

**OVERVIEW OF PRESENT LAW AND ANALYSIS RELATING
TO SELECTED PROVISIONS OF THE PRESIDENT'S
INDIVIDUAL INCOME TAX PROPOSALS**

Scheduled for a Public Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on March 21, 2001

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION



March 20, 2001
JCX-15-01

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on President Bush's budget proposals providing individual income tax relief on March 21, 2001. The President's budget proposals are contained in *Blueprint for New Beginnings, A Responsible Budget for America's Priorities* (H. Doc. 107-45) released in February 2001. The hearing will place particular emphasis on marriage tax penalty relief, death tax repeal, and doubling the child credit. The House passed a bill reducing marginal tax rates (H.R. 3, the "Economic Growth and Tax Relief Act of 2001") on March 8, 2001.

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present law and analysis with respect to the President's proposals in the following areas: child tax credit (Part I); marriage tax penalty (Part II); estate and gift taxes (Part III); charitable giving (Part IV); and education (Part V). Because many of the President's proposals are not described with specificity in the budget blueprint, the analysis contained in this document is limited to a general analysis of the issues relating to the proposals.

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of Present Law and Analysis Relating to Selected Provisions of the President's Individual Income Tax Proposals* (JCX-15-01), March 20, 2001.

I. CHILD TAX CREDIT

A. Present Law

Child tax credit

Present law provides a \$500 tax credit for each qualifying child under the age of 17. In general, the credit is nonrefundable for taxpayers with two or fewer children. However, for taxpayers with three or more qualifying children, a refundable child credit is provided up to the amount by which the liability for social security taxes exceeds the amount of the EIC (sec. 24(d)). In general, a qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. For taxable years beginning after 2001, the nonrefundable portion of the child credit (and other nonrefundable credits) that may be claimed by the individual may be affected by operation of the alternative minimum tax and the refundable portion of child credit may be reduced by the individual's alternative minimum tax liability, (See discussion, below).

For taxpayers with modified adjusted gross income ("modified AGI") in excess of certain thresholds, the otherwise allowable child credit is phased out. Specifically, the otherwise allowable child credit is reduced by \$50 for each \$1,000 of modified AGI (or fraction thereof) in excess of the applicable threshold. Modified AGI is the sum of the taxpayer's AGI plus amounts excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For married taxpayers filing joint returns, the threshold is \$110,000. For taxpayers filing single or head of household returns, the threshold is \$75,000. For married taxpayers filing separate returns, the threshold is \$55,000. These thresholds are not indexed for inflation. The length of the phase-out range depends on the number of the taxpayer's qualifying children. For example, in 2001, the phase-out range for a single person with one qualifying child is between \$75,000 and \$85,000 of modified AGI. The phase-out range for a single person with two qualifying children is between \$75,000 and \$95,000 of modified AGI in 2001.

Alternative minimum tax

In general

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) \$45,000 in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 in the case of unmarried individuals; and (3) \$22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI

exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Personal nonrefundable credits

Through 2001, an individual generally may reduce his or her tentative AMT liability by nonrefundable personal tax credits including the child credit and certain other credits such as the HOPE and Lifetime Learning credits. For taxable years beginning after December 31, 2001, these nonrefundable credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. For taxable years beginning during 2000 and 2001, these credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

Refundable credits

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). In addition, a refundable earned income credit is provided for individuals with earned income below certain amounts. The earned income credit and, for taxable years beginning after 2001, the refundable child credit are reduced by the amount of the individual's minimum tax liability.

B. Description of President's Budget Proposal²

The President's budget proposal would double the child tax credit to \$1,000 per child and would apply the credit to the alternative minimum tax.

C. Analysis

In general

One of the basic tenets of tax policy is that an accurate measurement of ability to pay taxes is essential to tax fairness. Some criticize the present-law child credit as too small because the current maximum amount of the credit does not adequately reflect the cost of raising a child. Proponents of an expansion of the size of the child credit argue that \$500 is inadequate, even if taken together with the personal exemption available for each qualifying child. They argue that the credit should be increased to better reflect the reduced ability to pay of taxpayers with children. Others argue that the full financial cost of raising a child should not be presumed to be

² References to the President's budget proposals in this document are to President Bush's proposals as described in *A Blueprint for New Beginnings, A Responsible Budget for America's Priorities* (H. Doc. 107-45).

a public responsibility, and that the child credit and dependent exemptions are not designed to offset fully the costs of raising a child.

Personal nonrefundable credits

For taxable years beginning after December 31, 2001, the child credit and the other nonrefundable personal credits are allowed only to the extent the individual's regular tax liability exceeds the individual's tentative minimum tax liability, determined without regard to the minimum tax credit. The rapidly expanding number of taxpayers (including middle-income taxpayers) who will experience a reduction in their child credit and other nonrefundable credits in the next few years as a consequence of the AMT is viewed as a significant source of complexity in the Code.

Refundable credits

The child tax credit is refundable only for taxpayers with three or more qualified children. Some commentators argue that extending refundability to all taxpayers regardless of the number of qualifying children would result in more uniform treatment of taxpayers with qualifying children. They argue that making the child credit refundable regardless of the number of qualifying children will help deliver the benefits of the child credit to taxpayers who have inadequate income tax liability to utilize the credit but are liable for other Federal taxes (e.g., payroll taxes). Proposals to enhance the ability of taxpayers to utilize the full value of the child credit could be fashioned in several ways. One option would be to allow the child credit against regular and alternative minimum tax liability. Such a proposal might also entail a review of the present-law provision that reduces the child credit and the earned income credit by the amounts of the individual's alternative minimum tax. Another option would be to make the child credit fully refundable. Some may argue that this would be the equivalent of creating a means tested grant program administered by the Internal Revenue Service rather than another administrative agency.

Distribution of the child tax credit

The following table provides information regarding the distribution of the child credit. As the following table shows, approximately 69 percent of the child tax credit is claimed by taxpayers with incomes below \$75,000.

Table 1.-Distribution of the Child Tax Credit, 2001

Income category ⁽¹⁾	Taxpayers claiming child credit (millions)	Child credit (Billions \$)
Less than \$10,000.....	0.1	(2)
10,000 to 20,000.....	1.5	\$0.5
20,000 to 30,000.....	3.7	2.0
30,000 to 40,000.....	3.5	2.7
40,000 to 50,000.....	3.2	2.6
50,000 to 75,000.....	6.1	5.3
75,000 to 100,000.....	4.4	4.0
100,000 to 200,000.....	3.3	2.7
200,000 and over.....	---	---
Total, all taxpayers.....	25.8	\$19.8

Source: Joint Committee on Taxation
Detail may not add to total due to rounding.

⁽¹⁾ The income concept used to place tax returns into income categories is adjusted gross income plus [1] tax exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] workers compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2001 levels.

⁽²⁾ Less than \$50 million.

II. MARRIAGE TAX PENALTY

A. Present Law and Legislative Background

Present Law

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 experience a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus. Although the marginal tax rate breakpoints³ and the standard deduction are typically considered the major elements of the Federal income tax system that create marriage penalties and bonuses, other provisions of present law also contribute to the amount of marriage penalty or bonus any couple will face.

Marriage penalties due to rate brackets and the standard deduction

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. For taxpayers in the 15-, 28-, and 31-percent marginal tax rate brackets, the bracket breakpoints and the standard deduction for single filers are roughly 60 percent of those for joint filers and those for head of household filers are between 80 and 86 percent of those for joint filers. For the 36-percent bracket, the breakpoints for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket, the bracket breakpoint is \$297,350 (for 2001) regardless of filing status.

With these ratios, the sum of the standard deductions two unmarried individuals would receive exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals.⁴ Furthermore, because of the way the bracket breakpoints are structured, taxpayers filing joint returns may have more of their taxable income pushed into a higher marginal tax bracket than when they were unmarried. In order for there to be no marriage

³ A bracket breakpoint is the dividing point between two marginal rate brackets.

⁴ Because lower-income taxpayers are more likely to use the standard deduction, this feature of present law is a more significant part of the marriage penalty for lower-income taxpayers relative to higher-income taxpayers.

penalties as a result of the rate structure and the standard deduction, the standard deduction and the bracket breakpoints for married taxpayers filing joint returns would have to be at least twice that for both single and head of household filers. Such a structure would enhance marriage bonuses, however.

Marriage penalties due to income-based phaseins and phaseouts

Marriage penalties or bonuses also will arise whenever a tax provision exists that has an income-based phasein or phaseout.⁵ For any such provision, whether a marriage penalty or a marriage bonus arises will depend on the circumstances of the particular taxpayers and on the income levels at which the phase-out ranges occur for single or head of household taxpayers versus married taxpayers filing jointly. While setting the bracket breakpoints for married taxpayers filing jointly at twice that for singles and head of households would eliminate marriage penalties arising from the rate structure, no such remedy is available with respect to phaseins or phaseouts of tax provisions, even if the phaseout ranges were double that of singles or heads of households. The reason for this is that a single taxpayer who qualifies for a particular tax benefit will no longer qualify if he or she marries and the combined income of the couple exceeds the level for married taxpayers filing joint returns to qualify for the benefit. This could happen regardless of where the phase-out ranges are set for married taxpayers filing joint returns, as long as one spouse had sufficient income to put the combined return over the income limits to qualify for the benefit. This situation is most likely to occur when one spouse has relatively high income, and thus the marriage penalty from the phaseout provision may be offset by a marriage bonus resulting from the rate structure and unequal distribution of income across spouses.

Marriage penalties in the earned income credit (“EIC”)

In addition to the potential for marriage penalties in the rate structure and standard deduction, the structure of the EIC may create marriage penalties for lower-income taxpayers. Because the EIC increases over one range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EIC for which they are eligible.⁶ This problem is particularly acute because the EIC does not feature a higher phaseout range for married taxpayers than for heads of households.

Marriage may reduce the size of a couple's EIC not only because their incomes are aggregated, but also because the number of qualifying children is aggregated. Because the amount of EIC does not increase when a taxpayer has more than two qualifying children, marriages that result in families of more than two qualifying children will provide a smaller EIC

⁵ There are a variety of such provisions under present law. For a complete discussion of various phase-in and phase-out rules, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS -3-98), February 3, 1998.

⁶ In the case of two individuals with very low wage income, marriage may increase the amount of the EIC available with respect to a qualifying child. If the individual with the qualifying child is in the phase-in range of the EIC, the aggregation of incomes upon marriage could increase the amount of the EIC.

per child than when their parents were unmarried. Even when each unmarried individual brings just one qualifying child into the marriage there is a reduction in the amount of EIC per child, because the maximum credit for two children is generally less than twice the maximum credit for one child.

The combined elements of present law can cause unmarried individuals who are eligible for the EIC to face significant marriage penalties. For example, in 2001, two individuals, each with one qualifying child and wage income of \$15,000, would face a marriage penalty of \$4,417⁷ due largely to the EIC.⁸

Legislative Background

The marriage penalty in the current income tax rate structure dates from changes in the structure of individual income tax rates in 1969.⁹ To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for married couples filing joint returns and single taxpayers were introduced.

Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. Under this tax structure, there was neither a marriage penalty nor a marriage bonus. However, this structure created an incentive to split incomes because, with a progressive income tax rate structure, a married couple with only one spouse earning income could reduce their combined tax liability if they could split their income and assign half to each spouse. While the Supreme Court upheld the denial of contractual attempts to split income,¹⁰ it

⁷ An individual with \$15,000 in wage income and one child would have a regular tax liability of \$383 before credits. The \$500 nonrefundable child credit would reduce this liability to \$0, and the remainder of the credit would go unused because it is a nonrefundable credit. Additionally, an EIC of \$2,122 would be allowed, for a net Federal tax liability of -\$2,122. If this individual marries another individual in the same circumstances (i.e., one with the same income and one child, and thus the same tax liability) their regular Federal income tax liability would be \$1,620 on their combined income of \$30,000, and thus they would be eligible for the full child credit of \$1,000 for the two children. Additionally, they would receive an EIC of \$447, for a net Federal income tax liability of \$173. The marriage penalty is thus $\$173 - (-\$2,122 + -\$2,122) = \$4,417$.

⁸ The amount of the marriage penalty would have been even larger if each individual had two or more children, for the reasons discussed in the text. This would be mitigated only somewhat by the fact that the resulting family would have three or more children and thus be entitled to a refundable child credit.

⁹ In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household" status). Because the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

¹⁰ *Lucas v. Earl*, 281 U.S. 111 (1930).

ruled that in States with community property laws, income splitting was required for community income.¹¹ As income tax rates and the number of individuals liable for income taxes increased before and during World War II, States had an increasing incentive to adopt community property statutes to give their citizens the tax benefits of income splitting.

The Revenue Act of 1948 provided the benefit of income splitting to all married couples by establishing a separate tax schedule for married couples filing joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income.¹² While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.¹³ As a result of this basic rate structure, by 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of those for married couples filing joint returns. This schedule created a marriage penalty for some taxpayers.

In 1981, Congress created a deduction for two-earner married couples. The maximum deduction equaled 10 percent of the lesser of: (1) the earned income of the spouse with lower income or (2) \$30,000. The two-earner deduction, was, in part, created to alleviate the work disincentive effects of high marginal tax rates on the second earner's income. The Tax Reform Act of 1986 repealed the two-earner deduction in conjunction with the enactment of generally lower tax rates.

B. Description of President's Budget Proposal

The President's budget proposal would reduce the marriage tax penalty by reinstating the two-earner deduction. Under the President's budget proposal, two-earner families would receive a deduction that allows the lower-earning spouse to deduct 10 percent --up to \$3,000 --of his or her earned income.

¹¹ *Poe v. Seaborn*, 282 U.S. 101 (1930).

¹² This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.

¹³ Because income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

C. Analysis

Data relating to marriage penalty under present law

There is no precisely accurate measure of the size of the marriage penalty under present law. The amount of penalty that any married couple will face depends on the particular characteristics of the couple's income, deductions, credits, etc., and how such items of income, etc., are assumed to be divided between the spouses.

In 1998, the Congressional Budget Office ("CBO") estimated the marriage penalty estimated for 1999 under their basic set of assumptions was \$32.2 billion for 21.7 million returns. Under this set of assumptions, the 21.7 million returns with a marriage penalty had an average penalty of \$1,480.¹⁴

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the income tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally. It specifies the married couple as the tax unit so that married couples

¹⁴ The basic assumptions assume that spouses divide unearned income and itemized deductions in proportion to their earnings. The first child is assigned to the spouse with higher earnings, the second child to the lower-earning spouse, and all others to the higher earner. If eligible, both spouses can file as head of household and claim the EIC. The data presented here are updated estimates of the CBO study. For a complete discussion of the assumptions and analysis, see Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997. This study discusses and estimates both marriage penalties and marriage bonuses.

with the same income pay the same tax. But the current tax system is not marriage neutral.¹⁵ A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity.¹⁶

There is disagreement as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality.¹⁷ Those who hold marriage neutrality to be more important tend to focus on marriage penalties that may arise under present law and argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with \$20,000 of income are equally well off regardless of whether their income is divided \$10,000-\$10,000 or \$15,000-\$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal

¹⁵ Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Many married couples would still have marriage bonuses. As described below, the joint return in such a system would allow married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple in which one spouse has \$60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with \$30,000 of income. With progressive taxation, the tax liability on \$30,000 would be less than half of the tax liability on \$60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

¹⁶ It should be noted that there is an exception to this rule if refundable credits are permissible. A system with a single tax rate and a per individual refundable credit would have marriage neutrality, equal taxation of couples with equal incomes, and progressivity. In such a system, the refundability of the tax credit combined with an equal tax rate on all income would make irrelevant any splitting of income between the individuals. Refundability of the tax credit also would create progressivity in what would otherwise be a proportional tax. Such a system could not have standard deductions, exemptions, or other deductions or exclusions from income.

¹⁷ This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax (i.e. a single rate on all income for all taxpayers) system. A proportional system would automatically produce marriage neutrality and equal taxation of couples with equal incomes.

income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes.¹⁸

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, other activities or leisure. It could, of course, be argued in response that the “leisure” of the non-earner may in fact consist of necessary job hunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.¹⁹

Marriage penalty, labor supply, and economic efficiency

Most analysts discuss the marriage penalty as an issue of fairness, but the marriage penalty also may create economic inefficiencies. The marriage penalty may distort taxpayer behavior. The most obvious decision that may be distorted is the decision to marry. For taxpayers for whom the marriage penalty exists, the tax system increases the “price” of marriage. For taxpayers for whom the marriage bonus exists, the tax system reduces the “price” of marriage. Most of what is offered as evidence of distorted choice is anecdotal. There is no statistical evidence that the marriage penalty has altered taxpayers’ decisions to marry. Even if the marriage decision were distorted, it would be difficult to measure the cost to society of delayed or accelerated marriages or alternative family structures.²⁰

Some analysts have suggested that the marriage penalty may alter taxpayers’ decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before

¹⁸ For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, see Marjorie E. Kornhauser, “Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return,” 45 *Hastings Law Journal* 63 (1993); Edward J. McCaffery, “Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code,” 40 *UCLA Law Review* 983 (1993); and Lawrence Zelenak, “Marriage and the Income Tax,” 67 *Southern California Law Review* 399 (1994).

¹⁹ If the two-earner couple had child care expenses many would think that the single-earner couple with children and the same income would have a greater ability to pay taxes as the family would benefit from the unpaid labor of the stay-at-home spouse with regard to child care.

²⁰ Marriage bonuses may similarly distort taxpayer behavior.

marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first \$7,450 of his earnings would be tax-free.²¹ However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.²² Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.²³

The possible disincentive effects of a higher marginal tax rate on the secondary worker arise in the case of couples who experience a marriage bonus as well. In the specific example above, the couple consisted of one person in the labor force and one person not in the labor force. As noted previously, such a circumstance generally results in a marriage bonus. By filing a joint return, the lower earner may become subject to the marginal tax rate of the higher earner. By creating higher marginal tax rates on secondary earners, joint filing may discourage a number of individuals from entering the work force or it may discourage those already in the labor force from working additional hours.²⁴

²¹ As a single taxpayer, the man could claim the standard deduction of \$4,550 and one personal exemption of \$2,900 for 2001, effectively exempting the first \$7,450 of his earnings. This example ignores payroll taxes.

²² This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent.

²³ See Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, for a review of econometric studies on labor supply of so-called primary and secondary earners. CBO, *For Better or Worse*, pp. 10-12, also reviews this literature.

²⁴ The decision to work additional hours may be less sensitive to changes in the marginal tax rate than the decision to enter the labor force. See, Robert K. Triest, "The Effect of Income Taxation on Labor Supply in the United States," *Journal of Human Resources*, 25, 1990.

Eliminating or reducing the marriage penalty

The marriage penalty with respect to the rate structure could be reduced or eliminated in a variety of ways. To eliminate the marriage penalty due to the rate structure through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. This change could either gain or lose revenue--depending on whether unmarried individuals have their rate brackets shifted down or joint filers have theirs shifted up.²⁵ Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same (they would differ only because of extra personal exemptions for the head of household's dependents and any EIC). Relying solely on extra personal exemptions to adjust for family size would result in unmarried individuals with dependents receiving smaller tax benefits than they now receive by filing as head of household (assuming that the head of household rate is adjusted downward to match the singles rate, rather than the reverse). Such a change in rate structure also would bring back the "singles penalty" that led to the creation of an unmarried filing status (separate from married, filing separately) in 1969.

An alternative approach would be to reduce the marriage penalty by returning to the 1982-1986 second-earner deduction, which allowed joint filers a deduction for 10 percent of the lesser of the earned income of the lower-earning spouse or \$30,000. This approach reduces the marginal tax rate on the lower-earning spouse, but does not eliminate the marriage penalty, especially if the size of the deduction is capped, as was the 1982-1986 deduction. While this approach is not tailored to the particular situation of a married couple, it is much easier to administer than calculating separate liabilities for each spouse. One advantage of the second-earner deduction approach is that the benefit of the deduction is more targeted to those taxpayers that actually face marriage penalties, while generally limiting increases in marriage bonuses.²⁶ The second-earner deduction would provide a tax benefit to some couples who already experience marriage bonuses (i.e., those couples where the earnings are split less evenly than 70/30 as previously discussed). However, the relative value of the deduction to those couples would be small because to be in the bonus situation the earnings of the lower-earning spouse are usually small.

²⁵ A revenue neutral result could be fashioned by the appropriate combination of increases in the breakpoints for married taxpayers and decreases in those for singles and heads of households. Regardless of the manner in which the rates were adjusted (i.e., by increasing bracket breakpoints for married taxpayers or reducing them for singles and heads of households), a structure with rates for married taxpayers at twice the level of single and heads of households would cause marriage bonuses.

²⁶ This follows because it is two-earner couples that generally have marriage penalties, while single earner couples, which would not benefit from the second-earner deduction, generally experience marriage bonuses. The two earner deduction would not affect marriage penalties that result from the EIC, and nor would changes to the general rate structure. Of the options considered here, only the separate filing option would impact marriage penalties that result from the EIC.

Allowing joint filers the option of calculating a combined tax liability as if they were not married could reduce the marriage penalty in the rate structure, but would add complexity to the Federal tax laws. To take advantage of the provision, taxpayers would have to calculate their tax liability under two alternatives and then choose the smaller liability. Rules would have to prescribe how taxpayers would allocate deductions, dependent exemptions, and unearned income (if any) between the two spouses, and what filing statuses are available.²⁷ In many cases, it would be difficult for the Internal Revenue Service to enforce detailed rules short of audit; in practice, taxpayers could have wide latitude to allocate deductions and unearned income in the most favorable way.²⁸

²⁷ The extent to which the marriage penalty is reduced or even eliminated would depend on resolution of these issues.

²⁸ For example, the Virginia State income tax allows separate reporting of income by married couples on a combined tax return, with separate allocations of personal exemptions and deductions as determined by the taxpayer.

III. ESTATE AND GIFT TAXES

A. Present Law and Legislative History

1. Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.²⁹ The unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million.³⁰ In addition, a 5-percent surtax is imposed on cumulative taxable transfers between \$10 million and the amount necessary to phase out the benefits of the graduated rates.³¹

The amount of gift tax payable for any calendar year generally is determined by (1) multiplying the applicable tax rate (from the unified graduated rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and (2) subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by (1) multiplying the applicable tax rate (from the unified graduated rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his or her lifetime or at death and then (2) subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

2. Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. From 1987 to 1997, the unified credit was \$192,800, which effectively exempted from estate and gift tax a total of \$600,000 in cumulative taxable transfers. The Taxpayer Relief Act of 1997 (the "1997 Act")³² increased the effective exemption to \$625,000 in 1998, \$650,000 in 1999,

²⁹ Prior to 1976, separate tax rate schedules applied to the gift tax and estate tax.

³⁰ The unified credit operates to effectively exempt from estate and gift tax the first \$675,000 of cumulative taxable transfers in 2001. For transfers in excess of \$675,000, estate and gift tax rates begin to apply at 37 percent. The effective exemption is scheduled to increase to \$1 million in 2006 and thereafter. (See discussion of unified credit at II.A.2., below.)

³¹ In order to phase out the benefit of the graduated rates, the 5-percent surtax is applied to taxable transfers between \$10 million and \$17,184,000. Thus, estates between \$10 million and \$17,184,000 are subject to a top marginal rate of 60 percent. Taxable transfers over \$17,184,000 are subject to a top marginal rate of 55 percent, as the benefit of the graduated rate has been phased out.

³² P.L. 105-34 (August 5, 1997).

\$675,000 in 2000 and 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter.

3. Transfers to a surviving spouse

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a “qualified terminable interest” also are eligible for the marital deduction. A “qualified terminable interest” is property: (1) which passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use the property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

4. Annual exclusion for gifts

A taxpayer may exclude \$10,000 of gifts made to any one donee during a calendar year. The \$10,000 exclusion is adjusted annually for inflation occurring after 1997. For 2001, the inflation-adjusted amount remains at \$10,000.³³ This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Married individuals may treat gifts made to any one donee as having been made one-half by such the donor and one-half by his or her spouse. This provision effectively allows a married couple to exclude \$20,000 of gifts made to any one donee during a calendar year.

5. Basis of property received

A taxpayer who receives property from a decedent’s estate or from a donor of a lifetime gift may want to sell or otherwise dispose of the property. Gain or loss, if any, on the disposition of the property is measured by the taxpayer’s amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer’s basis in such property.

Basis generally represents a taxpayer’s investment in property. From the time property is acquired, basis may be adjusted over time. An example of an adjustment that would increase basis would include the cost of capital improvements made to property. An adjustment that would decrease basis would, for example, be depreciation deductions taken with respect to the property.

Under present law, property received from a donor of a lifetime gift takes a carryover basis. “Carryover basis” means that the basis in the hands of the donee is the same as it was in the hands of the donor plus any gift tax paid. (Sec. 1015.)

Under present law, property received from a decedent’s estate generally takes a stepped up basis. “Stepped up basis” for estate tax purposes means that the basis in the hands of the beneficiary generally is the fair market value on the date of the decedent’s death. (Sec. 1014.)

³³ Rev. Proc. 2001-13.

6. Valuation

In general

For Federal estate and gift tax purposes, the value of property generally is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. For Federal estate tax purposes, fair market value is determined at either (1) the time of the decedent's death, or (2) the "alternate valuation date," which is six months after the decedent's death. For federal gift tax purposes, fair market value generally is determined on the date the gift is made.

Special-use valuation

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value which is based on the property's highest and best use. Currently, the maximum "special-use valuation" reduction in value for such real property resulting from an election under section 2032A is \$750,000. The \$750,000 maximum reduction in value is adjusted annually for inflation occurring after 1997. For 2001, the inflation-adjusted maximum special-use valuation reduction is \$800,000.³⁴

An estate may qualify for special-use valuation under section 2032A if:

- the decedent was a citizen or resident of the United States at the time of death;
- at least 50 percent of the adjusted value of the decedent's gross estate consists of the farm or closely-held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property);
- at least 25 percent of the adjusted value of the gross estate is qualified farm or closely-held business real property, which was used by the decedent or a member of the decedent's family for 5 of the 8 years leading up to the date of the decedent's death;³⁵
- the real property qualifying for current-use valuation passes to a qualified heir;³⁶ and

³⁴ Rev. Proc. 2001-13.

³⁵ For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current-use value.

³⁶ The term "qualified heir" means a member of the decedent's family, which includes his or her spouse, his or her lineal descendants, his or her spouse's lineal descendants, or the spouse of any lineal descendant.

- such real property was owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely-held business (a "qualified use") for 5 of the 8 years immediately preceding the decedent's death.

If, after an election is made to value property at its current-use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to "recapture" the estate-tax benefit of the current-use valuation. For purposes of the special-use valuation provisions, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax. In addition, recipients of property for which special-use valuation was elected take a basis equal to the property's special-use value, rather than its fair market value.

7. Qualified family-owned business interests

An estate is permitted to deduct the adjusted value of the qualified family-owned business interests of the decedent, up to a total of \$675,000.

The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit exemption amount is \$625,000, for a total of \$1.3 million. If the qualified family-owned business deduction is less than \$675,000, then the unified credit effective exemption amount is equal to \$625,000, increased by the difference between \$675,000 and the amount of the qualified-family owned business deduction. However, the unified credit effective exemption amount cannot be increased above the generally applicable exemption amount in effect for the taxable year.

A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if one family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in sec. 543). In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or member of the qualified heir's family) is required to actively participate in the trade or business for at least 10 years following the decedent's death.

The benefit of the deduction for qualified family-owned business interests is subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following recapture events occurs:

- the qualified heir ceases to meet the material participation requirements;
- the qualified heir disposes of any portion of his or her interest in the family-owned business, other than generally by a disposition to a member of the qualified heir's family or through a qualified conservation contribution;
- the principal place of business of the trade or business ceases to be located within the United States; or
- the qualified heir loses U.S. citizenship.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100 percent of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: seven years after the decedent's death, 80 percent; eight years after the decedent's death, 60 percent, nine years after the decedent's death, 40 percent, and 10 years after the decedent's death, 20 percent. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

An estate may claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50 percent of the decedent's gross estate, if the estate claimed special-use valuation, then the property's special-use value is used.

8. Exclusion for land subject to a permanent conservation easement

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$400,000 in 2001 and \$500,000 in 2002 and thereafter. If the value of the conservation easement is less than 30 percent of the value of the land without the easement (reduced by the value of any retained development rights), then the exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land.

A qualified conservation easement is one that meets the following requirements:

- the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture);
- the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and
- a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of this provision, preservation of a historically important land area or certified historic structure does not qualify as a conservation purpose.

In order to qualify a conservation easement for the exclusion, the easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is the same as it was in the hands of the decedent and is not stepped up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor.

For purposes of the special-use valuation provisions or qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

9. Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor).

Transfers subject to the generation-skipping transfer tax include "direct skips," "taxable terminations," and "taxable distributions." A "direct skip" is a transfer of an interest in property to a skip person (e.g., a transfer from grandparent to grandchild). A "taxable termination" is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A "taxable distribution" is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of \$1 million. The \$1 million generation-skipping

transfer tax exemption is adjusted annually for inflation occurring after 1998. For 2001, the generation-skipping transfer tax exemption is \$1,060,000.³⁷ Because both the generation-skipping transfer tax and the estate or gift tax can apply to the same transfer, the combined marginal tax rate on a generation-skipping transfer can reach nearly 80 percent.

A \$10,000 annual exemption also is provided for transfers that are “direct skips.” In general, if an outright gift is not subject to gift tax because of application of the gift tax annual exclusion, then it will not be subject to generation-skipping transfer tax. In addition, the annual exemption for “direct skips” also applies to certain transfers to trusts, if the trust is for the exclusive benefit of one beneficiary and the trust’s corpus would be included in the beneficiaries gross estate if the beneficiary were to die before the termination of the trust.

10. Installment payment of estate tax for closely-held businesses

In general, the estate tax is due within nine months of a decedent’s death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in 2 or more installments (but no more than 10). If the election is made, the estate pays only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.³⁸ A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million in taxable value of a closely-held business. Value for purposes of installment payment of estate tax would include a property’s special-use value, if the benefits of that provision are claimed. The \$1 million threshold is adjusted annually for inflation occurring after 1998. For 2001, the threshold is \$1,060,000. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of \$1 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

To qualify for the installment payment election, the decedent must have been a citizen or resident of the United States and the decedent’s interest in the closely-held business must exceed 35 percent of the decedent’s adjusted gross estate. An interest in a closely-held business includes:

- any interest as a proprietor in a business carried on as a proprietorship;
- any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners or if at least 20 percent of the partnership’s assets are included in determining the decedent’s gross estate; and

³⁷ Rev. Proc. 2001-13.

³⁸ For example, assume estate tax is due in 2001. If interest only is paid each year for the first five years (2001 through 2005), and if 10 installments of both principal and interest are paid for the 10 years thereafter (2006 through 2015), then payment of estate tax would be extended by 14 years from the original due date of 2001.

- stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate.

In general, the installment payment election is available only if the estate directly owns an interest in a closely-held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely-held active trade or business, but if the election is made, neither the five-year deferral (which provides that only interest payments, are required during the first five years) nor the special two-percent interest rate on the first \$1 million of taxable estate applies.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

In addition, if more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, then, in general, the extension of time for the payment of tax no longer applies, and the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. An exception to this rule is provided for transfers of property to a person entitled to receive the decedent's property under the decedent's will, the applicable State law, or a trust created by the decedent. Moreover, a similar exception applies in the case of a series of subsequent transfers of the property by reason of death so long as each transfer is to a member of the decedent's family, which includes the decedent's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

11. State death tax³⁹ credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State (or the District of Columbia) with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "soak-up" estate tax, which applies when the state death tax liability is less than the maximum Federal death tax credit. In such a case, a tax is imposed by the state, which is equal to the difference between the state death tax liability and the maximum Federal state death tax credit. This provides states with the maximum amount of death tax that for which the Federal state death tax credit provides.

³⁹ The term "death tax" is used to refer to any tax that is imposed at the time of the death of an individual. As used herein, this term includes inheritance taxes and estate taxes. An "inheritance" tax is a tax on the right to receive property at death from an individual and generally is measured by the amount that a particular legatee receives from the decedent. An "estate" tax is a tax on the right to transfer property at death and generally is measured by the total amount passing at the time of the decedent's death. Historically, inheritance taxes were imposed by States, while estate taxes were imposed by the Federal Government.

12. Transfers to certain foreign trusts and estates

Transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

13. Federal estate and income tax treatment of life insurance

For Federal estate tax purposes, the proceeds of life insurance on the life of a decedent, receivable by the executor, generally are included in the decedent's gross estate. Moreover, proceeds of life insurance are included in a decedent's gross estate to the extent he or she possessed at death any of the incidents of ownership exercisable alone or in conjunction with any other person. (Sec. 2042.)

No Federal income tax generally is imposed on earnings under a life insurance contract ("inside buildup"). Further, no Federal income tax is imposed on amounts received under a life insurance contract paid by reason of the death of the insured. This favorable tax treatment is available only if the policyholder or owner has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract. Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income. In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances. A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums. Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured.

14. Legislative history

Federal death taxes before World War I

While States extensively used death taxes, Federal death taxes in the United States, for most of its history, were imposed primarily to finance wars or the threat of war. The first Federal death tax was imposed from 1797 until 1802 as a stamp tax on inventories of deceased persons, receipts of legacies, shares of personal estate, probates of wills, and letters of administration to pay for the development of strong naval forces felt necessary because of strained trade relations

with France.⁴⁰ After repeal of the stamp tax,⁴¹ there were no death taxes imposed by the Federal Government until the Civil War, when the Federal Government imposed an inheritance tax between 1862 and 1870.⁴² In order to finance the Spanish-American War, the Federal Government imposed its first estate tax in 1898, which remained in effect until its repeal in 1902.⁴³ While prior death taxes were primarily imposed to finance warfare, President Theodore Roosevelt proposed, in 1906, a progressive tax on all lifetime gifts and death time bequests to limit the amount that one individual could transfer to another, although no legislation immediately resulted from such proposal.⁴⁴

Estate taxes from World War I through World War II

Estate taxes to finance World War I

The commencement of World War I caused revenues from tariffs to fall. The Federal Government in 1916⁴⁵ adopted a progressive estate tax on all property owned by the decedent at his or her death, certain lifetime transfers which were for inadequate consideration,⁴⁶ transfers not intended to take effect until death,⁴⁷ and transfers made in contemplation of death.

The 1916 estate tax provided an exemption (in the form of a deduction) of \$50,000 with rates from 1 percent on the first \$50,000 of transferred assets to 10 percent on transferred assets in excess of \$5 million. The next year, the revenue needs from the War resulted in increases in estate tax rates with a top rate of 25 percent on transferred assets in excess of \$10 million.⁴⁸

⁴⁰ Act of July 6, 1797, 1 Stat. 527.

⁴¹ Act of June 30, 1802, 2 Stat. 148.

⁴² Act of July 1, 1862, 12 Stat. 432, 483; Act of July 15, 1870, 16 Stat. 256.

⁴³ War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).

⁴⁴ See quotation in Paul, Randolph E., Taxation in the United States, p. 88 (Boston 1954).

⁴⁵ Act of September 8, 1916, 39 Stat. 756.

⁴⁶ This rule is contained in Code section 2043 of present law.

⁴⁷ This rule is contained in Code section 2037 of present law.

⁴⁸ Act of March 3, 1917, 39 Stat. 1000.

Estate and gift taxes between World Wars I and II

In the Revenue Act of 1918, estate tax rates on transfers under \$1 million were reduced, but the tax was extended to life insurance proceeds in excess of \$40,000 that were receivable by the estate or its executor and property subject to a general power of appointment.⁴⁹

In 1924, the estate tax was changed by: (1) increasing the maximum rate to 40 percent; (2) broadening property subject to the tax to include jointly-owned property and property subject to a power retained by the decedent to alter, amend, or revoke the beneficial enjoyment of the property;⁵⁰ and (3) allowing a credit for State death taxes of up to 25 percent of the Federal tax. In addition, the first gift tax was imposed.

In 1926, the gift tax was repealed and estate tax rates were reduced to a maximum rate of 20 percent on transfers over \$10 million. The exemption was increased from \$50,000 to \$100,000, and the credit for State death taxes was increased to 80 percent of the Federal tax.⁵¹

In 1932, with the advent of the Depression, revenues from other sources were declining, and the need for new revenues for Government projects increased. As a result, estate tax rates were increased, with a top rate of 45 percent on transfers over \$10 million.⁵² The tax was made applicable to lifetime transfers in which the transferor retained a life estate or the power to control who shall benefit from the property or income therefrom.⁵³ The exemption was reduced to \$50,000, and the Federal gift tax was reimposed (at 75 percent of the estate tax rates) for cumulative lifetime gifts in excess of \$5,000 per year.

Estate and gift tax rates were increased in 1934 with top rates of 60 percent and 45 percent, respectively, on transfers in excess of \$10 million and again in 1935 with top rates of 70 percent and 52.5 percent, respectively, on transfers in excess of \$50 million.⁵⁴ The exemption for both the estate and gift tax was reduced in 1935 to \$40,000 each.⁵⁵

In 1940, a 10-percent surcharge was imposed on both income and estate and gift taxes, in light of the need for additional revenue necessitated by the military build-up just prior to World

⁴⁹ These rules are now contained in sections 2041 and 2514 of present law.

⁵⁰ This rule is now contained in section 2038 of present law.

⁵¹ This rule is now contained in section 2011 of present law. The size of the credit has not changed even though the Federal estate tax rates subsequently have been changed several times.

⁵² Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).

⁵³ This rule is now contained in section 2036(a) of present law.

⁵⁴ Act of May 10, 1934, 48 Stat. 680.

⁵⁵ Act of August 30, 1935, 49 Stat. 1014.

War II.⁵⁶ Estate and gift tax rates were increased in 1941, with a top estate tax rate of 77 percent on transfers in excess of \$50 million.⁵⁷

Estate and gift taxes during World War II

In 1942, Congress again altered estate and gift taxes by: (1) setting the exemption from the estate tax at \$60,000, the lifetime exemption from gift tax at \$30,000, and providing an annual gift tax exclusion of \$3,000;⁵⁸ and (2) attempting to equate property in community property States with property owned in non-community property States by providing that in both community property States and non-community property States, each spouse would be taxed on the portion of jointly-owned or community property that each spouse contributed to that property's acquisition cost.⁵⁹

Estate and gift taxes after World War II

Post-World War II through 1975

The 1942 solution to the community property problem was viewed as complex. Congress provided a different solution in 1948 for equating community property States and non-community property States by providing the decedent or donor spouse a marital deduction for 50 percent of the property transferred to the other spouse, and, thus, effectively allowing both spouses to be taxed on one-half of the property's value.⁶⁰

In 1954, the estate tax treatment of life insurance was changed. Under a new rule, life insurance was subject to estate tax if the proceeds were paid to the decedent's estate or executor or if the decedent retained "incidents of ownership" in the life insurance policy.⁶¹

⁵⁶ Revenue Act of 1940, 54 Stat. 516.

⁵⁷ Act of September 20, 1941, 55 Stat. 687.

⁵⁸ The \$60,000 deathtime and the \$30,000 lifetime exemptions remained at these levels until the Tax Reform Act of 1976, when the estate and gift taxes were combined into a single unified tax that could be reduced by a unified credit which replaced the two exemptions.

⁵⁹ Act of October 21, 1942, 56 Stat. 798.

⁶⁰ Revenue Act of 1948, 62 Stat. 110.

⁶¹ This rule is now contained in section 2042 of present law.

The Small Business Tax Revision Act of 1958⁶² provided for payment of Federal estate tax on certain closely-held businesses in installments over a 10-year period.⁶³

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,⁶⁴ Congress substantially revised estate and gift taxes by:

- providing for a single unified rate structure for cumulative lifetime and deathtime transfers;⁶⁵
- providing an exemption in the form of a credit (called the “unified credit”), which effectively exempted \$175,625 of transfers from tax when fully phased in;
- revising and lowering the unified rate structure such that the maximum rate of tax was 70 percent;
- changing the income tax rules applicable to the disposition of inherited assets from a rule that only taxed post-death appreciation (i.e., the basis in the hands of the heir was “stepped up” to its value on the date of the decedent’s death) to one that provided that the heir’s basis generally would be the same as it was in the hands of the decedent (i.e., the decedent’s basis in the property would “carryover” to be the basis to the heir);
- providing a 100-percent marital deduction for the first \$250,000 of property transferred to a surviving spouse;
- changing the treatment of gifts made in contemplation of death from a rebuttable presumption that gifts made within three years of death would be subject to estate tax to a rule that subjects all gifts made within three years of death to the estate tax;⁶⁶
- providing that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly-held property;

⁶² P.L. 85-866 (September 2, 1958).

⁶³ This rule has been subsequently modified; it is now contained in section 6166 of present law.

⁶⁴ P.L. 94-455 (October 4, 1976).

⁶⁵ These rules are now contained in sections 2001 and 2501 of present law.

⁶⁶ This rule is now contained in section 2035 of present law.

- providing that a farm or other real property used in a closely-held business could be valued at its current-use value rather than its highest and best use value, so long as the heirs continue to use the property for 15 years after the decedent's death;⁶⁷
- providing a limited deduction for bequests to children with no living parents (the so-called "orphan's deduction");
- providing a new transfer tax on generation-skipping transfers basically equal to the additional estate or gift tax that the decedent's children would have paid if the property had passed directly to the children instead of skipping that generation and passing to, for example, a donor's or decedent's grandchildren;
- providing statutory rules governing the disclaimer of gifts and bequests under which an unqualified, irrevocable refusal to accept any benefits from the gift or bequest generally within 9 months of the creation of the transferee's interest is not treated as a gift by the disclaiming individual;⁶⁸ and
- liberalizing the provision that permits installment payment of estate tax on closely-held businesses by providing that only interest need be paid for the first four years after death and by lengthening the period of installment by an additional four years.

In 1980, the estate tax "carryover basis" rules were retroactively repealed, and the estate tax "step-up basis" rules were reinstated.⁶⁹

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 (the "1981 Act")⁷⁰ changed the estate and gift tax rules by:

- increasing the unified credit such that, when fully phased in 1987, it effectively exempted the first \$600,000 of transfers from the unified estate and gift tax;
- reducing the top unified estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982 through 1985);

⁶⁷ These "special-use valuation" rules are now contained in section 2032A of present law, and the rules now require the heirs to continue to use the property for only 10 years after the decedent's death.

⁶⁸ This rule is now contained in section 2518 of present law.

⁶⁹ Crude Oil Windfall Profits Act of 1980 (P.L. 96-223 (April 2, 1980)).

⁷⁰ P.L. 97-35 (August 13, 1981).

- providing for an unlimited deduction for transfers to spouses and permitted such a deduction even when the donee spouse could not control the disposition of the property after that spouse's death, so long as the spouse had an income interest in the property and that property was subject to that spouse's estate and gift tax (referred to as "qualified terminable interest property");⁷¹
- increasing the annual gift tax exemption from \$3,000 per year per donee to \$10,000 per year per donee;
- changing the presumption that each spouse equally provided for the acquisition cost of jointly-held property to an irrebuttable presumption;
- modifying the special-use valuation rules by shortening to 10 years the period that heirs who inherit farms or other real property used in a closely-held business were required to so use the property, and by increasing the maximum reduction in value of such property from \$500,000 to \$750,000;
- repealing the so-called "orphan's deduction";
- delaying the effective date of the generation-skipping transfer tax; and
- further liberalizing and simplifying the rules that permit the installment payment of estate tax on closely-held businesses.

The Deficit Reduction Act of 1984 modified the estate and gift tax rules by:

- delaying for three years the scheduled reduction of the maximum estate and gift tax rates (such that the maximum rate remained at 55 percent until 1988);
- eliminating the exclusion for interests in qualified pension plans;
- providing rules for the gift and income tax treatment of below-market rate loans; and
- extending the rules which permit the installment payment of estate taxes on closely-held businesses to certain holding companies.

Legislation from 1986 through 1997

The Tax Reform Act of 1986⁷² substantially revised the tax on generation-skipping transfers by applying a single rate of tax equal to the highest estate tax rate (i.e., 55 percent) to all generation-skipping transfers in excess of \$1 million and by broadening the definition of a

⁷¹ This rule is now contained in section 2056 of present law.

⁷² P.L. 99-514 (October 22, 1986). The generation-skipping transfer tax rules added by the Tax Reform Act of 1986 are contained in sections 2601 through 2654 of present law.

generation-skipping transfer to include direct transfers from a grandparent to a grandchild (i.e., direct skips).

The Omnibus Budget Reconciliation Act of 1987⁷³ modified the estate and gift tax by: (1) providing special rules for so-called “estate freeze transaction,” through which the estate of a person who engaged in such a transaction would be subject to estate tax on the entire value of such property; (2) providing a higher estate or gift tax rate on transfers in excess of \$10 million in order to phase out the benefit of the graduated rates under 55 percent and the benefit of the unified credit; and (3) again delaying the scheduled reduction in the estate and gift tax rates from 55 percent to 50 percent for five years.

The Omnibus Budget Reconciliation Act of 1990 replaced the special rules for estate freeze transactions with a new set of rules that effectively subject to gift tax the full value of interests in property, unless retained interests in that property take certain specified forms.⁷⁴

The maximum estate, gift, and generation-skipping transfer tax rate dropped to 50 percent after December 31, 1992, but the Omnibus Budget Reconciliation Act of 1993⁷⁵ restored the 55-percent top rate retroactively to January 1, 1993, and made that top rate permanent. The Taxpayer Relief Act of 1997⁷⁶ provided for gradual increases in the unified credit effective exemption amount from \$625,000 in 1998 to \$1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continues to phase out the benefit of the graduated rates, but not the benefit of the unified credit. A new exclusion for qualified conservation easements and a new deduction for interests in qualified family-owned businesses, in addition to other changes, also were enacted in 1997.

1999 and subsequent legislation

The Taxpayer Refund and Relief Act of 1999

The Taxpayer Refund and Relief Act of 1999 (H.R. 2488),⁷⁷ which was vetoed by President Clinton on September 23, 1999, would have phased out the estate, gift, and generation-skipping transfer taxes, until the taxes were repealed in 2009.⁷⁸ That legislation would have repealed the 5-percent surtax (which phases out the benefit of the graduate rates), converted the unified credit into an exemption, and reduced the tax rates from 2001 through 2008. Beginning

⁷³ P.L. 100-203.

⁷⁴ These rules are contained in sections 2701 through 2704 of present law.

⁷⁵ P.L. 103-66 (August 10, 1993).

⁷⁶ P.L. 105-34 (August 5, 1997).

⁷⁷ H.R. Conf. Rep. No. 106-289 (August 5, 1999).

⁷⁸ Section 1501 of H.R. 2488 provided that the provisions in the bill were to sunset beginning in 2009.

in 2009, the estate, gift, and generation-skipping transfer taxes would have been repealed, and a carryover basis regime generally would have taken been phased in transfers from estates valued in excess of \$2 million. Transfers to surviving spouses in excess of \$3 million also would have received a carryover basis.

Availability of the conservation easement exclusion would have been expanded. In addition, several technical modifications also would have been made to the generation-skipping transfer tax, which would have been effective prior to its repeal in 2009.

Small Business Tax Fairness Act of 2000

The Small Business Tax Fairness Act of 2000 (H.R. 3081),⁷⁹ which was passed by the House of Representatives on March 9, 2000, would have repealed the 5-percent surtax (which phases out the benefit of the graduated rates), the unified credit would have been converted into an exemption, and the rates of tax would have been reduced between 2001 and 2004.

Availability of the conservation easement exclusion also would have been expanded, as it would have in the Taxpayer Refund and Relief Act of 1999. In addition, the technical modifications to the generation-skipping transfer tax that were included in the Taxpayer Refund and Relief Act of 1999 also would have been included.

The Death Tax Elimination Act of 2000

The Death Tax Elimination Act of 2000 (H.R. 8),⁸⁰ which was vetoed by President Clinton on August 31, 2000, would have phased out the estate, gift, and generation-skipping transfer taxes, until the taxes were repealed in 2010. That legislation would have repealed the 5-percent surtax (which phases out the benefit of the graduate rates), converted the unified credit into an exemption, and reduced the tax rates from 2001 through 2009. Beginning in 2009, the estate, gift, and generation-skipping transfer taxes would have been repealed, and a carryover basis regime generally would have taken effect for transfers from estates in excess of \$1.3 million. Transfers to surviving spouses in excess of \$3 million also would have received a carryover basis.

Availability of the conservation easement exclusion would have been expanded. In addition, several technical modifications also would have been made to the generation-skipping transfer tax, which would have been effective prior to its repeal in 2010.

Summary

Table 2 provides a summary of the annual gift tax exclusion, the exemption value of the unified credit, the threshold level of the highest statutory estate tax rate, and the highest statutory estate tax rate for selected years, 1977 through 2001.

⁷⁹ H.R. Rep. No. 106-467 (November 11, 1999).

⁸⁰ H.R. Rep. No. 106-651 (June 6, 2000).

Table 2.—Annual Gift Exclusion Amount, Exemption Value of Unified Credit for Taxable Transfers, Threshold Level of Highest Statutory Tax Rate, and Highest Statutory Tax Rate Applicable to Taxable Transfers, Selected Years, 1977-2001

Year	Annual gift exclusion per donee single/joint (dollars)	Exemption value of unified credit (dollars)	Threshold of highest statutory tax rate (dollars)	Highest statutory tax rate (percent)
1977	3,000/6,000	120,667	5 million	70
1982	10,000/20,000	225,000	4 million	65
1983	10,000/20,000	275,000	3.5 million	60
1984	10,000/20,000	325,000	3 million	55
1985	10,000/20,000	400,000	3 million	55
1986	10,000/20,000	500,000	3 million	55
1987	10,000/20,000	600,000	3 million	55
1989	10,000/20,000	600,000	3 million	55 ¹
1995	10,000/20,000	600,000	3 million	55 ¹
1997	10,000/20,000	600,000	3 million	55 ¹
1998	10,000/20,000	625,000	3 million	55 ¹
1999	10,000/20,000	650,000	3 million	55 ¹
2000	10,000/20,000	675,000	3 million	55 ¹
2001	10,000/20,000	675,000	3 million	55 ¹

Source: Joint Committee on Taxation.

Note: From 1987 through 1997, the benefits of the graduated rate structure and unified credit were phased out at a 5-percent rate for estates between \$10,000,000 and \$21,040,000, creating an effective marginal tax rate of 60 percent for affected estates (with a \$600,000 unified credit). The Taxpayer Relief Act of 1997 provided for gradual increases in the unified credit from \$625,000 in 1998 to \$1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continues to phase out the benefit of the graduated rates, but the benefit of the unified credit is no longer phased out. Thus, the 5-percent surtax now applies to taxable estates between \$10 million and \$17,184,000.

B. Description of President's Budget Proposal

The President's budget proposal would repeal the estate tax.

C. Analysis

1. Background data

Estates subject to the estate tax

Table 3 details the percentage of decedents subject to the estate tax for selected years since 1935. The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid-1970s. The substantial revision to the estate tax in the mid-1970s⁸¹ and subsequent further modifications in 1981 reduced the percentage of decedents liable for the estate tax to less than one percent in the late 1980s. Since that time, the percentage of decedents liable for the estate tax has gradually increased.

⁸¹ See description of changes made to the estate tax in 1976 in Part III.A., above.

Table 3.B Number of Taxable Estate Tax Returns Filed as a Percentage of Deaths, Selected Years, 1935-1998

Year	Deaths	Taxable estate tax returns filed ¹	
		Number	Percent of deaths
1935	1,172,245	8,655	0.74
1940	1,237,186	12,907	1.04
1945	1,239,713	13,869	1.12
1950	1,304,343	17,411	1.33
1955	1,379,826	25,143	1.82
1961	1,548,665	45,439	2.93
1966	1,727,240	67,404 ²	3.90
1970	1,796,940	93,424 ²	5.20
1973	1,867,689	120,761 ²	6.47
1977	1,819,107	139,115 ²	7.65
1982	1,897,820	41,620 ^{2,3}	2.19
1983	1,945,913	35,148 ^{2,3}	1.81
1984	1,968,128	31,507 ^{2,3}	1.60
1985	2,068,440	30,518 ^{2,3}	1.46
1986	2,105,361	23,731	1.13
1987	2,123,323	21,335	1.00
1988	2,167,999	18,948	0.87
1989 ⁴	2,150,466	20,695	0.96
1990 ⁴	2,148,463	23,104	1.08
1991 ⁴	2,169,518	24,781	1.14
1992 ⁴	2,175,613	27,397	1.26
1993 ⁴	2,268,553	27,506	1.21
1994 ⁴	2,278,994	31,918	1.40
1995 ⁴	2,312,132	31,563	1.37
1996 ⁴	2,314,690	37,711	1.63
1997 ⁴	2,314,245	42,901	1.85
1998 ⁴	2,337,256	47,483	2.03

¹ Estate returns need not be filed in the year of the decedent's death.

² Not strictly comparable with pre-1966 data. For later years the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

³ Although the filing requirement was for gross estates in excess of \$225,000 for 1982 deaths, \$275,000 for 1983 deaths, and \$325,000 for 1984 deaths, the data are limited to gross estates of \$300,000 or more.

⁴ Taxable estate data from 1989-1998 are from Internal Revenue Service, *Statistics of Income*.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington Brookings Institutions), 1987; Internal Revenue Service, *Statistics of Income*; and U.S. National Center for Health Statistics.

The increasing percentage of decedents liable for estate tax in the period from 1940 through the mid-1970s and the similar increasing percentage since 1989 are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth. The amount of wealth exempt from the Federal estate tax always has been expressed at a fixed nominal value. If the general price level in the economy rises from one year to the next and asset values rise to reflect this inflation, the "nominal" value of each individual's wealth will increase. With a fixed nominal exemption, annual increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption largely explains the pattern in Table 3.⁸² The fixed nominal exemption was increased effective for 1977 and again between 1982 and 1987. Prior to 1977 and subsequent to 1987, the exemption was unchanged while the economy experienced general price inflation.

However, even if the exemption were modified annually to reflect general price inflation, one would still expect to see the percentage of decedents liable for estate tax rise because of the third factor, real growth. If the economy is experiencing real growth per capita, it must be

⁸² The 1988 percentage of decedents liable for estate tax of 0.87 may overstate the nadir achieved by the increase in the unified credit to an exemption equivalent amount of \$600,000. This is because the 1981 legislation also increased the marital exemption to an unlimited exemption. (See Part III.A., above.) An increase in the marital exemption would be expected to reduce the percentage of decedents liable for the estate tax, both permanently and during a temporary period following the increase. The permanent effect results from some married couples having neither spouse liable for estate tax. The temporary reduction in the percentage of decedents liable for estate tax arises as follows. A married couple may have sufficient assets to be subject to the estate tax. During the transition period in which husbands and wives first take advantage of the unlimited marital exemption, the number of decedents liable for estate tax falls as the first spouse to die takes advantage of the expanded marital deduction, despite the fact that the surviving spouse subsequently dies with a taxable estate. In the long run, the number of new couples utilizing the unlimited marital deduction may be expected to approximately equal the number of surviving spouses becoming taxable after their decedent spouse had claimed the unlimited marital deduction.

accumulating capital.⁸³ Accumulated capital is the tax base of the estate tax. Thus, real growth can lead to more individuals having real wealth above any given fixed real exempt amount.⁸⁴

Revenues from the estate, gift, and generation-skipping taxes

Table 4 provides summary statistics of the estate and gift tax for selected years. Total estate and gift receipts include taxes paid for estate, gift, and generation-skipping taxes as well as payments made as the result of IRS audits.

Between 1993 and 1999, estate and gift receipts averaged double digit rates of growth. There are three possible reasons for the rapid growth in these receipts. First, because neither the amount of wealth exempt from the estate and gift tax or the tax rates were indexed, as explained above, an increasing number of persons became subject to estate and gift taxes. Second, the tremendous increase in value in the stock market over the past several years increased the value of estates that would have already been taxable, and increased the number of estates that became taxable. For example, the Dow Jones Industrial Average ended 1993 at approximately 3750, and ended 1999 at approximately 11,000. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth has more than doubled during the past five years, one would expect brisk growth in estate tax receipts from this alone. Finally, the unlimited marital deduction included in the 1981 Act delayed the payment of estate tax, in most cases, until the surviving spouse died. On average, spouses survive their mates by about ten years. Therefore, during the decade of the 1990s, an increase in estate tax receipts is expected as the result of first-spouse deaths during the 1980s that used the unlimited marital deduction.

⁸³ The following analysis assumes that the capital accumulated is physical or business intangible capital. Real per capita GNP could grow if individuals accumulated more knowledge and skills, or what economists call "human capital." Accumulation of human capital unaccompanied by the accumulation of physical or business intangible capital would not necessarily lead to increasing numbers of decedents becoming liable for estate tax.

⁸⁴ This analysis assumes that the capital accumulation is held broadly. If the growth in the capital stock were all due to a declining number of individuals doing the accumulating, then the distribution of wealth would become less equal and real growth could be accompanied by a declining percentage of decedents being liable for estate tax.

**Table 4.B Revenue from the Estate, Gift, and Generation-Skipping
Transfer Taxes, Selected Fiscal Years, 1940-1999**

Year	Revenues (\$ Millions)	Percentage of total Federal receipts
1940.....	357	6.9
1945.....	638	1.4
1950.....	698	1.9
1955.....	924	1.4
1960.....	1,606	1.7
1965.....	2,716	2.3
1970.....	3,644	1.9
1975.....	4,611	1.7
1976.....	5,216	1.7
1977.....	7,327	2.1
1978.....	5,285	1.3
1979.....	5,411	1.2
1980.....	6,389	1.2
1981.....	6,787	1.1
1982.....	7,991	1.3
1983.....	6,053	1.0
1984.....	6,010	0.9
1985.....	6,422	0.9
1986.....	6,958	0.9
1987.....	7,493	0.9
1988.....	7,594	0.8
1989.....	8,745	0.9
1990.....	11,500	1.12
1991.....	11,138	1.06
1992.....	11,143	1.02
1993.....	12,577	1.09
1994.....	15,255	1.21
1995.....	15,087	1.12
1996.....	17,189	1.18
1997.....	19,845	1.26
1998.....	24,076	1.40
1999.....	27,782	1.52

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems*, 1964; Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 1987; Internal Revenue Service, Statistics of Income

On the other hand, the 1997 Act included provisions that would be expected to reduce the number of estates subject to the estate tax. As explained in Part I, above, the 1997 Act enacted a schedule of increases in the unified credit which will culminate in the unified credit effectively exempting \$1 million of a decedent's estate from tax beginning for decedents dying in 2006. Given most forecasts of inflation, this change increases the real (inflation adjusted) value of the \$600,000 exemption that was available under the estate and gift tax between 1987 and 1997.⁸⁵ As explained above, increases in the real value of the unified credit generally would be expected to reduce the number of estates subject to tax. The 1997 Act also provided an additional exemption for certain qualified family-owned business interests and a partial exclusion from the estate tax of the value of land subject to certain conservation easements, fewer estates would be expected to be subject to tax.

Table 5 shows the Joint Committee on Taxation staff present-law estimate of revenues from the estate, gift, and generation-skipping taxes for fiscal years 2000-2011. These estimates are based on the January 2001 baseline forecast for estate, gift, and generation-skipping taxes supplied by the Congressional Budget Office. Table 5 reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

⁸⁵ If the inflation rate were to be 3 percent for each year between 1997 and 2006; the inflation-adjusted value of \$600,000 in 2006 would be approximately \$783,000.

**Table 5.B Projections of Taxable Estates and Receipts from Estate, Gift,
and Generation-Skipping Transfer Taxes, 1999-2011**

<u>Year</u>	<u>Exemption value of unified credit</u>	<u>Number of taxable estates</u>	<u>Percent of deaths</u>	<u>Receipts (\$ billions)</u>
2000	675,000	51,700	2.18	29.0
2001	675,000	51,800	2.15	30.2
2002	700,000	55,700	2.30	32.5
2003	700,000	56,800	2.32	34.9
2004	850,000	58,600	2.38	36.0
2005	950,000	50,900	2.07	36.4
2006	1,000,000	46,600	1.86	37.3
2007	1,000,000	48,700	1.93	39.8
2008	1,000,000	53,500	2.11	43.7
2009	1,000,000	56,700	2.22	46.4
2010	1,000,000	60,500	2.35	49.3
2011	1,000,000	65,500	2.52	53.4

Source: Joint Committee on Taxation staff estimates and calculations based on U.S. Census Bureau estimates of deaths from Population Estimates Program, Population Projections Branch, Population Division, U.S. Census Bureau, 2000.

2. Comparison of transfer taxation in the United States and other countries

Among developed countries, an inheritance tax is more common than the type of estate tax that is imposed in the United States. An inheritance tax generally is imposed upon the amount of wealth the transferee or donee receives rather than on the total wealth of the transferor. That is, the funds the heir receives in a bequest determines the tax imposed. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to generations two or more younger than that of the transferee. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on

bequests that skip generations. Among developed countries, Australia and Canada impose neither an estate tax nor an inheritance tax.⁸⁶

Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of \$675,000 (in 2001) through the unified credit, and exempts \$10,000 of gifts per year per donee, the United States may have a larger exemption (a larger zero-rate tax bracket) than many other developed countries.⁸⁷ However, because most other countries have inheritance taxes, the total exemption depends upon the number and type of beneficiaries. While the effective exemption may be larger, with the exception of transfers to spouses, which are untaxed, marginal tax rates on taxable transfers in the United States generally are greater than those in other countries. This is particularly the case when comparing transfers to close relatives, who under many inheritance taxes face lower marginal tax rates than do other beneficiaries. On the other hand, the highest marginal tax may be applied at a greater level of wealth transfer than in other countries. It is often difficult to make comparisons between the U.S. estate tax and countries with inheritance taxes because the applicable marginal tax rate depends on the pattern of gifts and bequests.

It is difficult to assess the extent to which the practice of any of the foreign transfer taxes is comparable to the practice of transfer taxation in the United States. For example, in the United States, transfers of real estate generally are valued at their full and fair market value. In Japan, real estate is assessed at less than its fair market value. Land is assessed for inheritance tax purposes according to a valuation map known as *Rosen Ka*. The *Rosen Ka* values range from 25 to 80 percent of fair market value.⁸⁸ It is also unclear to what extent transferors may be able to exploit legal loopholes under the various systems imposed by other countries. Again, using Japan as an example, prior to 1988, a transferor could reduce inheritance tax liability by adopting children to increase the number of legal heirs.⁸⁹ Such adoptees of convenience would receive nominal compensation for agreeing to be an adoptive child. The larger the number of children, the greater the total exemption for inheritance taxes in Japan, even if not all children receive a

⁸⁶ For a survey of the transfer tax systems of 28 countries see Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95), June 1, 1995, pp. C-1 through C-17. In Australia, the transferee receiving assets with accrued capital gains transferred at death retains the transferor's basis in the assets (carryover basis). In Canada, gains accrued on assets held by a taxpayer at the time of his or her death are treated as realized and taxable as income to the taxpayer. Assets transferred to a spouse are untaxed but retain the decedent spouse's basis (carryover basis).

⁸⁷ Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95), June 1, 1995.

⁸⁸ Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Kreuger (eds.), *The Political Economy of Tax Reform* (Chicago: The University of Chicago Press), 1992, pp. 250-251.

⁸⁹ Adoption by another did not cause an adoptee to lose his or her legal right to be an heir of his or her biological parents.

bequest. This legal loophole was said to be widely recognized and exploited by wealthy families.⁹⁰

Table 6 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (“GDP”) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among these selected OECD countries, Belgium, France, and Japan collect more such revenue as a percentage of GDP than does the United States. Switzerland and the Netherlands collect modestly less revenue from such taxes as a percentage of GDP than does the United States. The remaining 21 countries in Table 6 collect substantially less revenue from such taxes as a percentage of GDP than does the United States. As a percentage of tax revenue, only Japan relies more heavily on its inheritance tax as a revenue source, although Belgium, France, and Switzerland each collected at least 0.8 of one percent of total tax revenue from estate, inheritance, and gift taxes.

⁹⁰ Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," p. 249.

Table 6.B Revenue from Estate, Inheritance and Gift Taxes as a Percentage of Total Tax Revenue and GDP in OECD Countries, 1998

Country	Percentage of total tax revenue	Percentage of GDP
Australia	0.00	0.00
Austria	0.12	0.06
Belgium.....	0.86	0.40
Canada.....	0.00	0.00
Czech Republic.....	0.08	0.03
Denmark.....	0.37	0.19
Finland.....	0.53	0.25
France.....	1.13	0.51
Germany.....	0.34	0.13
Greece ¹	0.68	0.26
Hungary.....	0.11	0.04
Iceland	0.27	0.09
Ireland.....	0.58	0.19
Italy.....	0.18	0.08
Japan.....	1.36	0.39
Korea.....	0.72	0.15
Luxembourg	0.24	0.10
Netherlands.....	0.78	0.32
New Zealand.....	0.01	0.00
Norway.....	0.24	0.11
Poland.....	0.06	0.02
Portugal.....	0.25	0.09
Spain.....	0.57	0.20
Sweden.....	0.20	0.11
Switzerland.....	1.00	0.35
Turkey.....	0.05	0.02
United Kingdom.....	0.57	0.21
United States.....	1.25	0.36

Note: Data not directly comparable to data reported in Table 3. The OECD attempts to collect standardized data across member countries. OECD data includes tax revenue collected by the State as well as the Federal Government. Therefore data in OECD reports for the United States may not perfectly correspond to data as reported by OMB.

¹ 1997 data.

Sources: Organization for Economic Cooperation and Development, *Revenue Statistics*, 1965-1998 (Paris: OCED), 2000.

The United States is a wealthy country, with higher average household wealth than most of the countries surveyed. While exemption levels are higher in the United States than most other countries, a significant amount of accumulated wealth still may be subject to estate and gift taxation as compared to the other countries. The data in Table 5 do not reveal the extent to which estate, inheritance, and gift taxes fall across different individuals within each country. In the United States, as reported in Table 2, above, of the 2.3 million deaths in 1998, only 47,483 or 2.03 percent of decedents, gave rise to any estate tax liability. Similar data were not available for the other countries in this survey.

3. Economic issues related to transfer taxation

Taxes on income versus taxes on wealth

Income taxes, payroll taxes, and excise and other consumption taxes generally tax economic activity as it occurs. Income and consumption represent ongoing, current economic activity by the taxpayer.⁹¹ Estate and gift taxes are levied on the transfer of accumulated wealth. Accumulated wealth does not result from any ongoing, current economic activity.⁹² Wealth depends upon previous economic activity either by the current wealth holder or other individuals. For example, current wealth can result from accumulated saving from income or from bequests received.

Taxes on wealth are not directly comparable to taxes on income. Because wealth is the accumulation of flows of saving over a period of years, taxes on wealth are not directly comparable to taxes on income or consumption which may represent only current, rather than accumulated, economic activity. For example, assume that a taxpayer receives wage income of \$10,000 per year, saves all of this income, and the savings earn an annual return of 5 percent. At the end of five years, the accumulated value of the taxpayer's investments would be \$58,019. Assume that the wealth is transferred at the end of the fifth year. If a 10-percent tax were imposed on wage income, one would conclude that a burden of \$1,000 was imposed annually. If a 10-percent tax were imposed on the transfer of wealth, one would conclude that a burden of \$5,801.90 was imposed at the end of the fifth year. If, after paying the wage tax, the taxpayer had invested the remaining \$9,000 each year to earn 5 percent, the taxpayer's holding would be \$52,217.10 at the end of five years. This is the same value that would remain under the wealth tax (\$58,019.00 less \$5,801.90). Thus, it is misleading to say that the burden of the wage tax is

⁹¹ Economists call income and consumption "flow" concepts. In simple terms, a flow can only be measured by reference to a unit of time. Thus, one refers to a taxpayer's annual income or monthly consumption expenditures.

⁹² Economists call wealth a "stock" concept. A stock of wealth, such as a bank account, may generate a flow of income, such as annual interest income.

\$1,000 in each year while the burden of the transfer tax is \$5,801.90 in the fifth year.⁹³

Wealth taxes, saving, and investment

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their saving. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.⁹⁴

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.⁹⁵ It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the

⁹³ James Poterba, "The Estate Tax and After-Tax Investment Returns," in Joel B. Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (New York and Cambridge: Russell Sage Foundation and Harvard University Press), 2000. Poterba converts the estate tax to a tax on capital income with the effective tax rate depending on the statutory tax rate as well as the potential taxpayer's mortality risk.

⁹⁴ For a more detailed discussion of the incidence of taxes on the income from capital and the responsiveness of saving to after-tax rate of returns, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-46.

⁹⁵ A recent discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod, eds., *Rethinking the Estate Tax*, (Washington, D.C: The Brookings Institution), forthcoming 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, 15, Winter, 2001, pp. 205-218.

United States' capital stock.⁹⁶ Others question the importance of the bequest motive in national capital formation.⁹⁷ Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.⁹⁸ Theoretically, it is an open question whether estate and gift taxes encourage or discourage saving and there has been no empirical analysis of this specific issue. By raising the cost, in terms of taxes, of leaving a bequest, potential transferors may be discouraged from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation in order to

⁹⁶ See, Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, 89, August, 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, 2, Spring, 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, 45, June, 1992. For recent attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

⁹⁷ Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *The Journal of Economic Perspectives*, 2, Spring, 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

⁹⁸ See, B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings.... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities." (p. 308).

Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), forthcoming 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

meet that goal. For example, some individuals purchase additional life insurance in order to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Regardless of any potential effect on aggregate saving, the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained by the capital markets in the amount of funds they can borrow. If they are so constrained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.⁹⁹ Undercapitalization may be prevalent among small businesses. One study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.¹⁰⁰

Others argue that potential deleterious effects on investment by small or family-owned businesses are limited. As a result of the Taxpayer Relief Act of 1997, certain small businesses can obtain an effective exemption of up to \$2.6 million per married couple, and other legitimate

⁹⁹ Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1988, pp. 141-195.

¹⁰⁰ Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102, February 1994, pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business is taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a \$150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact on their performance: the \$150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received.

tax planning can further reduce the burden on such enterprises. Some have argued that estate tax returns report a small fraction of the value of decedents' estates.¹⁰¹

As described above, several Code provisions may reduce the burden of the estate tax borne by small or family-owned businesses. Tables 7a and 7b, below, present data from estate tax returns filed in 1999 on the utilization of these provisions in comparison to all estate tax returns filed (Table 7a) and in comparison to those estate tax returns with a positive estate tax liability (Table 7b). In each table the data reported in the rows relate to returns claiming benefits under section 2032A (special use valuation of real property), section 2057 (exemption for qualified family-owned business interests), both section 2032A and section 2057 on the same return, and section 6166 (extended payment period and reduced interest charge on installment payments). The returns reported in the first three rows of each table are mutually exclusive. Returns reported claiming benefits under section 6166 also may have utilized section 2032A, section 2057, or both. The data in Tables 7a and 7b show that in 1999 approximately one percent of all returns filed utilized one or both of section 2032A and section 2057. Among taxable returns less than three-quarters of one percent utilized one or both of section 2032A and section 2057.

Table 7a. --Estate Tax Returns Filed in 1999 Utilizing Provisions to Benefit Small and Family-Owned Businesses

	Number of Estates	Percentage of All Estate Tax Returns Filed	Aggregate Value of Gross Estate (\$ Millions)	Percentage of Aggregate Value of All Estate Tax Returns Filed
Claiming benefits under sec. 2032A only.....	141	0.14%	212.6	0.11%
Claiming benefits under sec. 2057 only.....	804	0.77%	2,045.3	1.04%
Claiming benefits under both secs.				

¹⁰¹ See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, (Washington, D.C.: The Brookings Institution), 1979. Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, 1, (Cambridge, Mass.: The MIT Press), 1987; and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Internal Revenue Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers.

	Number of Estates	Percentage of All Estate Tax Returns Filed	Aggregate Value of Gross Estate (\$ Millions)	Percentage of Aggregate Value of All Estate Tax Returns Filed
2032A and 2057.....	84	0.08%	216.1	0.11%
Claiming benefits under sec. 6166.....	524	0.50%	5,161.0	2.63%

Source: Joint Committee on Taxation staff tabulations from Internal Revenue Service Statistics of Income data.

Table 7b. -- Taxable Estate Tax Returns Utilizing Provisions to Benefit Small and Family-Owned Businesses, 1999

	Number of Estates	Percentage of Taxable Estate Tax Returns Filed	Aggregate Value of Gross Estate (\$ Millions)	Percentage of Aggregate Value of Taxable Estate Tax Returns Filed
Claiming benefits under sec. 2032A only.....	77	0.15%	124.6	0.10%
Claiming benefits under sec. 2057 only.....	235	0.47%	1,102.2	0.92%
Claiming benefits under both secs. 2032A and 2057.....	34	0.07%	139.0	0.12%
Claiming benefits under sec. 6166.....	524	1.05%	5,161.0	4.33%

Source: Joint Committee on Taxation staff tabulations from Internal Revenue Service Statistics of Income data.

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined 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...."¹⁰² While, in theory, increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.¹⁰³

In the case of family-owned businesses, the estate tax could increase work effort of heirs as the benefits of the installment payment method, the special use valuation, and exclusion for qualified family-owned business interests will be lost and recaptured if the assets fail to remain in a qualified use. In addition, the estate tax also could distort, in either direction, the labor supply of the transferor if it distorts his or her decision to make a bequest.

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, Federal transfer taxes may help prevent an increase in the concentration of wealth. There are relatively few analyses of the distribution of wealth holdings.¹⁰⁴ Conventional economic wisdom holds that the

¹⁰² Andrew Carnegie, "The Advantages of Poverty," in *The Gospel of Wealth and Other Timely Essays*, Edward C. Kirkland (ed.), (Cambridge, MA: The Belknap Press of Harvard University Press), 1962, reprint of Carnegie from 1891.

¹⁰³ For a review of this issue, see John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, (New York, NY: North-Holland Publishing Co.) 1986. For a direct empirical test of what some refer to as the "Carnegie Conjecture," see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, 108, May 1993, pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that "the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above \$150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below \$25,000. Moreover, ... high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work" (pp. 432-433). Theory suggests also that those who choose to remain in the labor force will reduce their hours worked or labor earnings. Holtz-Eakin, Joulfaian, and Rosen finds these effects to be small.

¹⁰⁴ For some exceptions, see Martin H. David and Paul L. Menchik, "Changes in Cohort Wealth Over a Generation," *Demography*, 25, August 1988; Paul L. Menchik and Martin H. David, "The Effect of Income Distribution on Lifetime Savings and Bequests," *American Economic Review*, 73, September 1983; and Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," *The Review of Income and Wealth*, 33, September 1987.

Great Depression of the 1930s and the second world war substantially reduced the concentration of wealth in the United States, and that there has been no substantial change in the four decades following the second world war. Some analysts have measured some increased concentration of wealth since 1983.¹⁰⁵ Most analysts assign no role to tax policy in the reduction in wealth concentration that occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since the second world war.¹⁰⁶

Others note that the income tax does not tax all sources of income. They suggest that by serving as a "backstop" for income that escapes income taxation, transfer taxes may help promote overall fairness of the U.S. tax system. Others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the contribution of transfer taxes to the overall fairness of the U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets subject to tax, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of \$1 million to her son and incurs a gift tax liability of \$500,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by \$500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son \$1.5 million, so that the gift tax has reduced the son's economic well-being by \$500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the

¹⁰⁵ Edward N. Wolff, "Recent Trends in the Size Distribution of Household Wealth," *Journal of Economic Perspectives*, 12, Summer 1998, presents research indicating that wealth inequality increased from 1983 to 1989 and then leveled off from 1989 to 1995. Other analysts dispute his methodology and interpretation of his findings. See, John C. Weicher, "Correspondence: The Distribution of Wealth," *Journal of Economic Perspectives*, 13, Spring 1999, Arthur B. Kennickell, "Correspondence: The Distribution of Wealth," *Journal of Economic Perspectives*, 13, Spring 1999, and F. Thomas Juster, James P. Smith, and Frank P. Stafford, "Correspondence: The Distribution of Wealth," *Journal of Economic Perspectives*, 13, Spring 1999.

¹⁰⁶ See Michael K. Taussig, "Les inegalites de patrimoine aux Etats-Unis," in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolff, in "Estimate of Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth contribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

donor and donee generations may not be important to assessing the fairness of transfer taxes if both the donor and donee have approximately the same income.¹⁰⁷

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because the marginal tax rates under the estate tax range from 37 percent to 55 percent, while marginal income tax rates range from 15 to 39.6 percent, the after-tax cost of a charitable bequest is lower than the after-tax cost of a charitable gift made during one's lifetime.¹⁰⁸ Economists refer to this incentive as the "price" or "substitution effect." In short, the price effect says that if something is cheaper, people will do more of it. Some analysts have suggested that the charitable estate tax deduction creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. The decision to make a charitable bequest arises not only from the incentive effect of a charitable bequest's deductibility, or "tax price," but also from what economists call the "wealth effect." Generally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes net wealth, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.

A limited number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate

¹⁰⁷ Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992. These studies, however, examine data relating to a broad range of incomes in the United States and do not directly assess the correlation of income among family members with transferors subject to the estate tax.

¹⁰⁸ Economists note that when expenditures on specified items are permitted to be deducted from the tax base, before the computation of tax liability, the price of the deductible item is effectively reduced by a percentage equal to the taxpayer's marginal tax rate. Assume, for example, a decedent has a \$1 million taxable estate and that the marginal, and average, estate tax rate were 40 percent. This means that the estate tax liability would be \$400,000. A net of \$600,000 would be available for distribution to heirs. If, however, the decedent had provided that his estate make a charitable bequest of \$100,000, the taxable estate would equal \$900,000 and the estate tax liability would be \$360,000. By bequeathing \$100,000 to charity, the estate's tax liability fell by \$40,000. The net available for distribution to heirs after payment of the estate tax and payment of the charitable bequest would be \$540,000. The \$100,000 charitable bequest only reduced the amount of funds available to be distributed to heirs by \$60,000. Economists say that the \$100,000 charitable bequest "cost" \$60,000, or that the "price" of the bequest was 60 cents per dollar of bequest. More generally, the "price" of charitable bequest equals $(1 - t)$, where t is the estate's marginal tax rate.

and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.¹⁰⁹ Some analysts interpret these findings as implying that reductions in estate taxation could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life. On the other hand, some analysts have suggested that a more sophisticated analysis is required recognizing that a taxpayer may choose among bequests to charity, bequests to heirs, lifetime gifts to charity, and lifetime gifts to heirs and recognize that lifetime gifts reduce the future taxable estate. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.¹¹⁰

Table 8, below, documents that a substantial dollar value of charitable bequests are claimed annually. Over the past 15 years, more than one estate tax return in six has claimed a deduction for charitable bequests are claimed annually. Over the past 15 years, one estate tax return in six, or more, has claimed a deduction for charitable bequests. In 1999, the value of all charitable bequests claimed on estate tax returns exceeded \$14.5 billion and represented 7.4 percent of the aggregate value of the gross estates reported on those returns.

¹⁰⁹ For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, 44, June 1991, pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, 59, 1996, pp. 55-68. David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," *National Tax Journal*, 53, September 2000, pp. 743-763, provides a recent survey of these studies and presents new evidence. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue.

Not all studies find such responsiveness of charitable bequests to the marginal estate tax rate. Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," *National Tax Journal*, 37, June 1984, pp. 225-237, estimated that marginal tax rates had no effect on charitable bequests.

¹¹⁰ Auten and Joulfaian, "Charitable Contributions and Intergenerational Transfers," attempted to estimate this more complex framework. Their findings suggest that reductions in estate taxation would reduce charitable contributions during the taxpayer's life.

**Table 8.--Number of Returns Claiming Charitable Bequests
and Value of Charitable Bequests, selected years**

Year	1985	1990	1995	1999
Total number of estate tax returns filed.....	67,961	53,168	69,755	103,993
Number of returns with charitable bequest.....	11,713	9,709	13,039	17,559
Percentage of returns making charitable bequest.....	17.2%	18.3%	18.7%	16.9%
Dollar value of bequests (millions \$).....	\$4,543	\$5,538	\$8,695	\$14,575
Bequests as percentage of gross estate	7.2%	6.4%	7.4%	7.4%

Source: Joint Committee on Taxation staff tabulations from Internal Revenue Service Statistics of Income data.

Federal transfer taxes and complexity

Critics of Federal transfer taxes document that these taxes create incentives to engage in avoidance activities. Some of these avoidance activities involve complex legal structures and can be expensive to create.¹¹¹ Incurring these costs, while ultimately profitable from the donors' and donees' perspective, is socially wasteful because time, effort, and financial resources are spent that lead to no increase in national wealth. Such costs represent an efficiency loss to the economy in addition to whatever distorting effects Federal transfer taxes may have on other economic choices such as saving and labor supply discussed above. In the case of family-owned businesses, such activities may impose an ongoing cost by creating a business structure to reduce transfer tax burdens that may not be the most efficient business structure for the operation of the business. Reviewing more complex legal arrangements increases the administrative cost of the

¹¹¹ Richard Schmalbeck, "Avoiding Federal Wealth Transfer Taxes," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), forthcoming 2001, reviews a number of widely used estate planning techniques.

Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.¹¹² It is difficult to measure the extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.

Federal estate taxes and State revenues

As explained above, the State death tax credit acts as a revenue sharing provision with States that impose "pick-up" or "make-up" estate taxes. The State death tax credit effectively cedes revenue to those States that impose such taxes without increasing the aggregate tax burden imposed upon an estate. Repeal of the Federal estate tax would eliminate this source of revenue sharing. The burden of estate taxation would rest with the States.

All States and the District of Columbia impose estate, gift, or inheritance taxes. Most States impose only "pick-up" estate taxes. A few States also impose additional estate or inheritance taxes. In those States that impose only a "pick-up" estate tax, such taxes currently impose no incremental burden on the estate. With the repeal of the Federal estate tax, these taxes would now impose a burden on estates. This may create sentiment to repeal these State level taxes, but repeal of the State level taxes may require States to increase other taxes to make up for the loss of the implicit revenue sharing provided under present law.

Table 9, below, reports data related to the State death tax credit. In 1995, States collected \$4.9 billion in estate and gift taxes¹¹³ on which estates claimed \$3.0 billion in State death tax credits against the Federal estate tax. The \$4.9 billion in State estate and gift taxes represented one-half of one percent of total State revenues in 1995. If Federal grants are removed from the State revenue, the \$.9 billion in State estate and gift taxes represented seven tenths of one percent of State revenues from the States' own resources.¹¹⁴ In 1999, estates claimed \$6.1 billion in State death tax credits against the Federal estate tax.

¹¹² Joint Economic Committee, *The Economics of the Estate Tax*, December 1998, has stated "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised." Smallbeck, "Avoiding Federal Wealth Transfer Taxes" disagrees writing "[a]bout half of the estate planners consulted in the preparation of this paper reported that they had rather standard packages that they would make available to individuals who would leave estates in the three to ten million range that might be provided for as little as \$3000 to \$5000." See William G. Gale and Joel B. Slemrod, "Life and Death Questions About the Estate and Gift Tax," *National Tax Journal*, 53, December 2000, pp. 889-912, for a review of the literature on compliance cost.

¹¹³ Scott Moody, editor, *Facts & Figures on Government Finance*, (Washington, D.C.: The Tax Foundation), 1999.

¹¹⁴ Moody, *Facts and Figures*.

Table 9.--Number of Returns Claiming State Death Tax Credit and Value of State Death Tax Credit, selected years

Year	1985	1990	1995	1999
Total number of estate tax returns filed.....	67,961	53,168	69,755	103,993
Number of returns claiming state death tax credit.....	33,060	27,334	37,087	57,068
Percentage of returns claiming state death tax credit.....	48.6%	51.4%	53.2%	54.9%
Dollar value of state death tax credit claimed (millions \$).....	\$1,078	\$2,474	\$3,016	\$6,125
State death tax credit as a percentage of federal estate tax liability.....	21.4%	27.5%	25.5%	26.7%

Source: Joint Committee on Taxation staff tabulations from Internal Revenue Service Statistics of Income data.

IV. CHARITABLE GIVING

A. Present Law

1. Overview of tax-exempt organizations

The nonprofit sector in the United States includes a wide variety of organizations, both charitable and non-charitable, that are recognized as exempt from tax under section 501(a) of the Internal Revenue Code (the “Code”). At present, 25 different types of nonprofit organizations qualify for tax-exempt status. These include certain title and real property holding companies (sec. 501(c)(2)), social welfare organizations (sec. 501(c)(4)), labor, agricultural or horticultural organizations (sec. 501(c)(5)), trade associations (sec. 501(c)(6)), social clubs (sec. 501(c)(7)), cemetery companies (sec. 501(c)(13)), and credit unions (sec. 501(c)(14)).¹¹⁵ Only organizations described in section 501(c)(3) of the Code are considered “charitable.”

Tax-exempt organizations described in section 501(c)(3)--generally referred to as charities -- must meet requirements that other section 501(c) organizations do not face. Charities must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. No part of the net earnings of a charity may inure to the benefit of any private shareholder or individual. In addition, no substantial part of the activities of a charity may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

In exchange for meeting the more stringent requirements under section 501(c)(3), charities are entitled to certain Federal tax (and other) benefits not available to other tax-exempt entities. Within certain limitations, donors to charities are entitled to deduct their contributions for Federal income tax purposes (if they itemize their deductions) and for Federal estate and gift tax purposes. Charities also may use the proceeds of tax-exempt financing (discussed in more detail below) and are granted preferential postal rates. In contrast, contributions to other nongovernmental, tax-exempt organizations generally are not deductible and such organizations are eligible only for the exemption from Federal income tax. Charities and certain other tax-exempt organizations may also qualify for exemption from State and local taxes.

Charities are further classified as either “public charities” or “private foundations.”¹¹⁶ Private foundations are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or

¹¹⁵ In addition, other Code sections provide general tax-exempt status for other entities, such as political organizations (sec. 527), qualified pension plans (secs. 401(a) and 501(a)), and certain cooperatives (sec. 521).

¹¹⁶ Sec. 509(a).

a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from one or a limited number of sources (an individual, family, or corporation) and are subject to a number of restrictions not applicable to public charities.¹¹⁷ In general, more generous charitable contribution deduction rules apply to gifts made to public charities than the rules that apply to gifts made to private foundations.

Donors making contributions to other tax-exempt entities described in section 501(c) (i.e., non-charities) generally are not entitled to a deduction under section 170 for the contribution for Federal income, estate, or gift tax purposes, with the exception of certain gifts made to a veterans' organization or a domestic fraternal society.¹¹⁸ Contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate or gift tax purposes.¹¹⁹

Tax-exempt organizations generally are not subject to Federal income tax on dues and contributions the organization receives from its members, nor on income from activities that are substantially related to the purpose of the organization's tax exemption. Tax-exempt organizations generally are not subject to Federal income tax on investment income, although this general rule does not apply to certain organizations (e.g., social clubs described in sec. 501(c)(7), voluntary employees' beneficiary associations described in sec. 501(c)(9), and political organizations described in sec. 527). If a tax-exempt organization engages in business activities unrelated to its exempt purpose, the organization may be subject to unrelated business income tax ("UBIT").¹²⁰

2. Federal tax treatment of contributions to charities

In general

In computing taxable income, an individual taxpayer who takes the standard deduction, and thus does not itemize deductions, is not entitled to a separate deduction for contributions to charity.¹²¹ A taxpayer who itemizes deductions generally is allowed to deduct the amount of

¹¹⁷ Secs. 4940-4945.

¹¹⁸ Secs. 170(c)(3), 170(c)(4), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

¹¹⁹ Sec. 170(c)(5).

¹²⁰ Secs. 511-514.

¹²¹ Sec. 63. The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was \$25 for 1982 and 1983, \$75 for 1984, \$150 for 1985, and \$300 for 1986. The nonitemizer deduction terminated after 1986.

cash and the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity.¹²² The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.¹²³

In the case of a charitable contribution of ordinary-income or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.¹²⁴

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.¹²⁵ In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.¹²⁶

Contribution limits

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income ("AGI") for a taxable year (disregarding any net operating loss carryback).¹²⁷ To

¹²² Sec. 170(a). The deduction is also allowed for purposes of calculating alternative minimum taxable income.

¹²³ Secs. 170(b) and (e).

¹²⁴ Sec. 170(e)(1)(B).

¹²⁵ Sec. 170(f)(8).

¹²⁶ Sec. 6115.

¹²⁷ Sec. 170(b)(1)(A).

the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.¹²⁸

Contributions by individuals in excess of the 50-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with AGI in excess of a threshold amount, which is indexed annually for inflation.¹²⁹ The threshold amount for 2001 is \$132,950 (\$66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. The effect of this reduction is to limit partially a taxpayer's charitable contributions deduction.

Charitable contributions from Individual Retirement Arrangements ("IRAs")

Under present law, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals may also make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an amount withdrawn from a traditional IRA or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply and the charitable contribution is subject to the normally applicable limitations on such contributions.

¹²⁸ Sec. 170(b)(1)(B), (C), and (D).

¹²⁹ Sec. 68.

B. Description of President's Budget Proposal

President Bush's budget proposal includes two recommendations relating to the tax treatment of charitable contributions by individual taxpayers:

- (1) Expand the Federal charitable deduction to the 70 percent of taxpayers who do not itemize deductions; and
- (2) Permit charitable contributions from IRAs without penalty.

C. Analysis

1. Rationale for tax deduction for charitable donations

In general

Tax deductibility of charitable donations reduces the economic cost to the donor of his or her donation and, therefore, encourages charitable giving (see the discussion, below, concerning the economic effect of the charitable contribution deduction). There are a number of different rationales advanced for the deductibility of donations to charitable organizations. These rationales depend, in part, on differing views about the role of charitable organizations and the benefits they provide to society as a whole.

One rationale for the charitable contribution deduction is that income given to a charity should not be taxed because it does not enrich the giver. Or, stated differently, the charitable contribution reduces the taxpayer's ability to pay income tax. A contrasting view would be that charitable giving is a purely personal expenditure, a deduction for which should be denied under a theoretically pure income tax system.

A second rationale for the deduction for charitable contributions relates to the view that charitable organizations are providing many services at little or no direct cost to taxpayers. It is argued that such services would otherwise have to be provided by the government at full cost to taxpayers. In this view, the tax deduction for voluntary charitable contributions is seen as equivalent to deductions permitted for many State and local taxes. The charitable contribution deduction can be said to provide neutrality in the choice to provide certain services to the public through direct government operation and financing or through the private operation and mixed private and public financing of a charitable organization.

A third rationale for the charitable contribution deduction is that many charitable organizations are public in nature or provide significant spillover benefits to the public at large. For example, some charitable organizations maintain open spaces such as bird refuges. Open space is an example of a public good, that is, a good or service that may be simultaneously enjoyed by all. Other charitable organizations provide benefits that improve the health of specific individuals, such as through the provision of vaccinations, which provide spillover

benefits¹³⁰ to the population in general. Economists generally argue that, in the absence of a subsidy, the private market may provide insufficient levels of public goods or goods that create spillover benefits.¹³¹ Thus, it is argued that the tax deduction for charitable contributions under present law encourages donations to charities that provide public goods or significant spillover benefits and, therefore, promotes the provision of such benefits.

Effect of the standard deduction

The standard deduction provides a minimum exemption from income that many analysts view as providing relief to taxpayers who choose not to itemize their deductions, but who make charitable contributions, pay mortgage interest, or incur other expenses that are otherwise permitted as itemized deductions under the Code. Taxpayers generally will choose to itemize their deductions, rather than claim the standard deduction, if it is in their financial interest to do so.

Under this view, taxpayers who claim the standard deduction do not have total deductions that otherwise could be itemized in excess of the standard deduction amount. Thus, it could be argued that these taxpayers generally receive a tax benefit in excess of their actual expenses that would be deductible. From the perspective of those who see charitable contributions as reducing a taxpayer's ability to pay or providing parity to taxes paid to State and local governments, the standard deduction minimizes administrative burdens while achieving roughly the same results as permitting the taxpayer to itemize deductions. Under this view, the standard deduction more than compensates an individual who makes a charitable contribution for the income that was foregone by the contribution.

However, from the perspective that a specific incentive is required to achieve an efficient level in the provision of public goods or goods that produce spillover benefits, the standard deduction is not a substitute for the itemized deduction for charitable contributions. The taxpayer receives the standard deduction irrespective of any charitable contributions that are made. Thus, to the extent that tax incentives for charitable giving increase charitable contributions, there is no incentive under present law for the 70 percent of taxpayers who do not itemize deductions to make charitable contributions.

Economic effects of tax deductions for charitable contributions

As with any tax deduction or credit, the price to the donor of charitable giving that benefits from a tax incentive is reduced by the value of the tax benefit provided. For example, for a taxpayer who itemizes deductions and is in the 31-percent tax bracket, a \$100 cash gift to charity reduces the taxpayer's taxable income by \$100, and thereby reduces tax liability by \$31.

¹³⁰ Economists usually refer to such spillover benefits as "positive externalities," which are benefits that accrue to the individual who consumes the good and also to other individuals who are "external" to the initial consumption of the good.

¹³¹ For example, see Musgrave, Richard A. and Musgrave, Peggy B., *Public Finance in Theory and Practice* (New York: McGraw Hill), 1984, and Rosen, Harvey S., *Public Finance* (Homewood, IL: Irwin), 1988.

As a consequence, the \$100 cash gift to charity reduces the taxpayer's after-tax income by only \$69. Economists would say that the price of giving \$100 cash to charity is \$69 for this taxpayer. As the preceding example shows, the price of giving is determined as one minus the taxpayer's marginal tax rate. Alternatively stated, the value of the tax deduction is the amount deducted multiplied by the taxpayer's marginal tax rate. Under present law, a taxpayer who does not itemize deductions receives no value from the tax deductibility of charitable contributions and the tax price of giving \$1.00 is \$1.00 of foregone other expenditures.

The charitable contribution deduction is worth more the higher the taxpayer's marginal tax rate. Because higher-income taxpayers generally are in higher marginal tax rate brackets, the charitable contribution deduction under present law is generally more valuable to higher income taxpayers than to lower income taxpayers. As a result, under present law, higher income taxpayers generally have a lower tax price of giving than do lower income taxpayers. Lower income taxpayers are more likely to claim the standard deduction and, thereby, the tax price of their giving is \$1.00 of foregone other expenditures per \$1.00 of charitable contribution. Proposals to extend the charitable contribution deduction to nonitemizers would reduce the tax price of charitable contributions for this class of taxpayer.

While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the charitable contribution deduction has been a stimulant to charitable giving, at least for higher income taxpayers. Economic studies generally have established that charitable giving responds to the price of giving. While the economic literature suggests that individuals alter their giving in response to changes in the price of giving, there is less consensus as to how large are the changes in donations induced by the tax deductibility of charitable contributions.¹³² In addition, most studies rely upon data relating to taxpayers who itemize deductions. Inferences drawn from such studies may be inappropriate when applied to taxpayers who currently claim the standard deduction. Some evidence suggests that higher-income

¹³² See, Clotfelter, Charles, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985, for a review of the literature. Feldstein and Clotfelter argue that the deduction for charitable contributions induces charitable contributions in amounts exceeding the revenue lost to the government from the tax deduction. Feldstein, Martin and Clotfelter, Charles, "Tax Incentives and Charitable Contributions in the United States," *Journal of Political Economics*, 5, 1976. More recently, Randolph argues the opposite. Randolph, William C., "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, 103, August 1995, pp. 709-738. Randolph argues that earlier studies inadvertently confused timing effects that may be the result of an individual taxpayer's circumstances in a particular year or the result of changes from one tax regime to another with the permanent effects. Randolph's estimates suggest that, on a permanent basis, charitable contributions are much less responsive to the tax price than previously believed. Clotfelter, Charles T., "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in Slemrod, Joel, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986* (Cambridge: MIT Press), 1990, p. 228, points to the surge in giving in 1986 prior to enactment of the Tax Reform Act of 1986 as evidence of the tax-sensitive timing of gifts.

taxpayers are more responsive to the incentives provided by the charitable contribution deduction.¹³³

2. Analysis of proposals to expand the deduction for charitable contributions

In general

If taxpayers respond positively to the incentive effect of the tax deduction for charitable contributions, then proposals to expand the charitable contribution deduction should lead to increases in the size of the charitable sector because increased availability of the tax deduction would lead to increased contributions to the charitable sector. Depending upon the magnitude of the additional or induced contributions, the increase in the size of the charitable sector may be less than, equal to, or greater than the tax revenue foregone. If the increase in contributions to the charitable sector induced by the increased deduction exceeds the revenue lost to the government, then the tax deduction could be said to be an efficient means of providing public support to such charitable functions.¹³⁴

Opponents of proposals to expand the deduction for charitable contributions argue that many charitable contributions are not tax motivated, but would be made in any event for non-tax reasons. Accordingly, for such contributions, a tax deduction amounts to a windfall reduction in the taxpayer's liability with no change in the taxpayer's behavior.

Recordkeeping and compliance issues

In the past, concerns about the validity of charitable contribution deductions claimed by taxpayers led to legislation to require written substantiation and recordkeeping with respect to certain charitable contributions. Proposals to expand availability of the charitable contribution deduction may lead to increased concerns about whether taxpayers are claiming deductions for charitable contributions legitimately made. See the discussion in 3., below, concerning studies of the extent to which taxpayers overstate their charitable contributions.

If the proposals to expand the deduction for charitable contributions apply to contributions of property, valuation issues may arise. Many contributions of property to charities do not have a readily ascertainable value and taxpayers may overstate the value of such property in order to increase the tax benefit of the charitable contribution deduction. For example, an increasing number of charities are soliciting donations of used automobiles by individual taxpayers. Absent an expert appraisal, determining the value of a particular used automobile

¹³³ See, Clotfelter, Charles, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective."

¹³⁴ In the empirical economics literature, the notion of elasticity is used as a measure of taxpayer response to a change in the "tax price" or value of the tax deduction. An elasticity greater than one in absolute value (that is, a value smaller than negative one or a value greater than positive one) implies that recipients of charitable contributions receive more increased funding than the government loses in foregone revenue. See Clotfelter, *Federal Tax Policy and Charitable Giving*.

may be difficult both for an individual and the Internal Revenue Service. Certain published guidelines are available as a reference for this purpose, but there is the possibility of a wide variation in valuation even using such published guides. Determining the value of property such as used clothing and appliances presents more difficult valuation issues. Valuation issues place administrative burdens on taxpayers, who are required to maintain records to substantiate their charitable contributions deductions, and the Internal Revenue Service.

It has been noted that one benefit of the present-law standard deduction is that it eliminates the need to itemize and maintain supporting documentation for deductions. Some will note that a substantial increase in the standard deduction was enacted as part of the Tax Reform Act of 1986, in part, because “[t]axpayers who will use the standard deduction rather than itemize their deductions will be freed from much of the recordkeeping, paperwork, and computations that were required under prior law.”¹³⁵ If a separate deduction for charitable contributions of nonitemizers is enacted, then individual taxpayers will be required to keep records to substantiate the deductions claimed. In addition, increased administrative burdens would be imposed on the Internal Revenue Service to ensure that taxpayers only claim deductions for charitable contributions that are actually made.

3. Data on levels of charitable contributions and charitable contribution deductions

The staff of the Joint Committee on Taxation estimates that, for 2001, 37 million individual tax returns will claim more than \$149 billion in charitable contributions prior to application of the present-law limitations on the charitable contribution deduction (such as the percentage of AGI limitations and the overall limitation on itemized deductions (the so-called “Pease” provision). (See Table 10, below.)

¹³⁵ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, 11.

Table 10.--Tax Returns Claiming an Itemized Deduction For a Charitable Contribution
(2001 Projections)

Income category ¹	Number of tax returns (thousands)	Dollars claimed (millions) ²
Less than \$10,000	198	\$112
\$10,000 to \$20,000	524	\$588
\$20,000 to \$30,000	1,474	\$1,875
\$30,000 to \$40,000	2,556	\$3,601
\$40,000 to \$50,000	3,217	\$5,841
\$50,000 to \$75,000	8,210	\$17,887
\$75,000 to \$100,000	7,620	\$20,171
\$100,000 to \$200,000	9,913	\$36,537
\$200,000 and over	3,283	\$62,519
Total:	36,995	\$149,131

Source: Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

¹The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable Social Security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

²The dollars claimed include those charitable contributions allowed as a deduction before the application of any present law limitations on the deductibility of charitable contributions, such as the percentage of AGI limitations or the overall limitation on itemized deductions ("Pease").

A substantial amount of charitable donations made by individuals is not claimed as itemized deductions. However, there are no data that directly measure the magnitude of charitable contributions by non-itemizers. Tables 11 and 12, below, offer some indirect evidence on the magnitude of such giving. Table 11 present estimates of the American Association of Fund-Raising Counsel Trust for Philanthropy of the total amount of charitable contributions received by qualifying organizations from individuals. By contrast, Table 12 reports itemized deductions claimed for charitable contributions as reported to the Internal Revenue Service. Comparison of the two tables would suggest that, in 1997, nearly \$24 billion in charitable contributions made by individuals were not claimed as itemized deductions. Unfortunately, differences in the amounts reported in Tables 11 and 12 cannot be interpreted as measures of amounts of contributions made by non-itemizers. Evidence from audits and in taxpayer compliance studies establishes that many taxpayers overstate their actual charitable contributions when claiming itemized deductions.¹³⁶ These findings suggest that, if one were to use the difference in the amounts reported in Tables 11 and 12 to estimate the magnitude of charitable donations by non-itemizers, the result would be to underestimate actual charitable contributions

¹³⁶ Slemrod, Joel, "Are Estimated Tax Elasticities Really Just Tax Evasion Elasticities? The Case of Charitable Contributions," *The Review of Economics and Statistics*, Vol. 71 (August 1989), pp. 517-522.

by non-itemizers.¹³⁷ Moreover, experience with taxpayers who itemize suggests that, if non-itemizers were allowed to claim a deduction for their charitable contributions, many non-itemizers would also overstate their actual charitable contributions for the purpose of claiming a tax benefit.

Individual charitable contributions claimed as itemized deductions on individual tax returns have grown in every year since 1984, except from 1986 to 1987.¹³⁸ Itemized deductions and total individual charitable contributions have grown more rapidly than the rate of inflation over this period.¹³⁹ However, this real, inflation-adjusted, growth did not occur evenly over the period. Between 1984 and 1990, the real growth in individual charitable contributions claimed as itemized deductions was more modest than was real growth since 1990. There has been little analysis attempting to explain these trends.

¹³⁷ Such a conclusion assumes that the figures reported in Table 1 are accurate estimates of total giving by individuals. Errors in these estimates of total donations could raise or lower estimates of donations by non-itemizers.

¹³⁸ Most analysts attribute the high level of donations in 1986 followed by the lower level of donations in 1987 to the anticipation and enactment of the Tax Reform Act of 1986 which lowered expected future marginal tax rates for many taxpayers, thereby increasing the expected price of future donations. In addition, certain other modifications to charitable tax deductions as part of the individual alternative minimum tax may have altered the timing of some donations to charities. The increase in the standard deduction provided in the Tax Reform Act of 1986 also reduced the number of taxpayers who chose to itemize deductions.

¹³⁹ The price level, as measured by changes in the consumer price index, increased by 54.4 percent over the period 1984 through 1997.

**Table 11.--Total Individual Charitable Donations Estimated to Have Been Received
By Charitable Organizations, 1984-1997
(Billions of Dollars)**

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total individual donations	56.46	57.39	67.09	64.53	69.98	79.45	81.04	84.27	87.70	92.00	92.52	95.36	107.65	122.95

Source: *Giving USA* 1999. Data do not include donations from trusts. Tabulations prepared by the staff of the Joint Committee on Taxation.

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**Table 12.--Individual Itemized Charitable Donations Claimed on Tax Returns, 1984-1997
(Billions of Dollars)**

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Itemized deductions claimed for charitable donations	42.12	46.96	53.82	49.62	50.95	55.46	57.24	60.58	63.84	68.35	70.54	74.99	86.16	99.1

Source: Individual itemized deductions taken from Internal Revenue Service Statistics of Income data. Tabulations prepared by the staff of the Joint Committee on Taxation.

V. EDUCATION

A. Selected Tax Incentives for Education under Present Law

1. Education IRAs

Taxpayers may establish certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary (“education IRAs”) (sec. 530). Annual contributions to education IRAs may not exceed \$500 per designated beneficiary and may not be made after the designated beneficiary reaches age 18. The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for married taxpayers filing a joint return); the AGI of the contributor not the beneficiary controls whether a contribution is permitted by the taxpayer. No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program (as described below) on behalf of the same beneficiary.

Earnings on contributions to an education IRA generally are subject to tax when withdrawn.¹⁴⁰ However, distributions from an education IRA are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit under section 25A is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.¹⁴¹

Tax-free (and penalty-free) transfers or rollovers of account balances from one education IRA benefitting one beneficiary to another education IRA benefitting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the old beneficiary.

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, section 530(b)(2)(B) specifically provides that qualified higher education expenses include amounts paid

¹⁴⁰ In addition, education IRAs are subject to the unrelated business income tax (“UBIT”) imposed by section 511.

¹⁴¹ This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under section 127.

If an exclusion from gross income under section 530 is allowed for a particular student, then neither the HOPE credit nor the Lifetime Learning credit will be available in the same taxable year with respect to the same student. However, if a student elects to waive the exclusion from gross income under section 530, then either the student or a parent (if the student is claimed as a dependent by the parent) may claim the HOPE credit or the Lifetime Learning credit.

2. Qualified state tuition programs

Present law provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (sec. 529). The term "qualified higher education expenses" has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution,¹⁴² as well as certain room and board expenses (i.e., the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Present law also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.

¹⁴² "Eligible educational institutions" are defined the same for purposes of education IRAs (described below) and qualified State tuition programs.

A qualified State tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefitting one designated beneficiary to another account benefitting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for qualified higher education expenses.

No amount is includible in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) is includible in the gross income of the distributee. However, to the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or Lifetime Learning credit under section 25A with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

3. Tax benefits for certain types of bonds for educational facilities and activities

Tax-exempt bonds

In general

Interest on debt¹⁴³ incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (Code sec. 103).¹⁴⁴ Like other activities carried out or

¹⁴³ Hereinafter referred to as “State or local government bonds.”

¹⁴⁴ Interest on this debt is included in calculating the “adjusted current earnings” preference of the corporate alternative minimum tax.

paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds."¹⁴⁵ The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Private activity tax-exempt bonds may not be issued to finance schools for private, for-profit businesses.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to \$62.50 per resident of the State, or \$187.5 million if greater. The volume limits are scheduled to increase to the greater of \$75 per resident of the State or \$225 million in calendar year 2002. After 2002, the volume limits will be indexed annually for inflation.

¹⁴⁵ Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds.” Under present law, a total of \$400 million of qualified zone academy bonds may be issued in each of 1998 through 2001. The \$400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

“Qualified zone academy bonds” are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

B. Description of President’s Budget Proposal

President Bush’s budget proposal includes the following proposals relating to the tax treatment of education-related expenses:

- (3) Increase the annual contribution for education IRAs from \$500 to \$5,000, and

expand the expenses that can be paid tax-free from education IRAs to include expenses for kindergarten through high school;

- (4) Provide a full tax exemption for all qualified prepaid tuition and savings plans;
- (5) Provide a deduction of up to \$400 in out-of-pocket classroom expenses for teachers; and
- (6) Allow State private activity bonds to be used for school construction and repair.

C. Analysis

1. Background data on college enrollment and costs

Since 1990, more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 78 percent enrolled in public institutions and 22 percent in private institutions in 1997. The full-time equivalent enrollment has exceeded 10 million in every year since 1991. Of all those enrolled in 1997, 62 percent were enrolled in four-year institutions. From the average high school sophomore class in 1980, 66.4 percent had enrolled in some form of post-secondary education or training program by 1992. During this period, 7.9 percent had attained an associate's degree, 20 percent had attained a bachelor's degree, 2.7 percent had attained a master's degree, and 1.1 percent had attained a doctorate or professional degree.¹⁴⁶

In every year since 1981, the costs of attending a two- or four-year college have risen faster than the rate of inflation; by contrast, in the late 1970s, college costs lagged behind inflation. Table 13 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986. Since 1976, college tuition and fees generally have risen 70 percent more than the economy's overall price level. For the 1976-77 academic year, the total cost¹⁴⁷ of attending a four-year private college averaged \$3,977 (tuition and fees of \$2,534) and the total cost of attending a four-year public college averaged \$1,935 (tuition and fees of \$617). For the 1986-87 academic year, the comparable total cost figure had risen to \$10,039 (tuition of \$6,658) for a four-year private college and to \$4,138 (tuition of \$1,414) for a four-year public college. By the 1999-2000 academic year, the comparable total cost figure had risen to \$20,805 (tuition and fees of \$14,690) for a four-year private college and to \$8,265 (tuition and fees of \$3,351) for a four-year public college. For the 1999-2000 academic year, the average cost of tuition and fees at a two-year public college was \$1,336.¹⁴⁸

¹⁴⁶ Department of Education. National Center for Education Statistics, *Digest of Education Statistics 1997*.

¹⁴⁷ "Total cost" includes tuition and fees, and on-campus room and board costs.

¹⁴⁸ Department of Education. National Center for Education Statistics, *Digest of Education Statistics 1997, 2000*.

Over the past decade, governmental funding of higher education has declined as a share of total funding. Table 14 reports the revenues of all institutions of higher education by source. The table documents that, as a percentage of all revenues, Federal funds have remained relatively constant while State and local funding has declined. As a percentage of all revenues, tuition and fees have increased while other private funding has increased modestly. As Table 14 details, State and local contributions have not declined in dollar terms, though their total growth over the period 1986-87 to 1994-95 was only 7 percent more than would be accounted for by inflation, while full-time equivalent fall enrollment at public institutions increased 14.4 percent.

Table 13.--Average Undergraduate Tuition and Fees, 1986-87 Through 1999-00

Year	Current dollars				Constant 1996 dollars			
	Private four-year	Private two-year	Public four-year	Public two-year	Private four-year	Private two-year	Public four-year	Public two-year
1986-87	6,658	3,684	1,414	660	9,940	5,499	2,110	986
1987-88	7,116	4,161	1,537	706	10,225	5,979	2,209	1,014
1988-89	7,722	4,817	1,646	730	10,618	6,625	2,264	1,004
1989-90	8,396	5,196	1,780	756	10,984	6,798	2,328	989
1990-91	9,083	5,570	1,888	824	11,339	6,954	2,357	1,029
1991-92	9,759	5,754	2,117	936	11,760	6,934	2,551	1,228
1993-93	10,294	6,059	2,349	1,025	12,043	7,089	2,748	1,199
1993-94	10,952	6,370	2,537	1,125	12,468	7,251	2,888	1,280
1994-95	11,481	6,914	2,681	1,192	12,726	7,664	2,971	1,322
1995-96	12,243	7,094	2,848	1,239	13,189	7,643	3,068	1,335
1996-97	12,881	7,236	2,987	1,276	13,522	7,596	3,136	1,340
1997-98	13,344	7,464	3,110	1,314	13,744	7,688	3,203	1,353
1998-99	13,911	7,852	3,229	1,323	14,063	7,938	3,264	1,337
1999-00	14,690	8,107	3,351	1,336	14,456	7,978	3,298	1,315

Notes: Current dollar figures are adjusted to constant dollars by reference to the average CPI of the calendar years spanned by the academic year for which the tuition is reported.

Source: U.S. Department of Education, National Center for Education Statistics, Digest of Education Statistics 1997, 2000

**Table 14.--Current Funds and Revenues of All Institutions of Higher Education
by Source, Selected Years, 1986-1987 Through 1995-96**

[Dollar amounts in millions]

Year	Tuition and Fees		State and Local Sources		Federal Sources		Other Sources		Total
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	
1986-87	25,706	23.6	34,109	31.3	14,239	13.0	35,091	32.2	109,145
1990-91	37,434	25.0	43,412	29.0	18,236	12.2	50,684	33.8	149,766
1995-96	55,260	27.9	51,301	25.9	23,939	12.1	67,473	34.1	197,973

Source: U.S. Department of Education, National Center for Education Statistics, Digest of Education Statistics 1997, 2000.

2. The economics of subsidizing education

Overview of the goals of subsidies

All levels of government make substantial direct expenditures to subsidize post-secondary education. In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Internal Revenue Code are created for education. Other subsidies for education provided by the Internal Revenue Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the HOPE and Lifetime Learning credits, the deferral of tax on the earnings of contributions to qualified State tuition programs, and the exclusion from income of earnings on education IRAs and of the interest on U.S. savings bonds used to pay for post-secondary education.¹⁴⁹ Analysts attempt to evaluate subsidies in terms of their efficiency, equity, and administrability. In this regard, subsidies to post-secondary education have been argued to improve both economic efficiency and to promote economic equity.

Efficiency as a goal of subsidies to education

Economists generally have a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not

¹⁴⁹ Certain income limits restrict some benefits.

contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality."¹⁵⁰ On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society's perspective, total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages, many people have long believed that education also produces positive externalities. Commentators argue that society functions better with an educated populace and that markets function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as the single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether such subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that, while investors in housing or other tangible assets have property that can be pledged to secure financing to procure the asset, an individual cannot generally pledge his or her future earnings as security for a loan to obtain education or training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance

¹⁵⁰ For a more complete discussion of the notion of "positive externality," see Harvey S. Rosen, *Public Finance* (Homewood, Illinois: Irwin), 1988, pp. 142-146. Rosen discusses the notion of positive externality as applied to education. Rosen notes (pp. 144-145), "That college increases productivity may be true, but as long as the earnings of college graduates reflect their higher productivity, there is no externality [Rosen's emphasis]."

education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing is likely most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies to education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education.¹⁵¹ If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

3. Treatment of education expenses under an income tax

Educational expenditures

Students and their families incur direct educational expenses when they pay tuition and fees. Federal, State, and local governments and private persons make expenditures on behalf of students by funding State and local and private educational institutions.¹⁵² Such expenditures by governments or private persons are equivalent to the government or private person transferring funds to the student which the student subsequently pays over to the educational institution. Lastly, students incur implicit expenditures for education by choosing schooling over the alternative of taking a job and earning a wage. The time spent in school means forgone income. Alternatively viewed, it is as if the student worked, was paid, and used the wages to purchase education. Analysts have concluded that the largest cost of obtaining an education come from forgone wages.¹⁵³

¹⁵¹ For a cautionary note on the importance of the subsidy given, see Dennis Zimmerman, "Expenditure-Tax Incidence Studies, Public Higher Education, and Equity," *National Tax Journal*, 26, March 1973. Zimmerman finds that the subsidy structure can just as easily promote a less equal distribution of lifetime income.

¹⁵² Table 14, above, reports that Federal, State and local, and private expenditures accounted for 72.1 percent of post-secondary educational revenues for the 1995-96 academic year. Tuition accounted for 27.9 percent.

¹⁵³ See Michael J. Boskin, "Notes on the Tax Treatment of Human Capital," in Department of the Treasury, Conference on Tax Research, 1975 (Washington, D.C.: Department of the Treasury), 1977, pp. 185-195.

Post-secondary education helps individuals develop general analytic and reasoning skills (e.g., problem solving) and often job specific skills (e.g., nursing training) that enhance the student's ability to earn a future income. In this way, expenditures on education are like an investment in a capital good: an outlay is made in the present for a machine that will produce income over a number of years in the future. It is because of this similarity that economists often refer to expenditures on education as investment in "human capital." However, some part of expenditures on post-secondary education are not as obviously investments in human capital but are more like consumption. For example, the chemical engineering student who takes an elective course in the history of music probably would not find her future earning potential increased by that particular elective. It is difficult to determine what portion of post-secondary education represents consumption for any given student and what portion represents investment in human capital.

The distinction between education as investment and education as consumption is not important to the efficiency/externality rationale for providing a subsidy to education, as externalities can arise from either consumption or investment. However, the distinction between education as investment and education as consumption is important to the equity rationale for providing a subsidy to education, as the equity rationale generally is based upon education as an investment in future earning potential. The distinction between education as investment and education as consumption also is important for analysis of the income tax treatment of expenditures on education--that is, should education expenses be deductible to properly measure a taxpayer's net income?

Educational expenses under a theoretical income tax

Under a theoretical income tax, any expenditures undertaken in the present for returns that are expected in the future should be capitalized and recovered as the future returns are earned. Consumption expenditures are neither deductible nor amortizable under a theoretical income tax. Thus, certain expenditures on education should be capitalized by the taxpayer and recovered against future earnings. As discussed above, the relevant expenditures to be capitalized would only be those that represent investments in human capital,¹⁵⁴ not those related to consumption. Of course, making such decisions would be quite difficult in practice. For example, the would-be chemical engineer of the example above may not know whether her future employment will be in the chemical industry or perhaps as a chanteuse, making it difficult to know how to account for the costs of the chemical engineering courses and the music course. Many educational expenses are paid by a parent on behalf of a student. In such case, the theoretical income tax would permit amortization only by the student.

Educational expenses under the present-law income tax

As discussed above, there are three types of expenditures made by students on their education: (1) payment via implicit or explicit transfers received from governments or private

¹⁵⁴ For a discussion of government policy towards human capital investment, see C. Eugene Steuerle, "How Should Government Allocate Subsidies for Human Capital?" *American Economic Review*, 86, May 1996, pp. 353-357.

persons; (2) forgone wages; and (3) direct payment of tuition and other educational expenses by the student.

By not including the transfers from governments or private persons in the income of the student, present law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons.¹⁵⁵ This treatment (the equivalent of expensing) also is provided for direct transfers to students in the form of qualified scholarships or employer-provided educational assistance, which are excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receives expensing under the present-law income tax.

The present-law treatment of direct payment of tuition and other educational expenses by the student is subject to various tax treatments. With certain exceptions, the present-law income tax treats direct payments of tuition and other educational expenses as consumption, neither deductible nor amortizable.¹⁵⁶ An important exception to this treatment is expenses that qualify for the HOPE credit or the Lifetime Learning credit. The HOPE credit provides income tax treatment that is the equivalent of an investment tax credit for educational expenditures that qualify for the credit. For the first \$1,000 of qualified expenditures, a taxpayer receives a \$1,000 credit, which is the equivalent of a 100-percent investment tax credit. Such 100-percent investment tax credit is more generous tax treatment than is expensing. A 100-percent investment tax credit is, from the taxpayer's perspective, preferred to expensing because it permits a deduction from taxes owed, rather than a deduction from taxable income itself. Thus, a 100-percent credit allows a dollar-for-dollar credit against taxes owed, whereas the value of a deduction from taxable income depends on the taxpayer's marginal tax rate.¹⁵⁷ For the next

¹⁵⁵ Of course, the actual government expenditures themselves represent a wealth transfer to the student. It is only the income tax treatment of such expenditures (that is, not counting them as income to the student) that is the equivalent of expensing.

¹⁵⁶ Exceptions include the direct payment of education expenses with earnings from education IRAs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Such payments are permitted an exclusion from income tax. By not counting such interest or earnings in income, such amounts (the earnings components, but not the principal) are afforded treatment equivalent to expensing. Other tax benefits for direct expenditures on education expenses, such as the deductibility of certain interest expense or withdrawals from IRAs without imposition of the early withdrawal tax provide only minor benefits in comparison to expensing or amortization treatment of the full amount of education expenses.

¹⁵⁷ Specifically, the cost to the taxpayer of a dollar of expenditure on education that is permitted to be deducted is $(1-t)$ times the amount of the expenditure, where t is the taxpayer's marginal tax rate. For a taxpayer in the 28-percent tax bracket, a thousand dollar expenditure on education that is permitted to be deducted is only \$720 (the tax benefit of the deduction is thus \$280). If the taxpayer is allowed a credit for the thousand dollar expenditure, there is no cost to the taxpayer of the thousand dollar expenditure (that is, the tax benefit is the full \$1,000). In general, a taxpayer will prefer expensing treatment if his or her marginal tax rate exceeds the percentage value of the credit.

\$1,000 of expenditures, the taxpayer receives the equivalent of a 50-percent investment tax credit. The Lifetime Learning credit is the equivalent of a 20-percent investment tax credit on qualified expenditures.

The theoretical income tax would have all expenditures toward investment in human capital capitalized and recovered against the student's future earnings. By permitting the equivalent of expensing for the indirect expenditures related to a student's education (and direct expenditures made in the form of qualified scholarships or employer-provided education assistance), the present-law income tax subsidizes investment in human capital relative to investment in physical capital.¹⁵⁸ For direct expenditures by the student that qualify for the HOPE credit, the treatment of the first \$2,000 on qualified educational expenses in the first two years of post-secondary education provides greater subsidy than that provided for investment in physical capital.¹⁵⁹ Though certain educational expenses are thus afforded income tax treatment that is as favorable or more favorable than expensing, the present-law income tax generally permits no recovery of the direct tuition or other educational costs paid by the student that do not qualify for the HOPE or Lifetime Learning credits.¹⁶⁰ On balance, the variety and complexity of educational benefits afforded through the tax code, when coupled with expenditures that do not receive favorable tax treatment, make it difficult to determine the extent to which educational expenditures are subsidized by the tax code, relative to investments in physical capital.

¹⁵⁸ Expensing is more generous cost recovery than is capitalization and amortization. Under simplifying assumptions, the expensing of investment is economically equivalent to the nontaxation of the returns to that investment. Amortization attempts to measure, and tax annually, the return to the investment.

¹⁵⁹ Additionally, the Lifetime Learning credit provides a subsidy whose value in relation to expensing will vary depending on the marginal tax rate of the taxpayer. A taxpayer in a marginal rate bracket in excess of the value of the credit (20 percent under present law) would prefer expensing of such expenditures, whereas a taxpayer with a marginal rate bracket less than the value of the credit would prefer the present credit to expensing.

¹⁶⁰ As noted previously, exceptions include the direct payment of education expenses with earnings from education IRAs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Again, it is only the earnings from such accounts, not the principal, that is afforded the favorable tax treatment.