

**DESCRIPTION AND ANALYSIS OF PRESENT LAW
AND PROPOSALS RELATING TO
FEDERAL ESTATE AND GIFT TAXATION**

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
of the
SENATE COMMITTEE ON FINANCE
on March 15, 2001

Prepared by the Staff
of the
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 15, 2001, on estate and gift taxes. The hearing will address proposals relating to estate and gift taxes. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present law (Part I), background and economic analysis of estate and gift taxation (Part II), and a description of proposals relating to estate and gift taxation (Part III).

¹ This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation* (JCX-14-01), March 14, 2001.

I. PRESENT LAW AND LEGISLATIVE HISTORY

A. Present Law

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.² 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.³ 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.⁴

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")⁵ increased the effective exemption to \$625,000 in 1998, \$650,000 in 1999,

² Prior to 1976, separate tax rate schedules applied to the gift tax and estate tax.

³ 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 A. 2 below.)

⁴ 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.

⁵ 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 \$10,000.⁶ 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.)

⁶ Rev. Proc. 2001-13.

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.)

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 \$800,000.⁷

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;⁸

⁷ Rev. Proc. 2001-13.

⁸ For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current-use value.

- the real property qualifying for current-use valuation passes to a qualified heir;⁹ and
- 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.

⁹ 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.

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 \$1,060,000.¹⁰ 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.¹¹ 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:

¹⁰ Rev. Proc. 2001-13.

¹¹ 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.

- 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
- 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 tax¹² 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

¹² 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.

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.

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 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.

B. Legislative History

1. 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.¹³ After repeal of the stamp tax,¹⁴ 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 1870.¹⁵ 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 1902.¹⁶ 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.¹⁷

2. 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 1916¹⁸ 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,¹⁹ transfers not intended to take effect until death,²⁰ 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.²¹

¹³ Act of July 6, 1797, 1 Stat. 527.

¹⁴ Act of June 30, 1802, 2 Stat. 148.

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

¹⁶ War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).

¹⁷ See quotation in Paul, Randolph E., Taxation in the United States, p. 88 (Boston 1954).

¹⁸ Act of September 8, 1916, 39 Stat. 756.

¹⁹ This rule is contained in Code section 2043 of present law.

²⁰ This rule is contained in Code section 2037 of present law.

²¹ 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.²²

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;²³ 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.²⁴

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.²⁵ 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.²⁶ 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.²⁷ The exemption for both the estate and gift tax was reduced in 1935 to \$40,000 each.²⁸

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

²² These rules are now contained in sections 2041 and 2514 of present law.

²³ This rule is now contained in section 2038 of present law.

²⁴ 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.

²⁵ Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).

²⁶ This rule is now contained in section 2036(a) of present law.

²⁷ Act of May 10, 1934, 48 Stat. 680.

²⁸ Act of August 30, 1935, 49 Stat. 1014.

War II.²⁹ 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.³⁰

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;³¹ 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.³²

3. 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.³³

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.³⁴

The Small Business Tax Revision Act of 1958³⁵ provided for payment of Federal estate tax on certain closely-held businesses in installments over a 10-year period.³⁶

²⁹ Revenue Act of 1940, 54 Stat. 516.

³⁰ Act of September 20, 1941, 55 Stat. 687.

³¹ 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.

³² Act of October 21, 1942, 56 Stat. 798.

³³ Revenue Act of 1948, 62 Stat. 110.

³⁴ This rule is now contained in section 2042 of present law.

³⁵ P.L. 85-866 (September 2, 1958).

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,³⁷ Congress substantially revised estate and gift taxes by:

- providing for a single unified rate structure for cumulative lifetime and deathtime transfers;³⁸
- 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;³⁹
- providing that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly-held property;
- 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;⁴⁰

³⁶ This rule has been subsequently modified; it is now contained in section 6166 of present law.

³⁷ P.L. 94-455 (October 4, 1976).

³⁸ These rules are now contained in sections 2001 and 2501 of present law.

³⁹ This rule is now contained in section 2035 of present law.

⁴⁰ 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.

- 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;⁴¹ 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.⁴²

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 (the “1981 Act”)⁴³ 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);
- 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”);⁴⁴

⁴¹ This rule is now contained in section 2518 of present law.

⁴² Crude Oil Windfall Profits Act of 1980 (P.L. 96-223 (April 2, 1980)).

⁴³ P.L. 97-35 (August 13, 1981).

⁴⁴ This rule is now contained in section 2056 of present law.

- 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 1986⁴⁵ 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 generation-skipping transfer to include direct transfers from a grandparent to a grandchild (i.e., direct skips).

The Omnibus Budget Reconciliation Act of 1987⁴⁶ modified the estate and gift tax by: (1) providing special rules for so-called “estate freeze transaction,” through which the estate of a

⁴⁵ 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.

⁴⁶ P.L. 100-203.

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.⁴⁷

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 1993⁴⁸ restored the 55-percent top rate retroactively to January 1, 1993, and made that top rate permanent. The Taxpayer Relief Act of 1997⁴⁹ 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.

4. 1999 and subsequent legislation

The Taxpayer Refund and Relief Act of 1999

The Taxpayer Refund and Relief Act of 1999 (H.R. 2488),⁵⁰ 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 2009.⁵¹ 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 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.

⁴⁷ These rules are contained in sections 2701 through 2704 of present law.

⁴⁸ P.L. 103-66 (August 10, 1993).

⁴⁹ P.L. 105-34 (August 5, 1997).

⁵⁰ H.R. Conf. Rep. No. 106-289 (August 5, 1999).

⁵¹ Section 1501 of H.R. 2488 provided that the provisions in the bill were to sunset beginning in 2009.

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),⁵² 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),⁵³ 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.

5. Summary

Table 1 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.

⁵² H.R. Rep. No. 106-467 (November 11, 1999).

⁵³ H.R. Rep. No. 106-651 (June 6, 2000).

Table 1.—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.

II. BACKGROUND AND ANALYSIS RELATING TO ESTATE AND GIFT TAXATION

A. Background Data

Estates subject to the estate tax

Table 2 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-1970s⁵⁴ 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.

⁵⁴ See description of changes made to the estate tax in 1976 in Part I.B., above.

Table 2.B Number of Taxable Estate Tax Returns Filed as a Percentage of Deaths, Selected Years, 1935-1999

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	20,856	0.97
1990 ⁴	2,148,463	23,215	1.08
1991 ⁴	2,169,518	24,897	1.15
1992 ⁴	2,175,613	27,187	1.25
1993 ⁴	2,268,553	27,506	1.21
1994 ⁴	2,278,994	31,918	1.40
1995 ⁴	2,312,132	31,564	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 2.⁵⁵ 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 accumulating capital.⁵⁶ 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.⁵⁷

⁵⁵ 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 I.B., 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.

⁵⁶ 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.

⁵⁷ 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

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

Table 3 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.

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 3.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 1997.⁵⁸ 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 4 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 4 reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

⁵⁸ 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 4.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.

B. 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.⁵⁹

Because the U.S. estate and gift tax exempts transfers between spouses, it 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.⁶⁰ 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.⁶¹ 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.⁶² 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

⁵⁹ 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).

⁶⁰ Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95), June 1, 1995.

⁶¹ Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Krueger (eds.), *The Political Economy of Tax Reform* (Chicago: The University of Chicago Press), 1992, pp. 250-251.

⁶² 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.⁶³

Table 5 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 5 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.

⁶³ Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," p. 249.

Table 5.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 OCED 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.

C. 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.⁶⁴ Estate and gift taxes are levied on the transfer of accumulated wealth. Accumulated wealth does not result from any ongoing, current economic activity.⁶⁵ 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 \$1,000 in each year while the burden of the transfer tax is \$5,801.90 in the fifth year.⁶⁶

⁶⁴ 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.

⁶⁵ 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.

⁶⁶ 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

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.⁶⁷

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.⁶⁸ 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 United States' capital stock.⁶⁹ Others question the importance of the bequest motive in national

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.

⁶⁷ 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.

⁶⁸ 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.

⁶⁹ 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 formation.⁷⁰ Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.⁷¹ 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 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

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.

⁷⁰ 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.

⁷¹ 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.

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.⁷² 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.⁷³

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 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.⁷⁴

As described in Part I, above, several Code provisions may reduce the burden of the estate tax borne by small or family-owned businesses. Tables 6a and 6b, 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 6a) and in comparison to those estate tax returns with a positive estate tax liability (Table 6b). In each table the data reported in the rows relate to returns claiming benefits under sec. 2032A (special use valuation of real property), sec 2057 (exemption for qualified family-owned business interests), both sec. 2032A and 2057 on the same return, and sec. 6166 (extended payment period and reduced interest charge on installment payments). The

⁷² Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1988, pp. 141-195.

⁷³ 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.

⁷⁴ 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.

returns reported in the first three rows of each table are mutually exclusive. Returns reported claiming benefits under sec. 6166 also may have utilized sec. 2032A, sec. 2057, or both. The data in Tables 6a and 6b show that in 1999 approximately one percent of all returns filed utilized one or both of sec. 2034A and sec. 2057. Among taxable returns less than three-quarters of one percent utilized one or both of sec. 2032A or sec. 2057.

Table 6a. --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. 2032A and 2057.....	84	0.08%	216.1	0.11%
Claiming benefits under sec. 6166.....	524	0.50%	5.2	(1)

(1) Less than 0.01 percent.

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

Table 6b. --Taxable Estate Tax Returns Utilizing Provisions to Benefit Small and Family-Owned Businesses, 1999

	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.....	77	0.15%	124.6	0.54%
Claiming benefits under sec. 2057 only.....	235	0.47%	1,102.2	4.81%
Claiming benefits under both secs. 2032A and 2057.....	34	0.07%	139.0	0.61%
Claiming benefits under sec. 6166.....	524	1.05%	5.2	0.02%

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...."⁷⁵ While, in theory, increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.⁷⁶

⁷⁵ 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.

⁷⁶ 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

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.⁷⁷ Conventional economic wisdom holds that the 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 succeeding decades. 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.⁷⁸

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

"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.

⁷⁷ 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.

⁷⁸ 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.

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 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.⁷⁹

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.⁸⁰ Economists refer to this incentive as the "price" or "substitution effect."

⁷⁹ 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.

⁸⁰ 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

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 and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.⁸¹ 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

cents per dollar of bequest. More generally, the "price" of charitable bequest equals $(1 - t)$, where t is the estate's marginal tax rate.

⁸¹ 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.

lifetime gifts reduce the future taxable estate. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.⁸²

Table 7, 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.

Table 7.--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.⁸³ Incurring these costs, while ultimately profitable from the donors'

⁸² 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.

⁸³ 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

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 Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.⁸⁴ 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 in Part I, 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 8, below, reports data related to the State death tax credit. In 1995, States collected \$4.9 billion in estate and gift taxes⁸⁵ on which estates claimed \$3.0 billion in State death tax

Brookings Institution), forthcoming 2001, reviews a number of widely used estate planning techniques.

⁸⁴ 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.

⁸⁵ Scott Moody, editor, *Facts & Figures on Government Finance*, (Washington, D.C.: The Tax Foundation), 1999.

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.⁸⁶ In 1999, estates claimed \$6.1 billion in State death tax credits against the Federal estate tax.

Table 8.--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.

⁸⁶ Moody, *Facts and Figures*.

III. DESCRIPTION OF PROPOSALS

A. The President's Fiscal 2002 Budget

On February 28, 2001, President George W. Bush released the Administration's Fiscal 2000 budget. Included in the Administration's budget is a proposal to repeal the estate tax.⁸⁷ The details of the proposal have not yet been released.

B. S. 9, the "Working Family Tax Relief Act of 2001"

S. 9, the "Working Family Tax Relief Act of 2001," was introduced by Senators Daschle, Baucus, Rockefeller, Conrad, Kerry, and others on January 22, 2001. In general, the bill would increase the amount of the unified credit effective exemption from \$675,000 in 2001 (reaching \$1 million in 2006 and thereafter) as follows: \$1 million in 2002 through 2006; \$1.125 million in 2007 and 2008; \$1.5 million in 2009; and \$2 million in 2010 and thereafter. The qualified family-owned business deduction "applicable deduction amount" of section 2057 also would be increased as follows: \$1.375 million in 2002 through 2006; \$1.625 million in 2007 and 2008; \$2.375 million in 2009; and \$3.375 million in 2010 and thereafter.

The qualified family-owned business deduction and unified credit effective exemption amount would continue to be coordinated as under present law so that, if an estate claims a qualified family-owned business deduction, its unified credit effective exemption amount would be limited to \$625,000. If the qualified family-owned business deduction claimed by the estate is less than the maximum allowable deduction of \$675,000, then the unified credit would be increased by the excess of the qualified family-owned business applicable deduction amount over the amount of deduction allowed, but not above the amount that would apply for the taxable year without regard to the qualified family-owned business deduction.

In addition, the bill would provide portability of any of the first spouse's unused qualified family-owned business deduction. Under the bill, if an immediately predeceased spouse of the decedent has any unused qualified family-owned business deduction, the decedent generally could use such unused amount. This additional deduction would be limited to the amount of any unused qualified family-owned business deduction less the amount of any increase in the immediately predeceased spouse's unified credit.

C. S. 31, the "Estate and Gift Tax Rate Reduction Act of 2001"

S. 31, the "Estate and Gift Tax Rate Reduction Act of 2001," was introduced by Senator Campbell and others on January 22, 2001. In general, the bill would repeal estate, gift, and generation-skipping transfer taxes in the case of decedents dying and gifts and generation-skipping transfers made after December 31, 2001, after which property received from a decedent's estate would continue to receive a step up in basis. In the interim, all estate, gift, and generation-skipping transfer tax rates would be reduced by 5 percentage points each year from

⁸⁷ *A Blueprint for New Beginnings, A Responsible Budget for America's Priorities*, H. Doc. 107-45, p. 35.

2002 through 2011. The state death tax credit rates also would be reduced 1.5 percentage points per year from 2002 through 2011.

D. S. 35, the “Tax Cut With a Purpose Act of 2001”

S. 35, the “Tax Cut With a Purpose Act of 2001,” was introduced by Senators Gramm, Kyl, Miller and others on January 22, 2001. The bill contains several tax provisions. The estate, gift, and generation-skipping transfer taxes provisions in the bill generally would repeal estate, gift, and generation-skipping transfer taxes in 2009, after which property received from a decedent’s estate would continue to receive a step up in basis, which generally is a basis equal to the fair market value of the property on the date of the decedent’s death. In the interim, all estate, gift, and generation-skipping transfer tax rates would be reduced by 5 percentage points each year in 2002 through 2006, then by 10 points in 2007 and 2008.

E. S. 82, the “Estate and Gift Tax Repeal Act of 2001”

S. 82, the “Estate and Gift Tax Repeal Act of 2001,” was introduced by Senator Lugar and others on January 22, 2001. The bill would repeal estate, gift, and generation-skipping transfer taxes as of the date of enactment, after which property received from a decedent’s estate would continue to receive a step up in basis, which generally is a basis equal to the fair market value of the property on the date of the decedent’s death. The Treasury Secretary would be required to submit to the Congress within 90 days after the effective date a draft of any technical and conforming amendments necessary to reflect the changes in the Internal Revenue Code as a result of repeal of estate, gift, and generation-skipping transfer taxes.

F. S. 83, the “Estate and Gift Tax Phase-Out Act of 2001”

S. 83, the “Estate and Gift Tax Phase-Out Act of 2001,” was introduced by Senator Lugar and others on January 22, 2001. The bill would repeal estate, gift, and generation-skipping transfer taxes in 2007, after which property received from a decedent’s estate would continue to receive a step up in basis, which generally is a basis equal to the fair market value of the property on the date of the decedent’s death. In the interim, the unified credit effective exemption amount would be increased as follows: \$1,000 in 2002, \$1.5 million in 2003, \$2 million in 2004, \$2.5 million in 2005, and \$5 million in 2006. The Treasury Secretary would be required to submit to the Congress within 90 days after the effective date a draft of any technical and conforming amendments necessary to reflect the changes in the Internal Revenue Code as a result of repeal of estate, gift, and generation-skipping transfer taxes.

G. S. 84, the “Farmer and Entrepreneur Estate Tax Relief Act of 2001”

S. 84, the “Farmer and Entrepreneur Estate Tax Relief Act of 2001,” was introduced by Senator Lugar and others on January 22, 2001. The bill would increase the unified credit effective exemption amount to \$5,000,000 in 2002 and thereafter.

H. S. 100, the “Death Tax Termination Act of 2001”

S. 100, the “Death Tax Termination Act of 2001,” was introduced by Senator Allard on January 22, 2001. The bill would repeal estate, gift, and generation-skipping transfers taxes with respect to estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2000, after which property received from a decedent’s estate would continue to receive a step up in basis which generally is a basis equal to the fair market value of the property on the date of the decedent’s death.

I. S. 179

S. 179, was introduced by Senator Dorgan on January 25, 2001. In general, the bill would increase the amount of the qualified family-owned business deduction as follows: \$2.375 million in 2001, \$4.375 million in 2002, \$6.375 million in 2003, \$8.375 million in 2004, and \$9.375 million in 2005 and thereafter.

The bill also would increase the amount of the unified credit effective exemption as follows: \$1 million in 2001 and 2002, \$1.125 million in 2003 and 2004, \$1.5 million in 2005, and \$2 million in 2006 and thereafter.

Through 2005, the qualified family-owned business deduction and unified credit effective exemption amount would continue to be coordinated as under present law so that, under the proposal, if an estate claims a qualified family-owned business deduction, its unified credit effective exemption amount would be limited to \$625,000. If the estate’s qualified family-owned business deduction is less than the applicable deduction amount, then the unified credit would be increased by the excess of the qualified family-owned business applicable deduction amount over the amount of deduction allowed, but not above the amount that would apply for the taxable year without regard to the qualified family-owned business deduction.

Beginning in 2006, the qualified family-owned business deduction and unified credit effective exemption amount would no longer continue to be coordinated so that, under the proposal, an estate would be allowed a separate deduction for qualified family-owned business interests as well as the maximum available unified credit effective exemption amount for the taxable year. For example, in 2006, an estate would be allowed a maximum qualified family-owned business deduction of \$9.375 million and a maximum unified credit effective exemption amount of \$2 million.

In addition, the bill would provide portability of any of the first spouse’s unused qualified family-owned business deduction. Under the bill, if an immediately predeceased spouse of the decedent has any unused qualified family-owned business deduction, the decedent generally could use such unused amount. This additional deduction would be limited to the amount of any unused qualified family-owned business deduction less the amount of any increase in the immediately predeceased spouse’s unified credit.

The bill would provide portability of any of the first spouse’s unused unified credit effective exemption amount. Under the bill, if an immediately predeceased spouse of the

decedent has any unused unified credit effective exemption amount, the decedent generally may use such unused amount.

J. S. 275, the “Estate Tax Elimination Act of 2001”

S. 275, the “Estate Tax Elimination Act of 2001,” was introduced by Senators Kyl, Breaux, Gramm, Lincoln, and others on February 7, 2001. The bill would repeal estate, gift, and generation-skipping transfers taxes after the date of enactment, after which property received from a decedent’s estate generally would receive a carryover basis, which is the basis of the property in the hands of the decedent. An executor could “step up” the basis of a decedent’s property by adding to the basis of such property an additional \$2.8 million, which is adjusted for inflation occurring after 2001. Such an addition to basis could not exceed the total fair market value of the decedent’s property. Property receiving a carryover basis generally would have its basis determined under the present-law gift tax carryover basis rules.

Executors would be required to furnish the Treasury Secretary with information regarding any basis adjustments made by an executor.