include the following:

- If a phase-out is appropriate, an increase in the applicable exclusion amount is preferable to phasing in reduced rates because it would reduce the administrative burden to both taxpayers and to the IRS by reducing the number of returns filed. Although lowering estate tax rates during a phase-out will reduce tax burdens somewhat, it will not reduce the administrative costs of the IRS during the phase-out period. A phase-out of top tax rates also will not appreciably reduce the burden on holders of illiquid assets—such as IRAs and other pension assets, stock options, personal residences, small businesses and farms—during the phase-out period.

- The phase-out should be accomplished as expeditiously as possible.

- If a carryover basis regime is implemented, a substantial step-up in income tax basis should be adopted. This allowance should be substantial in order to avoid the problems inherent in determining carryover basis for the vast majority of estates. In addition, the step-up allowance should be indexed annually for inflation.\(^\text{16}\)

- In addition to any general basis step-up, a limited basis step-up for a decedent’s principal residence, up to the amount of gain that would have been excluded if the residence were sold immediately before death, should be provided.\(^\text{17}\)

- If a carryover basis regime is implemented, it should include a statutory safe harbor as an elective method for determining the basis of lifetime gifts and transfers at death. In some cases, an executor or beneficiary will not have adequate records to calculate carryover basis of assets held at death. A safe harbor could be tied to inflation rates or other measures of price appreciation, based on historical published prices, or based on a statutorily allowed percentage of fair market value.

- Tax professionals, preparers, beneficiaries, and executors who use a “reasonable” method to determine carryover basis when adequate records do not exist should not be penalized under a carryover basis regime.

- If allowances for basis step-ups are included in a carryover basis regime, an elective safe harbor procedure should be included for allocating the allowable basis step-up pro rata to all assets and all beneficiaries in a taxable estate.

- After repeal, uniform procedures for how basis information should be communicated to heirs and to the IRS must be established. As under current law, $10,000 annual gifts ($20,000 if gift-splitting is elected) should not require reporting. It is also likely that an information return of some sort would still be required in order to report basis information to heirs. The filing of the information return should also start the running of the statute of limitations.

- Any repeal of the transfer tax presents problems and new issues for the income tax. These issues should be addressed prior to repeal in order to prevent widespread erosion

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\(^{16}\) Under the Administration’s proposal, the allowable basis step-up would be indexed for inflation after 2009.

\(^{17}\) As an alternative, the Administration’s proposal provides that the current law exclusion of gain on sale of a principal residence would be extended to heirs. However, this would still put pressure on heirs to sell a principal residence that they might prefer to keep in the family.
of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens after final repeal.

- Donees who have received previously taxed gifts should be allowed to increase their basis in the gifted asset by the entire amount of gift tax paid.
- An automatic, long-term holding period for all inherited assets should be continued as under current law.
- Immediate modifications to the GST tax similar to those included in previous tax bills (and the Administration’s proposal) should be included in any legislation that does not provide for outright and immediate repeal of the estate tax.

Advantages

A phased out repeal of the estate, gift, and generation-skipping transfer taxes would eventually provide significant estate tax savings for the 48,000 or so taxpayers currently paying estate tax and reduce compliance burdens for over 100,000 taxpayers currently filing estate and gift tax returns. \(^{18}\) Complete repeal would reduce administration costs and reduce the tax planning costs incurred by taxpayers, although other estate planning costs related to broader succession issues would remain. Complete repeal would solve the liquidity problems currently faced by farmers, small businesses, and others with illiquid and/or inaccessible assets.

Specific advantages of estate tax repeal include the following:

- The tax return filing burden would eventually be eliminated for over 100,000 taxpayers who would otherwise file estate and gift tax returns.

In addition, over 48,000 taxpayers, who would otherwise pay estate tax, would be removed from tax payment responsibilities. This includes a substantial number of estates with farm assets and/or business assets. In addition, tax planning expenses would be reduced for a great number of taxpayers.

- The administrative burden and costs incurred by the IRS would be significantly reduced as large numbers of taxpayers would be eliminated from tax filing responsibilities.
- The transfer tax system would be simplified through the complete repeal of the estate, gift, and GST taxes.
- Liquidity concerns affecting farmers, small businesses, and other decedents with illiquid or inaccessible assets would be largely eliminated as the incidence of tax would be shifted to the sale or distribution of those assets.
- Complex planning techniques and the creation of entities used solely for estate tax planning would be curtailed.
- Complete repeal of the transfer tax might make it difficult to resurrect other forms of estate and inheritance taxes in the future.

Concerns

Although revenue concerns may necessitate a phase-out of the estate tax rather than immediate repeal, phase-outs result in a great deal of uncertainty, significant transition issues, and additional and costly planning by taxpayers. Specific concerns of estate tax repeal include the following:

- The estate tax may not ultimately be fully phased out if Congress is later

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\(^{18}\) It is likely that some reporting mechanism will still be required to report the carryover basis of gifts and inherited assets for income tax purposes.
faced with revenue constraints or increased spending needs. This concern is exacerbated by the possibility that—by the end of a long-term phase-out period—a future Congress may be composed of new members, have changed leadership, and face markedly different challenges than the Congress that approved repeal. In addition, a phase-out of rates provides very little relief during the phase-out period for smaller estates, including those containing small businesses, farms, and illiquid assets.

- It is likely that estate tax revenues have been substantially deferred by the impact of the unlimited marital deduction. The wealth of many surviving spouses has grown enormously over the last 20 years. Oustage repeal of the estate tax may be viewed as a windfall for wealthy surviving spouses, especially those who may have recently received a full step-up in income tax basis upon the death of their spouse.

- Future revenue needs may require Congress to impose one or more tax increases.

- The complexities inherent in a carryover basis regime (without large allowances for income tax basis step-up) are at least as great as that in the current transfer tax system.

- Even with reporting of carryover basis, the lack of a gift tax would increase the incentive for taxpayers to make gifts to family members in lower income tax brackets or family members living abroad to reduce their income tax liability. Without special rules, taxpayers could sim-

ply make gifts of appreciated assets to family members in lower tax brackets or family members in other countries who would then sell or receive income from the assets and give the proceeds back to the original donor. Finally, it should be noted that manipulating the basis of assets by making “death bed” gifts would be problematic after the estate tax is repealed unless the basis rules in I.R.C. section 1014(e) are expanded.19

- The repeal of the Federal transfer tax system might force states to establish their own systems of estate and inheritance taxes. Most states will also lose income tax revenue if taxpayers make gifts of appreciated assets to family members in other states or in lower tax brackets. Changes in the states’ revenue collection infrastructure would be complex and costly for taxpayers and their advisers and difficult for the states to implement and administer.

- A carryover holding period for inherited assets may be problematic for heirs seeking to diversify their inherited investment portfolio after the death of a family member. A need to liquidate investments to meet current cash needs is made more difficult by the prospect of paying income taxes at ordinary rates for assets that do not meet a one-year holding requirement.

- How will the IRS deal with carryover basis of assets that have passed through multiple generations? Will the IRS take the view that the basis is zero unless the taxpayer can prove otherwise?20

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19 I.R.C. section 1014(e) disallows a step-up in income tax basis for appreciated property acquired by a decedent by gift within one year of death that passes back to the donor at death. The Administration’s proposal would disallow a basis step up for property acquired by the decedent by gift (other than from a spouse) during the 3-year period ending on the date of the decedent’s death (U.S. Treasury Department, 2001).

20 The Administration’s proposal states that upon the sale of inherited property or property acquired by gift, that the taxpayer would be required to substantiate the basis of the property. “If the basis is unknown but the
Restructuring Estate and Gift Taxes

- Who will have responsibility for determining the basis of inherited assets? Some type of reporting system will clearly have to be devised. Will the executor or the beneficiaries be responsible for this task? Will some sort of separate informational reporting be required to include carryover basis information? If so, what penalties might an executor or preparer be exposed to if incomplete or inaccurate information is reported? Will a beneficiary of carryover basis property be able to rely on information (or be bound by information) provided by an executor or will the IRS be able to continually challenge “old and cold” information due to the lack of a statute of limitations?21

- A carryover basis regime will present many practical problems and increase complexity for many taxpayers. Providing a limited step-up in income tax basis might address carryover basis issues for some taxpayers. However, other taxpayers would have to deal with a new source of complexity caused by the need to allocate the step-up in income tax basis among assets.

- Any repeal of the transfer tax presents problems and new issues for the income tax that must be thought through and addressed prior to repeal in order to prevent widespread erosion of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens under the new regime.

Conclusion

Implementing a repeal of the transfer tax system necessitates consideration of a number of issues including the effect of immediate repeal of the transfer tax on state revenues, Federal revenue, and income tax erosion. Likewise, a long-term phase-out of the transfer tax could be problematic. In order to simplify a phase-out and to immediately relieve taxpayers of filing and payment burdens, any phase-out should be accomplished by increasing the applicable exclusion amount along with reducing tax rates throughout the rate structure. Although there are problems in determining and dealing with carryover basis, some of these problems can be avoided by providing a substantial allowance for step-up in income tax basis allowance. Regardless of the phase-out period or method of phase-out, it is imperative that the GST tax be modified immediately during the phase-out period.

MODIFY THE CURRENT SYSTEM

In contrast to outright repeal of the transfer tax, many observers have suggested making substantial modifications to the current system (for example, see Tucker, 2001). Possible modifications include: (1) increasing the applicable exclusion amount and changing its structure; (2) altering tax rates and the tax rate structure; (3) increasing targeted relief aimed at small businesses and farms; and (4) extending and modifying liquidity relief provisions currently provided in the law.

INCREASE THE APPLICABLE EXCLUSION AMOUNT AND CHANGE ITS STRUCTURE

Increasing the applicable exclusion amount has been proposed as a way to

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21 The Administration’s proposal provides that a donor would be required to report to the IRS and the donee the basis and character of gifted property with a value in excess of $25,000. Likewise, under the Administration’s proposal, the executor would be required to report to the IRS and to heirs, basis and fair market value information for transfers of non-cash assets in excess of $1.3 million.
alleviate many of the perceived problems with the current transfer tax system with minimal impact on the overall system of taxing wealth transfers. Proposals have included an immediate phase–in of the $1,000,000 applicable exclusion amount (currently scheduled to gradually phase–in by 2006) to more generous increases of up to $10,000,000. Proponents of increasing the applicable exclusion amount argue that increases in the amount have not kept pace with increases in the value of real estate, stocks, and other assets over the last 85 years. Adjusted for economic growth, Robbins and Robbins (1999) state that in 1916, estates under $9 million (in today’s dollars) would not have been taxed. An inflation–adjusted exclusion based on a baseline amount of $600,000 in 1987 would exceed $900,000 in 2000 (Joint Committee on Taxation, 1997, adjusted for post–1997 years by the author). In addition to increasing the exclusion, making the exclusion portable would benefit taxpayers by allowing any exclusion unused at the death of a taxpayer to be used by a surviving spouse.

ALTER TAX RATES AND THE TAX RATE STRUCTURE

The current transfer tax system has been criticized for its high tax rates and numerous brackets, starting at an effective rate of 37 percent and increasing to a top rate of 55 percent. After adding the impact of income taxes, opponents of the current estate and gift tax argue that the total tax burden is excessive. Although the estate and gift tax rates and brackets have generally fluctuated over time, they have not changed since 1981. For example, when top income tax rates were reduced from 70 percent to 50 percent by the Economic Recovery Tax Act of 1981, estate and gift tax rates were also reduced from 70 percent to 50 percent. However, when top income tax rates were reduced from 50 percent to 33 percent (28 percent plus a 5 percent surtax) and brackets were indexed for inflation by the Tax Reform Act of 1986, no further reductions were made in the top estate tax rates.

Decreasing marginal rates within the current transfer tax system has been offered by some as a cure for many of its problems. Alternatives for reducing rates include: (1) decreasing transfer tax rates to reflect the current income tax rates on ordinary income (currently ranging from 15 percent to approximately 40 percent); (2) decreasing the top transfer tax rate to the highest income tax rate applied to capital gains (currently 20 percent); (3) decreasing the top transfer tax rate to 30 percent; and (4) changing the way the applicable exclusion works to make the first dollar of taxable estate subject to the lowest 18 percent rate rather than the 37 percent rate.

INCREASE TARGETED RELIEF AIMED AT FAMILY FARMS AND SMALL BUSINESSES

Expanding targeted relief for small businesses and family farms has been proposed as a way to alleviate the liquidity problems and forced sales alluded to by estate tax opponents. In the 106th Congress, House Democrats proposed increasing the small business exclusion from a maximum of $1.3 million to $2 million and would have permitted the portion of

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22 For example, H.R. 5058 of the 106th Congress, introduced by Rep. James A. Leach (R–IA), would increase the applicable exclusion amount to $10,000,000 and reduce top rates to 30 percent.
23 The Tax Reform Act of 1984 deferred the scheduled rate decreases, effectively maintaining a top rate of 55 percent.
24 The Revenue Reconciliation Act of 1993 increased the top individual income tax rate to 39.6 percent and made permanent the top estate tax rate of 55 percent. It also phased out the benefit of the lower transfer tax brackets and the unified credit for large estates.
the exclusion not used in the estate of the first spouse to die to be used by the estate of the surviving spouse. House Ways and Means Committee ranking Democrat, Charles Rangel (D–NY) said this alternative would have provided relief to 99 percent of farmers and small businesses currently impacted by the estate tax (BNA, Inc., 2000a). The Senate version of this proposed legislation would have increased the exclusion to $8 million per couple by 2010. Senate Minority Leader Thomas Daschle (D–SD) said that this would have ultimately allowed estate tax relief for all but about 0.7 percent of those estates that remain taxable (BNA, Inc., 2000b).

However, relief aimed solely at farmers and small business owners does not provide any benefit to holders of other illiquid and inaccessible assets, including retirement accounts, personal residences and other real estate, installment obligations, stock options, etc. In today’s economy, liquidity relief must be much broader than in the past.

EXTEND AND MODIFY LIQUIDITY RELIEF PROVISIONS

Under current law, I.R.C. sections 2031(c), 2032A, 2057, and 6166 provide limited relief to a small number of business owners, land owners, and farmers by allowing exclusions, special valuations, deductions, and deferral of estate tax payments if a number of restrictions are met. Some have suggested extending these liquidity relief provisions to all taxpayers regardless of the composition of the gross estate, arguing that this would decrease the burden caused by the need to quickly liquidate assets and pay estate tax liabilities within nine months of death. However, rather than extending these little-utilized provisions with their inherent restrictions and complexities, a new regime for deferring the payment of estate tax for all estates, regardless of asset makeup, is needed.

ANALYSIS OF POSSIBLE MODIFICATIONS TO THE CURRENT WEALTH TRANSFER TAX SYSTEM

The Impact on Behavior

Modifying the current wealth transfer tax system may alter taxpayer behavior in a number of ways. Decreasing the number of taxable estates and the estate tax burden may limit some of the more aggressive efforts to minimize the estate tax. For example, one might expect a reduction in highly complex and expensive strategies like tiered family partnerships and corporations intended to create multiple layers of valuation discounts.

Taxpayers with smaller estates may be less willing to make lifetime gifts or to make charitable contributions at death. The use of charities in testamentary planning and charitable remainder trusts could become less attractive. Although the empirical evidence regarding the impact of estate taxes on charitable giving is mixed (see previous discussion), AICPA survey respondents indicated that only 31 percent of their clients would have made

25 Other targeted relief bills of the 106th Congress included: H.R. 4562 introduced by Rep. Bob Etheridge (D–NC) and S. 3111 introduced by Senator Daniel K. Inouye (D–HI). H.R. 4562 would have increased the maximum estate tax deduction for family owned business interests from $1.3 million to $4 million by 2005. S. 3111 would have provided an extension of time for the payment of estate tax under section 6166 to more estates with closely held businesses by increasing the number of allowable partners and shareholders from 15 to 75.

26 In 1998, only 565 estates took advantage of the provisions of I.R.C. section 6166, deferring only $47 million of estate tax, while 463 estates utilized the provisions of section 2032A (Eller et. al., 2000). Likewise, preliminary evidence suggests that I.R.C. sections 2057 and 2031(c) are not being frequently used by taxpayers (unpublished IRS estimates, conversation in January 2001 with Barry Johnson, IRS Statistics of Income).

27 If the government is concerned about the overuse of such an estate tax deferral mechanism, its attractiveness could be limited by adjusting the interest rate and deferral period.
charitable contributions at death if there were no transfer tax (AICPA, 2001).

In addition, the purchase of life insurance as a liquidity tool could be significantly affected. In general, the enhanced liquidity provided by these modification proposals should reduce the effect of transfer tax considerations on personal and dispositive aspects of all financial and investment decisions.

The Impact on Complexity and Compliance

Increasing the applicable exclusion amount would decrease the number of estate and gift tax returns filed, reducing the compliance burden faced by taxpayers and reducing administration costs incurred by the IRS. It also would make dispositive planning simpler and easier for most taxpayers. Increasing the applicable exclusion amount and/or altering tax rates and their structure would require no additional training for IRS personnel, require little change in current forms and instructions, and would require little change in the Internal Revenue Code. On the other hand, altering tax rates and structure without increasing the applicable exclusion amount would have little impact on the compliance burden of taxpayers.

Although the compliance costs of the current estate tax may be high, a substantial part of an estate’s administrative costs has little or nothing to do with the estate tax. As noted earlier, “even without the estate tax, assets must be marshaled, debts must be paid, heirs must be pacified, property must be valued, special orders must be sought, asset schedules must be prepared, claims and debts must be listed, income and expenses must be tracked.”(Davenport and Soled, 1999).

Complexity could be minimized if liquidity relief provisions, including deferral mechanisms, were available to all estates with no phase-ins and no acceleration. However, to the extent that limitations and requirements are either retained or added in subsequent years, the complexity level would increase dramatically. For example, few executors and trustees can deal with the complexities of current I.R.C. sections 2031(c), 2032A, 2057, and 6166 (e.g., eligibility, valuation issues, acceleration rules, etc.) without sophisticated professional help. Targeted relief provisions are by their nature very complex and are little utilized. Attempting to make sure that an estate qualifies for special valuation, deductions, and tax deferral under current law has been a difficult task for both taxpayers and their advisers. In addition, regardless of the complexity, executors and trustees may be reluctant to take advantage of the deferral provisions since they require holding an estate open for many years.28

The Impact on Liquidity

To the extent the tax burden is eliminated or reduced by increasing the applicable exclusion amount, increasing targeted relief, or decreasing tax rates, liquidity problems will be reduced. Liquidity concerns would also be minimized by adopting simple payment options available to all taxpayers. There would be no need for additional targeted relief provisions aimed at solving liquidity problems facing small business owners, farmers,

28 Broad payment relief measures would extend by years the involvement of families, executors, trustees, advisers, and the government in the tax collection process. More estates might remain open to take advantage of tax payment deferral. This likely would result in greater administration fees and possibly result in frustration on the part of beneficiaries whose distributions might be delayed. Likewise, government costs to administer an installment payment regime would be increased, although such costs might be mitigated by a reduction in the administration costs of other aspects of estate taxation (e.g., reduced need for audits of more aggressive tax reduction techniques).
taxpayers with large retirement accounts, and others with large amounts of illiquid assets. By making payment relief measures available to all taxpayers, estate tax could be paid from a combination of future income and the proceeds of an orderly, deliberate sale of assets.

The Impact on the Redistribution of Wealth

Proposals to modify the current transfer tax system through increased exclusions and reduced rates may affect the distribution of wealth in a variety of ways. If it is necessary to replace the revenue lost or deferred with other tax revenues, these new tax sources may result in a reduction in the overall progressivity of the tax system. If the lost revenues are not replaced, the governmental services provided to lower economic strata might be diminished, effectively reducing wealth redistribution. If charitable bequests are diminished, the lack of wealth redistribution may be exacerbated since many charities provide benefits to lower economic strata.

On the other hand, if the proposals reduce the tax burden of the wealthy, greater wealth would be passed to succeeding generations. This might increase the capital available to invest in businesses, possibly resulting in more jobs created for all economic strata (the “trickle down” argument for reduction in taxes on the wealthy).

The Impact on Tax and Succession Planning

A decrease in the number of taxable estates and a reduction in their tax burden should reduce the planning required to address estate tax costs and that may be motivated primarily by estate tax savings. Likewise, the need for particular estate planning techniques is likely to be reduced. For example, costs could outweigh the benefits for estate tax savings techniques such as family limited partnerships, qualified personal residence trusts, certain life insurance products (such as second-to-die policies), irrevocable life insurance trusts, charitable remainder trusts, generation-skipping transfer and dynasty trusts, etc. Making the exclusion amount portable would reduce costs associated with changing the legal title of assets held by each spouse in order to equalize estates. Of course, non-tax planning related to succession and administration of estates and trusts would still be required.

The Impact on Revenue

Increasing the applicable exclusion amount and/or altering tax rates and the tax rate structure would decrease the potential amount of estate and gift tax revenue collected. However, the cost would be substantially less than that of estate tax repeal. For example, a substitute bill offered by House Ways and Means Committee ranking Democrat Charles Rangel (D–NY), that would increase the current estate tax exclusion to $2 million in 2002 and $2.5 million in 2010, would cost only $39 billion (Glenn, 2001). In addition, this decrease in revenue may be offset in part by a decrease in administration costs incurred by the IRS and increases in income and other taxes. In addition, the decreased use of certain estate planning techniques could lead to a proportionate increase in revenue. On the other hand, the amount of gratuitous transfers to family members and others in lower income tax brackets might increase, resulting in a reduction in income tax revenue.

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29 The impact on progressivity is difficult to judge and depends on overall budget considerations, the need to replace revenue, other spending needs, etc.

30 It should be noted that scholars and economists disagree with respect to the “trickle down” argument.
As estate taxes assessed by individual states are typically based on Federal estate taxes, reductions in Federal estate taxes may force states to restructure estate taxes or find other sources of revenue. However, the impact on states will be significantly less than that resulting from outright repeal of the estate tax.

Interestingly, changing the current applicable exclusion amount to a true exemption, without changes in the underlying credit for state estate taxes, would reduce the overall tax on estates (both Federal and state) almost entirely at the cost of state revenue (see Table 3). If states counter these changes at the Federal level with increases in their own estate and inheritance taxes, the overall tax burden at death could conceivably increase.

The revenue effect of an expansion of payment options for all taxable estates could be significant, especially in the short term. For example, if estate taxes were payable over ten years, it would take ten years before estate tax revenues in a given year stabilized to an amount comparable to collections under current law. That is, at the conclusion of the tenth year, 10 percent of the tax from each of the previous ten years would be collected. The effect of this deferral would be mitigated by the collection of interest on the deferred amount, and possibly by a reduction in planning by taxpayers attempting to reduce the amount of tax immediately payable. There would be a similar effect on state revenue to the extent that states piggyback Federal law. The short-term revenue effect to both Federal and state governments would probably be worsened by the additional administrative costs of monitoring and collecting the tax over an extended period of time.

**Transition Issues**

One of the advantages of modifying the current estate and gift tax system is that transition problems are minimized and very few taxpayers are adversely affected.31

**Suggestions**

If the current transfer tax system is modified, specific suggestions include the following:

- Increase the exclusion amount to $5 million per taxpayer in order to

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**TABLE 3**

<table>
<thead>
<tr>
<th></th>
<th>Current Law</th>
<th>True Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Estate</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Less: Marital Deduction</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Less: Charitable Deduction</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Less: Exemption</td>
<td>N/A</td>
<td>675,000</td>
</tr>
<tr>
<td>Taxable Estate</td>
<td>$900,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Tentative Estate Tax</td>
<td>$306,800</td>
<td>$62,800</td>
</tr>
<tr>
<td>Less: Applicable Credit Amount</td>
<td>220,550</td>
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<tr>
<td>Estate Tax Due Before State Estate Tax Credit</td>
<td>$86,250</td>
<td>$62,800</td>
</tr>
<tr>
<td>Less: State Estate Tax Credit</td>
<td>$27,600</td>
<td>$1,800</td>
</tr>
<tr>
<td>Net Federal Estate Tax Due</td>
<td>$58,650</td>
<td>$61,000</td>
</tr>
</tbody>
</table>

31 There still might be a perception of unfairness on the part of those executors, trustees and heirs of estates faced with paying estate taxes just before the effective date of any changes. Even those individuals whose estates may benefit from these proposals might feel frustrated because they arranged their affairs (e.g., purchased life insurance, made lifetime gifts, etc.) in a manner inconsistent with any changes in the law.
eliminate estate tax concerns for 90 to 95 percent of previously taxable estates.\(^{32}\)

- The applicable exclusion amount should be made portable (i.e., $10 million per couple), so that any portion unused by the first spouse to die could be utilized by the surviving spouse. Although it can be accomplished under current law through effective tax planning, portability should be made an explicit part of the law.\(^{33}\)

- Increasing the applicable exclusion amount would necessitate corresponding increases in the $1,060,000 GST tax exemption. To the extent that these increases are made without modifications addressing the erosion of the efficacy of the GST tax due to repeal of the Rule Against Perpetuities at the state level, the ability to use dynastic trusts to create wealth will be exacerbated. In addition, the GST tax should be immediately modified and simplified by including the GST tax modifications included in the President’s and House Ways and Means Committee’s proposals in any subsequent tax legislation.

- The applicable exclusion amount should be modified so that it becomes a true exemption. Under the current rate structure, this would result in the first dollar of taxable estate facing a marginal tax rate of 18 percent instead of the current 37 percent.

- If the estate tax rate structure is altered, across the board reductions and fewer brackets are preferable to simply reducing the highest marginal rate. In addition to reducing the rates affecting smaller estates, the top marginal rate should be reduced to a rate that is no higher than the maximum individual income tax rate (currently 39.6 percent).

- As an alternative to targeted relief provisions, a new regime of broadened liquidity/payment relief measures should be implemented. I.R.C. sections 2031(c), 2032A, 2057, and 6166 should be eliminated and replaced with broader, simpler provisions available to all taxpayers. If concerned about overuse, the government could limit the attractiveness of such a tax payment deferral regime by adjusting interest rates and the deferral period.

- The full step-up in income tax basis to fair market value for inherited assets should be retained as under current law.

- The state death tax credit should be retained in its current framework, as a credit instead of a deduction, and any revenue losses to the states should be minimized.

**Advantages**

Substantial modifications to the current wealth transfer tax system would provide significant reductions in tax payment and tax compliance burdens, reduce adminis-

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\(^{32}\) Based on 1997 IRS SOI data, of 90,006 estate tax returns filed in 1997, only 3,399 reported gross estates over $5 million. Of 42,901 estates actually paying estate tax that year, only 2,335 had gross estates exceeding $5 million (IRS, 1999/2000). When AICPA survey respondents were asked how large the applicable exclusion amount would need to be to eliminate estate tax liability concerns for 90 percent of their clients, the median response was $4 million and the mean response was $8.8 million (AICPA, 2001).

\(^{33}\) Portability of the applicable exclusion amount introduces potential problems relating to remarriages and may require taxpayers that would otherwise not be required to file an estate tax return to file some type of information return to claim their deceased spouse’s unused exclusion.
tration costs, and simplify the transfer tax system with little impact on the income tax system. In addition, modifying the current system as described above offers a reasonable and practical solution to the long-range revenue implications of outright repeal, while effectively providing immediate repeal for the vast majority of taxpayers currently affected by the estate tax.

Specific advantages of modifying the current transfer tax system include the following:

- The compliance burden would be substantially reduced because the number of taxpayers subject to the transfer tax would be greatly decreased. Importantly, elimination of taxpayers would start with smaller estates because of the increased exemption, leaving only the largest estates subject to a transfer tax. In 1997, of 90,006 estate tax returns filed, only 3,399 reported gross estates over $5 million. Of 42,901 returns actually paying estate tax that year, only 2,335 had gross estates exceeding $5 million. Said another way, over 96 percent of the 90,006 estate tax returns filed in 1997 would be exempt from filing requirements and over 94 percent of the 42,901 taxable returns would be removed from the tax payment rolls if the applicable exclusion amount and corresponding filing threshold were increased to $5 million. In addition, estate planning expenses would be reduced for substantial numbers of taxpayers.

- The administrative burden and costs incurred by the IRS would be reduced as large numbers of taxpayers would immediately be eliminated from tax filing responsibilities.

- The complexities associated with a gradual transition from one system to another would be avoided. Transition rules are typically among the most complicated rules in the tax system.

- Transfer tax simplification would be achieved by replacing multiple targeted relief provisions with broadly-based liquidity relief available to all taxpayers. Targeted relief has proven to be complex and largely unused.

- Overall simplification would be achieved by avoiding significant changes to the income tax system, for example, by avoiding conversion to a carryover basis regime for assets passing to heirs at death, and avoiding special complex rules that would otherwise be needed to prevent the erosion of the income tax system.

- The re-education of taxpayers, tax professionals, and tax administrators would be minimized. Other alternatives, including carryover basis, a tax on appreciation at death, a comprehensive income tax, and an accessions tax, would require significant investments of both time and money by taxpayers, their advisers, and the government.

- It is less likely that the Federal government would need alternative sources of revenue in the future. While the exact revenue impact of these modifications is not known, in 1997, 2,335 taxable estates with gross estates exceeding $5 million paid almost half of the total estate tax collected from 42,901 taxable estates.

- States would not be forced to establish their own systems of estate and inheritance taxes, which many states have previously repealed. This would avoid significant changes in the states’ revenue collection infrastructure that would be complex and costly for taxpayers and their advisers to learn and for the states to implement and administer.
Restructuring Estate and Gift Taxes

**Concerns**

A significant concern with modifications of the current system is that the modifications might not be undertaken in a comprehensive manner or at significant levels, thus allowing some or many of the problems to persist and the criticisms to remain. Specific concerns include the following:

- The transfer tax infrastructure would remain in place making it easier for future Congresses to expand the impact of the transfer tax system should, for example, revenue pressures demand such a course of action.
- Phase-ins of changes generally cause problems for taxpayers who must continually readjust their estate plans to follow the phased-in changes.
- As long as the first-to-die’s applicable exclusion amount is not portable, taxpayers might be compelled to retitle assets, perhaps multiple times to affect their planning objectives during the phase-in period.
- If the applicable exclusion amount is applied after the estate tax is determined (rather than changed to a true exemption), smaller estates will still be subject to a higher marginal rate of tax.
- A phased-in reduction in estate tax rates that begins by reducing the top rates may be viewed as benefiting the wealthy without offering immediate relief to smaller estates, including those containing farms and small businesses.
- To the extent targeted relief provisions are retained, many estates that do not contain small business or farm assets would still face unresolved liquidity problems. Unless liquidity relief is expanded to allow all estates to opt for installment payment of their estate tax liability, beneficiaries will incur significant income taxes and other costs to enable them to pay the estate tax bill. For example, beneficiaries may have to liquidate assets during unfavorable market conditions. Targeted relief provisions are also economically inefficient in that their requirements may pressure elderly taxpayers to hold assets that they otherwise would (and perhaps should) dispose of and may force heirs to continue holding farms and businesses just to receive tax advantages.
- The current GST tax rules contain expensive tax “traps” for taxpayers and malpractice risks for practitioners in preparing gift tax returns. Families may not discover a missed GST tax exemption allocation for many decades, at which time the GST tax liability to the family as a result of the missed allocation may have increased exponentially due to compounding and the impact of inflation. Without default allocation schemes covering both direct skips and transfers to trusts, GST tax-generated problems will persist.

**Conclusion**

A combination of an increased applicable exclusion amount, alteration of the rate structure and brackets, broad deferral relief for all estates, and modifications to the GST tax would satisfy many of the criticisms of the current estate tax. Although both Federal and state revenue would be reduced, the long-term revenue impact would be much less than that resulting from outright repeal.

Other alternatives to the current transfer tax system have been proposed from time to time. These include (1) a tax on appreciation at death; (2) a comprehensive income tax; and (3) an accessions tax.
TAX ON APPRECIATION AT DEATH

If repeal of the transfer tax accompanied by a carryover basis regime proves difficult to implement, another option is to expand the income tax by taxing appreciated assets at death. Taxing appreciation at death is not a new idea. Subotnik (1989) notes that the idea of taxing constructive realization of income at death was proposed as early as the 1930s. The Kennedy Administration recommended a tax on appreciation at death in 1963, and Treasury re-introduced the concept in 1969. In 1987, two proposals dealing with the taxation of appreciation at death were included in the Joint Tax Committee’s Overview of Tax Proposals for Consideration in Revenue Reconciliation (Subotnik, 1989).

Proponents of taxing appreciation at death argue that conceptually there is no reason why the appreciation on property transferred at death should not be subject to both an income tax on the gain and estate tax on the gratuitous transfer. Practically, if a taxpayer sells appreciated property during his or her lifetime, the gain is subject to income tax, and if the taxpayer transfers the proceeds of the sale (less the income tax paid) at death to his or her heirs, the estate tax would apply also. Therefore, the current treatment of appreciation at death and the subsequent step-up in income tax basis produce inequity between taxpayers who realize income (appreciation) during life and those who transfer unrealized appreciation at death. Either carryover basis at death or a tax on appreciation at death would prevent the permanent avoidance of a tax on gains that occurs under current law.

Conceptually, the argument for carryover basis is that postponing the tax until an actual sale of the property avoids the need to determine the property’s fair market value and the tax is imposed at the time that the taxpayer realizes cash flow from the property. Taxing appreciation at death would enforce the long-standing concept that income should be taxed to the person who earned it. It also imposes tax at an ideal time in terms of the ability to pay (because the decedent no longer has any need for the funds used to pay the tax) and would limit the maximum deferral possibility to a single lifetime.

On the other hand, opponents argue that income tax should only be paid on realization and that death is not, and should not be, a realization event. They also argue that the tax would cause liquidity problems for many taxpayers and that exceptions (such as for marital transfers) can force unnatural dispository decisions to avoid the harsh cash drain at the death of the first to die.

Although a tax on appreciation at death has often been referred to by the popular press as a capital gains tax, there is no conceptual reason that the appreciation of non-capital assets should escape tax under such a regime. In fact, early proposals suggested a tax on the appreciation of all assets. As described in a 1969 Treasury proposal, “the new rule would be that gain on an asset, the sale or exchange of which would produce ordinary income or capital gain, or a combination of both, will be taxed at death with ordinary income to the required extent and capital gain as to the remainder” (U.S. Treasury Department, 1969).

Regardless of the approach taken in taxing all assets or only capital assets, it is likely that such a tax would have to be structured to provide exemptions for assets passing to a spouse or to charity.

34 While this argument would suggest the need for both the estate tax and an income tax on gains at death, most current proponents of a tax on appreciation at death offer it as a substitute to the current estate tax. Likewise, this discussion assumes the tax is imposed instead of the estate tax.

35 The 1963 plan called for an exemption of up to 50 percent of the gain if 50 percent of the estate passed to a spouse, plus a complete exemption for a residence passing to a spouse. The 1969 and 1987 proposals provided
Likewise, Congress would need to consider the potential for avoiding such a tax through inter-vivos gifts and generation-skipping transfers. In addition, the provision of one or more special exclusions might be necessary in order to eliminate “small” estates from the tax and to provide relief for family farms, small businesses, and estates with other illiquid assets.

ANALYSIS OF A TAX ON APPRECIATION AT DEATH

The Impact on Behavior

Taxing appreciation at death would solve the “problem” of lock-in by removing any advantage of holding property until death for a step-up in income tax basis. An argument against a small-estate exclusion is that property subject to the exclusion would continue to be subject to the lock-in effect. Charitable bequests likely would not be affected if a deduction were allowed for assets passing to charity at death.

Under the current transfer tax and income tax systems, there is a strong incentive to hold assets that generate capital gains rather than ordinary dividends and interest. At a minimum, the income tax on capital gains is now postponed until the asset is sold and gains may escape income taxation entirely if held until death. If unrealized gains are taxed at death, taxpayers may react by reducing investments in assets expected to generate capital gains.

One of the biggest changes in behavior is likely to revolve around the purchase of life insurance. While currently excluded from the income tax, there is no conceptual reason to exclude insurance proceeds from a tax on appreciation at death when viewing life insurance as an investment. Without a special exclusion, the “gain” on life insurance proceeds received at death would be taxed as ordinary income.

Likewise, unless specifically excluded from the tax, the immediate taxation of otherwise tax-deferred retirement plans, IRAs, stock options, etc. at death likely would force a dramatic change in compensation and retirement planning.

The Impact on Complexity and Compliance

Replacing the current transfer tax with a tax on appreciation at death with few exceptions and exclusions likely would result in simplification for taxpayers. However, complexity becomes a problem when exceptions, deductions and exclusions are allowed. Although probably necessary, providing for a marital deduction would generate complexity and uncertainty. Until funding of the marital bequest is complete, the income tax liability generated by appreciation of the decedent’s remaining assets could not be computed. Similar problems would exist for charitable bequests of appreciated property.

The most complex aspect of a tax on appreciation at death results from the need to determine the basis of each asset held at death in order to calculate taxable gains. The IRS would also likely incur significant retooling costs if the current transfer tax system were abandoned in favor of an appreciation tax. In other respects, the administration of the appreciation tax...
would be similar to the current estate tax. As with the estate tax, assets generally receive a fair market value basis following the imposition of the tax at death. However, providing carryover basis for assets passing to a surviving spouse, exempting charitable bequests, and allowing a small-estate exclusion would complicate the job of executors in deciding which assets to distribute to heirs and other beneficiaries.

The Impact on Liquidity

A major problem with a tax on appreciation at death is its impact on illiquid estates. In the late 1960s and early 1970s, opponents argued that the tax would cause significant problems for illiquid estates (Abbin, 1993). As a result of tremendous growth in qualified retirement plan benefits, deferred compensation arrangements, Keogh plans, and IRAs, the problems today would be even worse. Many of these assets cannot be sold and are payable over long periods of time to a taxpayer’s beneficiaries. However, a tax on appreciation at death would require payment of tax at ordinary income tax rates at the time of death.

A marital exemption would eliminate a potential liquidity problem for a surviving spouse. However, when assets are passed to other beneficiaries, liquidity remains a problem. The most persuasive argument against the taxation of appreciation at death is that the tax can be imposed on substantially illiquid estates that consist of farms, closely-held businesses, retirement accounts, etc., that could lead to forced sales to raise the cash necessary to pay the tax. One possible solution is to provide targeted relief, special valuation, and tax deferral mechanisms for farms and closely held businesses as under the current estate tax. However, unless expanded beyond the present scheme, targeted relief would provide no benefit to estates with other illiquid assets, including retirement accounts, stock options, and personal residences and other real estate.

The Impact on the Redistribution of Wealth

The distribution of tax burdens is likely to be different under a tax on appreciation at death. Poterba and Weisbenner (2000) find that taxing capital gains at death would collect more revenue than the current estate tax for about half of those with estates of $1 million or less. For those with larger estates, a tax on capital gains at death would result in a substantial reduction in total tax payments.

The Impact on Tax and Succession Planning

If a marital exemption is provided, the executor would have an incentive to transfer low basis assets to the surviving spouse and high basis assets to other beneficiaries in order to defer the tax on appreciation. In addition, tax considerations may encourage the funding of the marital bequest with low basis assets when an alternative funding method may make more practical sense. Likewise, the fact that the appreciation attached to property that is the subject of a charitable bequest is not taxed may cause the executor to satisfy the charitable bequest with low basis assets. If a small-estate exclusion is allowed, planning would be made complicated by the need to pick which assets receive the benefit of the exclusion. Taxpay-

38 However, one must question the efficacy of crafting targeted relief provisions for a tax on appreciation at death given the problems inherent in the targeted relief provisions of the current estate tax.

39 It should be noted that executors are not likely to undertake such planning without clear authority in the will or trust document, placing an additional burden on drafters.
ers likely would continue to emphasize planning techniques for discounting the fair market value of assets.

**The Impact on Revenue**

Taxing unrealized appreciation at death (with no exemptions and exclusions) is estimated to yield about $25 billion of annual revenue in the near term, somewhat less than current collections under the estate tax. However, taking into account an exemption for gains left to a spouse and to charity, and special exclusions for a family business, personal residence and personal property, the CBO (1999) estimated that only $9 to $12 billion of annual revenue would result over the next five years. Although providing an unlimited marital deduction would result in some immediate revenue loss, that revenue would only be deferred until the second spouse dies. Allowing unlimited charitable bequests would have more impact on revenue because the tax on the gain is permanently forgiven.

**Transition Issues**

Transition issues and complexities associated with a tax on appreciation at death may be substantial. Other alternatives and options may be less disruptive to taxpayers and may be easier to implement than a tax on appreciation at death.

**Suggestions**

If a tax on appreciation at death is enacted, specific suggestions include the following:

- In view of the unlimited marital deduction in our current estate and gift tax system and the non-recognition rule of I.R.C. section 1041 on lifetime transfers between spouses, a tax on appreciation at death likely would be acceptable only with a marital exemption. The assets used to fund the marital bequest should retain a pure carryover basis so that appreciation on assets would eventually be subject to the income tax when sold.40

- Gain on property bequeathed to charity should not be taxed at death and similar treatment should be given to lifetime charitable gifts of appreciated property. Under current law, a lifetime gift of appreciated property to charity gives rise to an income tax deduction for the fair market value of the property, but does not require the donor to recognize the gain on the disposition.

- Under current law, the GST tax prevents a taxpayer from avoiding transfer tax at each generation by using a generation-skipping transfer. Similarly, rules would be needed to define what types of generation-skipping events would trigger a tax on appreciation at death.

- At some point, estates are sufficiently small and so little revenue is generated from taxing their appreciation that one cannot justify imposing the complexities of a tax on all appreciated assets. One possible solution is to design an exemption from a tax on appreciation that is similar to the current applicable exclusion amount in the estate tax.41 For estates not subject to the tax on appreciation, current law would apply—no recognition of gain at death, and a stepped-up fair market value basis for inherited property.

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40 While a carryover basis on assets subject to a marital deduction is recommended, this may result in added complexity when surviving spouses dispose of these assets.

41 The exclusion could be based on value, the amount of the gain, or could take the form of a minimum basis (like that in the 1963 and 1969 proposals). In addition to a general exclusion applying to all assets, some commentators suggest an additional exclusion for non-business tangible personal property.
• Other items of ordinary income, such as inventory appreciation and depreciation recapture, need to be considered. With respect to inventory, taxpayers expect to pay income tax on the gains from the sales of inventory in the ordinary course of business, so there is no reason to allow such gain to escape income taxation through a small-estate exclusion. However, rather than tax the gain at death, carryover basis should be applied and the gain recognized in the ordinary course of the business.

• A tax on appreciation at death should logically be imposed on depreciation recapture. Allowing a carryover basis to apply would result in a deferral of an unlimited duration. Similarly, if the small-estate exclusion was applied to depreciation recapture, the opportunity exists that the recapture would never be taxed. The price of taking an artificial depreciation deduction against ordinary income should be the recapture of that depreciation at death.

• Another special circumstance involves a principal residence. Given that the current income tax statute exempts $500,000 of gain from the sale of the principal residence for married persons, there should be an exclusion for the principal residence from a tax on appreciation at death. This might be included in the general applicable exclusion amount or allowed as a separate exclusion of up to $500,000.

• Currently, I.R.C. section 101 excludes life insurance proceeds payable by reason of the death of the insured from gross income for income tax purposes. On the other hand, life insurance proceeds payable to an estate or owned by the decedent are subject to estate tax. If tax is imposed on appreciation at death, the treatment of life insurance proceeds must be considered. There are several options for taxing life insurance proceeds. One of the primary reasons for owning life insurance is to provide liquidity at the death of the insured for the payment of the death taxes. Rules could be designed to limit any exclusion to the excess of the tax on appreciation over the total of other liquid assets in the estate.

• Although this discussion has been concerned with a tax on appreciation, losses should be netted against gains in calculating the tax. A question arises as to the deductibility of a net loss against ordinary income on the decedent’s final income tax return. If losses are deductible against ordinary income without limitation, the executor may be inclined to allocate assets with gains to the surviving spouse, and assets with losses to the other beneficiaries, thereby deferring the gain until the death of the surviving spouse. If the deductibility of the net losses against ordinary income on the decedent’s final income tax return is limited, there should be some provision to carryback the net losses to the decedent’s prior years’ income tax returns, or to carry over the net losses to the income tax returns of the beneficiaries who inherit the property that gave rise to the loss. It also appears that some limitation on the deductibility of net losses should apply to lifetime gifts. Perhaps I.R.C. section 267, which disallows losses on sales between related persons, should apply to gifts between related persons.

Advantages

A tax on appreciation at death is conceptually sound and could serve as an
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appropriate backstop to the current income tax system. If a tax on appreciation at death was assessed at a reasonable tax rate and structured in a way to provide exemptions to assets passing to a spouse or charity, and exclusions for family farms, small businesses, and other estates with illiquid and inaccessible assets, such a tax could be feasible. However, it would also be very complex.

Specific advantages of a tax on appreciation at death include the following:

- It eliminates the lock-in effect by removing any advantage of holding property until death in order to receive a step-up in income tax basis.
- It could yield significant revenue, particularly if structured with no exemptions and exclusions.

**Concerns**

The complexities of a tax on appreciation at death are numerous. Specific concerns include the following:

- The exemptions and exclusions that would be needed under such a regime might quickly result in a tax that is as complex as the estate tax it would replace. Special rules would need to be crafted to handle lifetime gifts and generation-skipping transfers as well.
- A major dilemma arises with regard to incomplete lifetime gifts, i.e., a gift of property in trust with the donor retaining an interest in the transferred property. It seems clear that gifts of appreciated property should also trigger the recognition of gain, and hence a tax on that gain. At what point is an incomplete transfer deemed sufficient to impose a tax on appreciation, or should the tax be postponed until the retained interest is terminated, i.e., at the death of the transferor? Current law provides several possible answers. From an income tax perspective, one could refer to the rules that govern whether a grantor will continue to be taxed on the income from incompletely transferred property. However, it would seem to be more appropriate to craft rules for taxing gains on lifetime gifts based on the current transfer tax statutes.
- Paying a tax at death (albeit at a lower rate than the current estate tax) would still cause liquidity problems for estates composed of illiquid assets such as farms, closely held businesses, personal residences, and retirement accounts. This likely would result in the need for liquidity relief and tax payment deferral provisions of some sort.

**Conclusion**

While a tax on appreciation at death is conceptually sound, it does not address criticisms of the current estate tax related to whether death should be a taxable event. More importantly, due to the complexities of an appreciation tax and the inherent liquidity problems facing owners of IRAs and other pension assets, real estate, stock options, small businesses, and farms, the tax likely would not be feasible without numerous exclusions, exemptions, and targeted relief. Even then, it would be difficult to write those exclusions, exemptions, and other necessary liquidity relief provisions in a way that would be simple and useful for taxpayers. Consequently, replacing the current estate tax with a tax on appreciation at death does not appear to reduce complexity or taxpayer compliance burdens or ease administration.

Although an appreciation tax would reduce the burden on many estates by taxing only appreciation and at significantly lower rates than the current estate tax, the distribution of the tax burden would fall
most heavily on small estates. The benefits of a tax on appreciation at death appear to be outweighed by its complexities and liquidity concerns.

CONCLUSION AND RECOMMENDATIONS

Repeal of the estate tax (whether immediate or through a phase out) requires consideration of a number of issues, including the effect on Federal revenues, state revenues, the complexity resulting from a carryover basis regime, and the potential for income tax erosion. As appealing as repeal sounds, its inherent problems lead me to recommend substantial modifications instead.

A combination of an increased applicable exclusion amount, alteration of the rate structure and brackets, broad deferral relief for all estates, and modifications to the GST tax would satisfy many of the critics of the current estate tax. Although both Federal and state revenue would be reduced from current levels, the long-term revenue impact would be much less than that resulting from outright repeal.

Specific recommendations include:

- Increase the applicable exclusion amount and the GST tax exemption to $5 million per taxpayer, indexed annually for inflation, and with portability between spouses (i.e., $10 million per couple) so as to exempt 90 to 95 percent of estates from tax filing responsibilities.
- Change the exclusion to a true exemption so that the first dollar of taxable estate is taxed at the lowest possible tax rate (rather than the current exclusion that taxes the first dollar of taxable estate at a rate of 37 percent, even though the lowest tax rate is 18 percent).
- Reduce the top marginal transfer tax rate to a rate not exceeding the top income tax rate (currently 39.6 percent), with similar reductions throughout the rate structure.
- Reduce the number of transfer tax rate brackets to a more manageable number similar to the number of brackets in the income tax rate structure.
- Retain the full step–up in income tax basis to fair market value for inherited assets as under current law.
- Eliminate the highly complex and largely unused targeted relief provisions under I.R.C. sections 2031(c), 2032A, 2057, and 6166.
- Provide practical and workable liquidity relief through a new tax payment deferral mechanism available to all estates, not just small business owners and farmers.
- Modify the GST tax (as included in the President’s proposal and the House Ways and Means Committee alternative) to eliminate traps for the unwary.
- Keep the state death tax credit in its current framework (a credit instead of a deduction) and attempt to minimize any revenue losses to the states.

These modifications should be enacted as expeditiously as possible, rather than through prolonged phase–ins or phase–outs. Phase–ins and phase–outs result in a great deal of uncertainty on the part of taxpayers, can result in significant transition costs, and require additional and costly planning.

The primary advantages of this approach to reform, as compared to a phased out repeal or a tax on appreciation at death are significant (and immediate) reductions in taxpayer compliance burden, ease of administration, and simplification of both the transfer tax and income tax systems. In addition, this approach provides a reasonable and practical solution to the long–range revenue implications of outright repeal while effectively providing immediate repeal for the vast majority of tax-
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payers currently affected by the estate tax. Specific advantages of the approach include the following:

- The compliance burden would be substantially reduced, as the number of taxpayers subject to the transfer tax would be greatly decreased. Importantly, elimination of taxpayers would start with smaller estates because of the increased exemption, leaving only the largest estates subject to a transfer tax. In 1997, of 90,006 estate tax returns filed, only 3,399 reported gross estates over $5 million. Of 42,901 returns actually paying estate tax that year, only 2,335 had gross estates exceeding $5 million. Said another way, over 96 percent of the 90,006 estate tax returns filed in 1997 would be exempt from filing requirements and over 94 percent of the 42,901 taxable returns would be removed from the tax payment rolls if the applicable exclusion amount and corresponding filing threshold were increased to $5 million.

- The administrative burden and costs incurred by the IRS would be reduced as large numbers of taxpayers would immediately be eliminated from tax filing responsibilities.

- The complexities associated with a gradual transition from one system to another would be avoided. Transition rules are typically among the most complicated rules in the tax system.

- Simplification of the transfer tax system would be achieved through the replacement of multiple targeted relief provisions in the Internal Revenue Code with broad-based liquidity relief available to all taxpayers. Targeted relief has proved to be complex and largely unused.

- Simplification of the overall tax system would be achieved by avoiding significant changes to the income tax system (e.g., avoiding converting to a carryover basis regime for assets passing to heirs at death, and avoiding special complex rules that would otherwise be needed to prevent the erosion of the income tax system).

- The re-education of taxpayers, tax professionals and tax administrators would be minimized. Other alternatives, including carryover basis and a tax on appreciation at death would require significant investments of both time and money by taxpayers, their advisers, and the government in order to understand the new regime.

- It is less likely that the Federal government would need alternative sources of revenue in the future. While the exact revenue impact of these recommendations is not known, in 1997, 2,335 taxable estates with gross estates exceeding $5 million paid almost half of the total estate tax collected from 42,901 taxable estates.

- States would not be forced to establish their own systems of estate and inheritance taxes (which many states have previously repealed). This would avoid significant changes in the states’ revenue collection infrastructure that would be very complex and costly for both taxpayers and their advisers and difficult and costly for the states to implement and administer.

Acknowledgments

The analysis of the current estate tax and its alternatives as presented in this paper draws heavily from the American Institute of Certified Public Accountants (AICPA) Study on Reform of the Estate and Gift Tax System. The AICPA Study was prepared by the Estate Tax Repeal Task Force and approved by the Tax Executive Committee of the Tax Division of the AICPA and is available at the AICPA
website (www.aicpa.org). The task force was co–chaired by Roby B. Sawyers and Byrle M. Abbin. Other members of the task force included Barbara A. Bond, Evelyn M. Capassakis, Robert M. Caplan, John H. Gardner, Ruchika Garga, and Brian T. Whitlock. The author would also like to acknowledge and thank Pam Pecarich and Ward Bukofsky, of the AICPA’s Tax Executive Committee, and the AICPA Tax Division Staff, including Gerald W. Padwe, Edward S. Karl, Eileen R. Sherr, and Bonner Menking for their help in preparing and editing the AICPA Study. While the AICPA Study concluded that the current transfer tax system warrants significant reform, noted advantages and concerns about each alternative, and made substantial suggestions with respect to each alternative, the Study stopped short of making specific recommendations with respect to a preferred alternative. The recommendations presented in this paper are solely my own and have not been approved or endorsed by the AICPA.

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