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DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO ESTATE AND GIFT TAXATION

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON APRIL 10, 1997

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 10, 1997, on estate and gift tax proposals. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of tax proposals relating to estate and gift taxation.

Part I of the pamphlet is a description of present law and legislative background. Part II is a description and analysis of proposals relating to estate and gift taxation. Part III provides background data on estate and gift taxation and economic analysis on estate and gift taxation.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Proposals Relating to Estate and Gift Taxation* (JCS-7-97), April 8, 1997.

I. PRESENT LAW AND BACKGROUND

A. Present Law

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] Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers[3] and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10,000,000 and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[4]

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then 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 multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then 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.[5]

An unlimited marital deduction generally is permitted for the value of property transferred between spouses. In addition, a charitable deduction generally is permitted for the value of property transferred to charitable organizations.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been $192,800 (sec. 2010), which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax.

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

[3] Due to the operation of the unified credit, the first $600,000 in cumulative taxable transfers is effectively exempt from estate and gift tax. For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent.

[4] Thus, if a taxpayer has made cumulative taxable transfers exceeding $21,040,000, his or her average transfer tax rate is 55 percent.

[5] For transfers by gift, the basis of the property in the hands of the transferee generally is the same as the basis of the transferor. In contrast, the basis of property passed from a decedent generally is the fair market value of the property at the date of the decedent's death.

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of $47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made by an individual ($20,000 per married couple) to any one donee during a calendar year (sec. 2503). This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Valuation

Generally, for Federal transfer tax purposes, the value of property 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. Fair market value is determined as of either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death (sec. 2032).

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 highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of death; (2) the value 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) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[6] (4) the real property qualifying for current use valuation must pass to a qualified heir;[7] (5) such real property must have been 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 last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of the decedent's family in 5 years out

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

[7] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

of the 8 years immediately preceding the decedent's death (Code sec. 2032A (a) and (b)).[8]

If, after an election is made to specially 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 (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation. Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax under section 2032A(c). *Martin v. Commissioner*, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); *Williamson v. Commissioner*, 93 T.C. 242 (1989) (cash lease to family member).

Statute of limitations

Generally, any estate or gift tax must be assessed within three years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the three-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within six years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. *See, e.g.*, Evanson v. United States, 74 AFTR 2d 94-5128 (9th Cir. 1994); Stalcup v. United States, 946 F. 2d 1125 (5th Cir. 1991); Estate of Levin, 1991 T.C. Memo 1991-208, *aff'd* 986 F. 2d 91 (4th Cir. 1993); Estate of Smith v. Commissioner, 94 T.C. 872 (1990). *But see* Boatman's First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

Contributions for conservation purposes

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). Qualifying conservation purposes are: (1) the

[8] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit, and is either for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy; or (4) the preservation of an historically important land area or certified historic structure (sec. 170(h)(4)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST 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 GST tax include direct skips, taxable terminations and taxable distributions.[9] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million. 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 be as high as 80 percent (assuming a 55-percent marginal tax rate).

Under the "predeceased parent exception", a direct skip transfer to a transferor's grandchild is not subject to the GST tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Installment payment of estate tax

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of

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[9] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift 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 a direct skip).

deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. All interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. If the deduction is taken against the estate tax, supplemental returns must be filed each year to recompute the value of the taxable estate.

To qualify for the installment payment election, the business must be an active trade or business and the value of 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: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) 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; or (3) 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 (i.e., the provision that requires no principal payments be made until the fifth year) nor the special 4-percent rate 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.

B. Legislative Background

Federal death taxes before World War I

While States extensively used death taxes,[10] Federal death taxes in this country, for most of its history, were imposed primarily to finance wars or 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.[11] Subsequent to the repeal of the stamp tax,[12] 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.[13] In order to finance the Spanish-American War, the Federal Government imposed its

[10] The term "death taxes" is used to refer to taxes that are imposed at the time of the death of an individual. As used herein, the term includes taxes with other names. Such taxes include "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.

[11] Act of July 6, 1797, 1 Stat. 527.

[12] Act of June 30, 1802, 2 Stat. 148.

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

first estate tax in 1898, which remained in effect until its repeal in 1902.[14] While prior death taxes were primarily imposed to finance war-related costs, 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.[15]

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 1916[16] 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,[17] transfers not intended to take effect until death,[18] 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 caused increases in estate tax rates with a top rate of 25 percent on transfers in excess of $10 million.[19]

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.[20]

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;[21] and (3) allowing a credit for State death taxes for 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.[22]

In 1932, with the advent of the Depression which reduced revenues from other sources and with the need for revenues for new Government projects, estate tax rates were increased with a top

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[14] War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).
[15] See quotation in Paul, Randolph E., *Taxation in the United States*, (Boston, 1954) p. 88.
[16] Act of September 8, 1916, 39 Stat. 756.
[17] This rule is contained in section 2043 of present law.
[18] This rule is contained in section 2037 of present law.
[19] Act of March 3, 1917, 39 Stat. 1000.
[20] This rule is now contained in sections 2041 and 2514 of present law.
[21] This rule is now contained in section 2038 of present law.
[22] 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.

rate of 45 percent on transfers over $10 million.[23] 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.[24] 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 to top rates of 60 percent and 45 percent, respectively, on transfers in excess of $10 million and again in 1935 to top rates of 70 percent and 52.5 percent, respectively, on transfers in excess of $50 million.[25] The exemption for both the estate and gift tax was reduced in 1935 to $40,000 each.[26]

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 War II.[27] 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.[28]

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 the gift tax at $30,000, and providing an annual gift tax exclusion of $3,000;[29] 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 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.[30]

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.[31]

In 1954, the estate tax treatment of life insurance was changed to a rule that subjected life insurance proceeds 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.[32]

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[23] Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).
[24] This rule is now contained in section 2036(a) of present law.
[25] Act of May 10, 1934, 48 Stat. 680.
[26] Act of August 30, 1935, 49 Stat. 1014.
[27] Revenue Act of 1940, 54 Stat. 516.
[28] Act of September 20, 1941, 55 Stat. 687.
[29] 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 where combined into a single unified tax that could be reduced by a unified credit which replaces the two exemptions.
[30] Act of October 21, 1942, 56 Stat. 798.
[31] Revenue Act of 1948, 62 Stat. 110.
[32] This rule is now contained in section 2042 of present law.

The Small Business Tax Revision Act of 1958[33] provided for payment of Federal estate tax on certain closely held businesses in installments over a 10-year period.[34]

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,[35] Congress substantially revised estate and gift taxes by: (1) providing for a single unified rate structure for cumulative lifetime and deathtime transfers;[36] (2) providing an exemption in the form of a credit (called the "unified credit") which exempted $175,625 of transfers from tax when fully phased-in; (3) revising the unified rate structure and lowering the maximum rate of tax to 70 percent; (4) 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 its basis to the decedent (i.e., the decedent's basis in the property would "carryover" to be the basis to the heir); (5) providing a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse; (6) 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;[37] (7) providing that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly held property; (8) providing that a farm or other real property used in a closely held business could be valued at its "current use value" instead of its "highest and best use" value, so long as the heirs continued to so use the property for 15 years after the decedent's death;[38] (9) providing a limited deduction for bequests to children with no living parents (the so-called "orphan's deduction"); (10) 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 in a form where the children received only an income interest or power to control the enjoyment of the property; (11) 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;[39] and liberalized the provision which permits installment payment of estate tax on closely-held business by providing that only interest need be paid for the first four years after death and lengthening the period of installment an additional four years to 14 years.

[33] P.L. 85-566.

[34] This rule has been subsequently modified, and is now contained in section 6166 of present law.

[35] P.L. 94-455.

[36] These rules are contained in sections 2001 and 2501 of present law.

[37] This rule is now contained in section 2035 of present law.

[38] These rules are now contained in section 2032A of present law, although the 15-year period has been shortened to ten years.

[39] This rule is now contained in section 2518 of present law.

In 1980, the "carryover basis" rule was retroactively repealed and replaced by the "stepped-up basis" rules that applied before the 1976 legislation.[40]

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 ("1981 Act")[41] made the following changes to the estate and gift taxes: (1) increased the unified credit such that, when fully phased-in in 1987, it effectively exempted the first $600,000 of transfers from the unified estate and gift tax; (2) reduced the top unified estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982-1985); (3) provided for an unlimited deduction for transfers to spouses and permitted such a deduction (the so-called "QTIP deduction") even where the donee spouse could not control disposition of the property after that spouse's death, so long as that spouse had an income interest in that property and that property was subject to that spouse's estate and gift tax;[42] (4) increased the annual gift tax exemption from $3,000 per year per donee to $10,000 per year per donee; (5) changed the presumption that each spouse equally provided for the acquisition cost of jointly held property to an irrebuttable presumption; (6) modified the "current 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 the value of such property from $500,000 to $750,000; (7) repealed the so-called "orphan's deduction;" (8) delayed the effective date of the generation-skipping transfer tax, (9) further liberalized and simplified the rules which permit the installment payment of estate tax on closely-held businesses.

The Deficit Reduction Act of 1984: (1) delayed for three years the scheduled reduction of the maximum estate and gift tax rates (such that maximum rate remained at 55 percent until 1988); (2) eliminated the exclusion for interests in qualified pension plans; (3) provided rules for the gift tax treatment of below-market rate loans; and (4) extended the rules which permit the installment payment of estate taxes on closely-held businesses to certain holding companies.

1986 and subsequent legislation

The Tax Reform Act of 1986[43] substantially revised the tax on generation-skipping transfers by applying a single rate 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").[44]

The Omnibus Budget Reconciliation Act of 1987 made the following modifications: (1) provided special rules for so-called "estate freeze transactions" under which the person who engaged in such a transaction would be subject to estate tax on the value of such

[40] Crude Oil Windfall Profits Act of 1980 (P.L. 96-223).
[41] P.L. 97-34.
[42] This rule in now contained in section 2056 of present law.
[43] P.L. 99-514.
[44] a These rules are now contained in sections 2601 through 2654 of present law.

property; (2) provided a higher estate or gift tax rate on transfers in excess of $10 million to phase-out the unified credit and rate brackets lower than 55 percent; and (3) again delayed for five years the scheduled reduction in the estate and gift tax rates from 55 percent to 50 percent.

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.[45]

The maximum estate, gift, and generation-skipping transfer tax rate dropped to 50 percent on December 31, 1992, but the Omnibus Budget Reconciliation Act of 1993 restored the 55-percent top rate retroactively to January 1, 1993, and made that top rate permanent.[46]

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, 1977–1996.

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

Year	Annual gift exclusion single/joint in dollars	Exemption value of unified credit (dollars)	Threshold of highest statutory tax rate ($ millions)	Highest statutory tax rate (percent)
1977	3,000/6,000	120,667	5	70
1982	10,000/20,000	225,000	4	65
1983	10,000/20,000	275,000	3.5	60
1984	10,000/20,000	325,000	3	55
1985	10,000/20,000	400,000	3	55
1986	10,000/20,000	500,000	3	55
1987	10,000/20,000	600,000	3	55
1988	10,000/20,000	600,000	3	[1]55
1990	10,000/20,000	600,000	3	[1]55
1992	10,000/20,000	600,000	3	[1]55
1994	10,000/20,000	600,000	3	[1]55
1996	10,000/20,000	600,000	3	[1]55

[1] Since 1987 the benefits of the graduated rate structure have been 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.

Source: Joint Committee on Taxation.

[45] These rules are contained in sections 2701 through 2704 of present law.
[46] P.L. 103-66.

II. DESCRIPTION OF PROPOSALS

A. The "American Family Tax Relief Act" (S. 2) (Senator Roth and others)

Increase in estate and gift tax unified credit

S. 2 would increase the present-law unified estate and gift tax credit to provide an effective exemption of $650,000 for decedents dying, and gifts made, in 1997; $700,000 in 1998; $750,000 in 1999; $800,000 in 2000; $850,000 in 2001; $900,000 in 2002; $950,000 in 2003; and $1,000,000 in 2004 and thereafter.

Estate tax exclusion for qualified family-owned businesses

S. 2 would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the remaining value of qualified family-owned business interests. In general, a qualified family-owned business interest would be any nonpublicly-traded 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 ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. To qualify for this beneficial treatment, 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 death, and each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of each eight-year period ending within 10 years after the decedent's death.

The benefit of the exclusion for qualified family-owned business interests would be 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: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. The portion of the reduction in estate taxes that is recaptured would depend upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the

qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes would be recaptured; if the participation was for at least seven years but less than eight years, 60 percent would be recaptured; if the participation was for at least eight years but less than nine years, 40 percent would be recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes would be recaptured. In general, there would be 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. As under present-law section 2032A, however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death.

The provision would apply to decedents dying, and gifts made, after December 31, 1996.

Installment payments of estate tax attributable to closely held businesses

S. 2 would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest. Under the bill, there would be no interest imposed on the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely held business. The interest rate imposed on the amount of deferred estate tax attributable to the value of the closely held business in excess of $1,000,000 would remain as under present law (i.e., the rate applicable to underpayments of tax under section 6621, which is the Federal short-term rate plus 3 percentage points).

The provision would apply to decedents dying, and gifts made, after December 31, 1996.

B. The "Targeted Investment Incentive and Economic Growth Act of 1997" (S. 20) (Senator Daschle and others)

Family-owned business exclusion

S. 20 would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $900,000 of value in qualified family-owned business interests from the decedent's estate. This $900,000 amount would be reduced by any amount that a previous spouse of the decedent utilized upon his or her death (i.e., a married couple would be entitled to a total exclusion of $900,000, which could be utilized entirely by the first spouse to die, entirely by the second spouse to die, or split between them in any proportion they choose).

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This new exclusion for qualified family-owned business interests would be provided in addition to the unified credit (which effectively exempts $600,000 of taxable transfers from the estate and gift tax) and the special-use provisions of section 2032A (which permit the exclusion of up to $750,000 in value of qualified real property used in farming or another qualifying closely-held trade or business from a decedent's estate).

The definition of qualified family-owned business interests, the material participation requirements, and the recapture provisions would be the same as in S. 2.

The provision would be effective with respect to the estates of decedents dying after December 31, 1996.

Increase in the portion of estate tax subject to 4-percent interest rate

For estates that elect to pay the estate tax attributable to a closely-held business in installments (pursuant to sec. 6166), S. 20 would increase the amount of value in a closely-held business that is eligible for the special 4-percent interest rate, from $1,000,000 to $1,600,000, for decedents dying after December 31, 1996.

Estate tax recapture from cash leases of specially-valued property

S. 20 would provide that the cash lease of specially-valued real property by a qualified heir to a member of the decedent's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

The provision would be effective for cash rentals after December 31, 1976.

C. The "Estate Tax Relief for the American Family Act of 1997" (S. 479) (Senators Grassley, Baucus and others)

Increase in estate and gift tax unified credit

S. 479 would increase the present-law unified estate and gift tax credit to provide an effective exemption of $700,000 for decedents dying, and gifts made, in 1997 after the date of enactment; $800,000 in 1998; $850,000 in 1999; $900,000 in 2000; $950,000 in 2001; and $1,000,000 in 2002 and thereafter.

Estate tax exclusion for qualified family-owned businesses

S. 479 would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the next $8,500,000 in value of qualified family-owned business interests. The definition of qualified family-owned business interests, the material participation requirements, and the recapture provisions would be the same as in S. 2. However, unlike in S. 2, the special treatment would be elective. A technically defective election could be corrected if the executor supplies the missing information or signatures within a reason-

able period of time (not exceeding 90 days) after notification by the Treasury Department. The provision would be effective for decedents dying after December 31, 1997.

Special use valuation modifications

S. 479 would provide that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c). This provision would be effective for cash rentals after December 31, 1976.

The bill also would increase the maximum reduction in value for purposes of the special use valuation provisions of section 2032A, from $750,000, to $1,000,000, for decedents dying after December 31, 1996.

Lastly, the bill would allow a technically defective special use valuation election to be corrected if the executor supplies the missing information or signatures within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department. The provision would be effective for decedents dying after the date of enactment.

Installment payments of estate tax attributable to closely held businesses

S. 479 would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest. There would be no interest imposed on the first $153,000 of deferred estate tax attributable to the value of the closely held business (i.e., the amount of deferred estate tax that qualifies for the special 4-percent rate under present law). The interest rate imposed on the amount of deferred estate tax attributable to the closely held business in excess of $153,000 would remain as under present law. The provision would apply to decedents dying after December 31, 1996.

Revaluation of gifts after expiration of statute of limitations

S. 479 would provide that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made in calendar years after the date of enactment, the bill also would extend the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations would not run on an inadequately disclosed transfer in calendar years after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

The provision generally would apply to gifts made after the date of enactment. The extension of the special rule under chapter 14 to all gifts would apply to gifts made in calendar years after the date of enactment.

Expansion of exception from generation-skipping transfer tax for transfers to individuals with deceased parents

S. 479 would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would apply to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the bill would extend the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) is deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

The provision would be effective for generation skipping transfers occurring after December 31, 1997.

D. The "American Farm and Ranch Protection Act of 1997" (S. 499) (Senator Chafee and others)

S. 499 would provide that an executor could elect to exclude from the taxable estate the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land must be located within 50 miles of a metropolitan area, a national park or wilderness area, or an Urban National Forest, (2) the land must have 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 (3) a qualified conservation contribution of a qualified real property interest has been granted by the transferor or a member of his or her family. For purposes of the proposal, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death would be a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property would not be eligible for the exclusion.

The exclusion amount would be calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment of estate taxes attributable to retained development rights may be deferred for up to two and one-half years.

Other provisions of S. 499 would: (1) exclude a gift of land subject to a conservation easement from the Federal gift tax upon the

same terms as pertain to the exclusion from estate taxes provided that the easement meets the standards listed above; and (2) provide that the granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A.

The above provisions would apply to contributions made, and easements granted, after December 31, 1996.

S. 499 also would allow a charitable deduction to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible." Present law provides for a charitable deduction in such a case if the mining rights have been separated from the land prior to June 13, 1976. The bill would provide that such a charitable deduction could be taken regardless of when the mining rights had been separated. This provision would be effective for contributions made after December 31, 1992.

E. Other Bills—S. 29, S. 30, and S. 31 (Senator Lugar); S. 75 (Senator Kyl and others); S. 241 (Senator McCain); S. 288 (Senator Dorgan); and S. 482 (Senator Collins and others)

S. 29 (Senator Lugar) and S. 75 (Senator Kyl and others)

S. 29 and S. 75 would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax for decedents dying, gifts made, and generation-skipping transfers occurring after the date of enactment.

S. 30 (Senator Lugar)

S. 30 would increase the present-law unified estate and gift tax credit to provide an effective exemption of $5,000,000 for decedents dying, and gifts made, after December 31, 1997.

S. 31 (Senator Lugar)

S. 31 would increase the present-law unified estate and gift tax credit to provide an effective exemption of $1,000,000 for decedents dying, and gifts made, in 1998; $1,500,000 in 1999; $2,000,000 in 2000; $2,500,000 in 2001; and $5,000,000 in 2002. For decedents dying, and gifts made, after December 31, 2002, the Federal estate and gift tax and the Federal generation-skipping transfer tax would be repealed.

S. 241 (Senator McCain)

S. 241 would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $1,500,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the remaining value of qualified family-owned business interests. The definition of qualified family-owned business interests and the material participation requirements would be similar to those provided in S. 2. The benefit of the exclusion for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and

before the qualified heir's death, the qualified heir ceases to meet the material participation requirements, or the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution. If either of these events occurs within 10 years of the decedent's death, the entire reduction in estate taxes attributable to that heir's interest in the family-owned business would be recaptured. The bill would be effective for decedents dying after December 31, 1996.

S. 288 (Senator Dorgan)

S. 288 would increase the present-law unified estate and gift tax credit to provide an effective exemption of $675,000 for decedents dying, and gifts made, in 1997; $750,000 in 1998; $825,000 in 1999; $860,000 in 2000; $895,000 in 2001; $930,000 in 2002; $965,000 in 2003 and $1,000,000 in 2004 and thereafter.

The bill also would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. The bill would exclude the first $1,000,000 of value in qualified family-owned business interests from the decedent's estate. As in S. 20, this $1,000,000 amount would be reduced by any amount that a previous spouse of the decedent utilized upon his or her death. The definition of qualified family-owned business interests, the material participation requirements, and the recapture provisions would be the same as in S. 2 and S. 20.

Further, the bill would increase the amount of value in a closely-held business that is eligible for the special 4-percent interest rate so that the tax on the first $1,000,000 in *taxable* value of the closely held business would be eligible for the special rate. The bill would be effective with respect to the estates of decedents dying after December 31, 1996.

S. 482 (Senator Collins and others)

S. 482 would provide special estate tax treatment for qualified "family-owned business interests," if such interests comprise more than 50 percent of a decedent's estate. Subject to certain requirements, the bill would exclude the first $400,000 in value of qualified family-owned business interests from the decedent's estate and also would exclude 50 percent of the next $1,100,000 in value of qualified family-owned business interests. The definition of qualified family-owned business interests, the material participation requirements, and the recapture provisions would be the same as in S. 2 and S. 20. The bill would be effective for decedents dying after the date of enactment.

F. The President's Fiscal Year 1998 Budget Proposal

The President's budget proposal would make several modifications to the installment payment provisions of section 6166. The proposal would increase the amount of value in a closely held business that would be eligible for the special low interest rate, from $1,000,000 to $2,500,000. Interest paid on the deferred estate tax would not be deductible for estate or income tax purposes, but the 4-percent rate would be reduced to 2 percent, and the deferred es-

tate tax on any value of a closely held business in excess of $2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments.

The proposal also would expand the availability and benefits of the holding company exception to include partnerships that function as holding companies, and would clarify and expand the non-readily tradeable stock requirement to include non-publicly traded partnerships. In addition, an estate using the holding company exception (as modified by the proposal) would be able to take advantage of the five-year deferral (i.e., the provision that requires no principal payments be made until the fifth year) and special 2-percent rate, thus providing the same relief to closely held businesses whether owned directly or through holding companies.

Finally, the proposal would authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien.

The proposal would apply to the estates of decedents dying after December 31, 1997. Estates that are deferring estate tax under current law could make a one-time election to use the lower interest rates and forgo the interest deduction.

G. The "Balanced Budget Act of 1995" (H.R. 2491, 104th Cong.) (the "BBA") [47]

Increase in estate and gift tax unified credit; indexing of certain other provisions

The BBA would have increased ratably the present-law unified estate and gift tax credit over a six-year period beginning in 1996, from an effective exemption of $600,000 to an effective exemption of $750,000. After 2001, the effective exemption amount of $750,000 would have been indexed annually for inflation.

The BBA also would have indexed annually for inflation the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 ceiling on the value of a closely-held business eligible for the special 4-percent interest rate, beginning in 2001.

Estate tax exclusion for qualified family-owned businesses

The BBA would have provided special estate tax treatment for qualified "family-owned business interests," if such interests comprised more than 50 percent of a decedent's estate. Subject to certain requirements, the BBA would have excluded the first $1,000,000 in value of qualified family-owned business interests from the decedent's estate and also would have excluded 50 percent of the value of qualified family-owned business interests between $1,000,000 and $2,500,000. The definition of qualified family-owned business interests, the material participation requirements, and the recapture provisions would have been the same as those provided in S. 2.

The provision would have been effective with respect to the estates of decedents dying after December 31, 1995.

[47] The Balanced Budget Act of 1995 ("BBA") was passed by the Congress in 1995, but was vetoed by President Clinton.

Reduction in estate tax for certain land subject to permanent conservation easement

The BBA would have provided that an executor could elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land must be located within 25 miles of a metropolitan area or a national park or wilderness area, or within 10 miles of an Urban National Forest; (2) the land must have 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 (3) a qualified conservation contribution of a qualified real property interest had been granted by the transferor or a member of his or her family. For purposes of the BBA, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death would be a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property would not be eligible for the exclusion.

The exclusion amount would be calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights could be deferred for up to two years, or until the disposition of the property, whichever is earlier.

The 40-percent exclusion from estate taxes for land subject to a qualified conservation easement (described above) could only be taken to the extent that the value of such land, plus the value of qualified family-owned business interests that qualify for the reduction in estate taxes, does not exceed $5 million.

If the value of the conservation easement is less than 30 percent of (1) the value of the land without the easement, reduced by (2) the value of any retained development rights, then the exclusion percentage would be reduced. The reduction in the exclusion percentage would be equal to two percentage points for each point that the above ratio falls below 30 percent.

The BBA also would have provided that the granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A.

The provision would have been effective for decedents dying after December 31, 1995.

Modification of generation-skipping transfer tax for transfers to individuals with deceased parents

The BBA would have extended the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would have applied to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the BBA would have extended the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) was deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

The provision would have been effective for generation-skipping transfers occurring after December 31, 1994.

Estate tax recapture from cash leases of specially-valued property

The BBA would have provided that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

The provision would have been effective for cash rentals after December 31, 1995.

Estate and gift tax simplification

The BBA also would have made a number of estate and gift tax simplification changes.

III. BACKGROUND DATA AND ECONOMIC ANALYSIS

A. Background Data Relating to Estate and Gift Taxation

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-1970s[48] 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.

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

Table 2.—Number of Taxable Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years, 1935–1995

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	[2] 67,404	3.90
1970	1,796,940	[2] 93,424	5.20
1973	1,867,689	[2] 120,761	6.47
1977	1,819,107	[2] 139,115	7.65
1982	1,897,820	[2,3] 41,620	2.19
1983	1,945,913	[2,3] 35,148	1.81
1984	1,968,128	[2,3] 31,507	1.60
1985	2,086,440	[2,3] 30,518	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]	[5] 2,312,180	31,564	1.37

[1] Estate returns need not be filed in the year of the decedent's death.
[2] Not strictly comparable with pre-1996 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 on from Internal Revenue Service, *Statistics of Income*.
[5] Preliminary.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 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 percentages 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 in-

creases 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 helps explain the pattern in Table 2.[49] 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.[50] 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.[51]

Indexing the exemption for inflation is equivalent to creating a fixed real exemption rather than a fixed nominal exemption. Had the $600,000 effective exemption created by the 1981 Act (effective for 1987) been indexed for inflation subsequent to 1987, its nominal value today would be approximately $838,000. Had the $175,625 effective exemption created by the 1976 Act (effective for 1982) been indexed for inflation subsequent to 1982, its nominal value today would be approximately $289,000.

Table 3 below shows the distribution of taxable estate returns, the value of the gross estate, and the estate tax liability by size of the gross estate for taxable estate tax returns filed in 1995. As shown in Figure 1, taxable estates with gross assets valued at less than $1 million accounted for 43.8 percent of all taxable returns. Figures 2 and 3 show that these estates represented 16.7 percent of the assets of taxable estates and paid 5.5 percent of estate taxes. Those 231 taxable estates with a gross estate valued at $20 million or more represented 0.7 percent of all taxable estates in 1995, but

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[49] 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.

[50] 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.

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

represented 18.9 percent of assets of taxable estates and paid 16.9 percent of estate taxes.

In addition, in 1995, 38,207 estates filed tax returns on estates valued at $600,000 or more for which there was no estate tax liability because of use of the unified credit, marital deduction, charitable deduction, or other credits. Of these nontaxable returns, 23,498 represented estates with gross estate value between $600,000 and $1 million; 11,849 represented estates with gross estate value between $1 million and $2.5 million; 2,032 represented estates with gross estate value between $2.5 million and $5 million; 578 represented estates with gross estate value between $5 million and $10 million; 182 represented estates with gross estate value between $10 million and $20 million; and 68 represented estates with gross estate value of $20 million or more.[52]

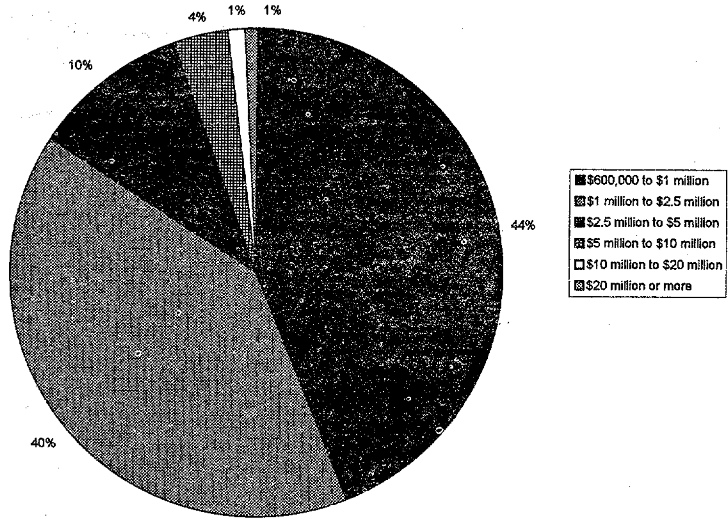
Table 3.—Distribution of Taxable Returns, Gross Estates, and Estate Tax Liability by Size of Gross Estate, 1995

Size of gross estate	Number of taxable returns	Aggregate values of taxable gross estate date of death ($1,000)	Net estate tax after credits ($1,000)
$600,000 to $1 million	13,830	11,195,554	651,160
$1 million to $2.5 million	12,710	18,845,531	2,999,760
$2.5 million to $5 million	3,298	11,288,768	2,748,165
$5 million to $10 million	1,105	7,769,030	2,053,433
$10 million to $20 million	390	5,366,395	1,384,768
$20 million or more	231	12,717,850	2,003,748
Total	31,564	67,183,128	11,841,034

Source: Martha Britton Eller, "Federal Taxation of Wealthy Transfers, 1992–1995," Internal Revenue Serivce, *SOI Bulletin,* 16, Winter, 1996–1997, pp. 8–63.

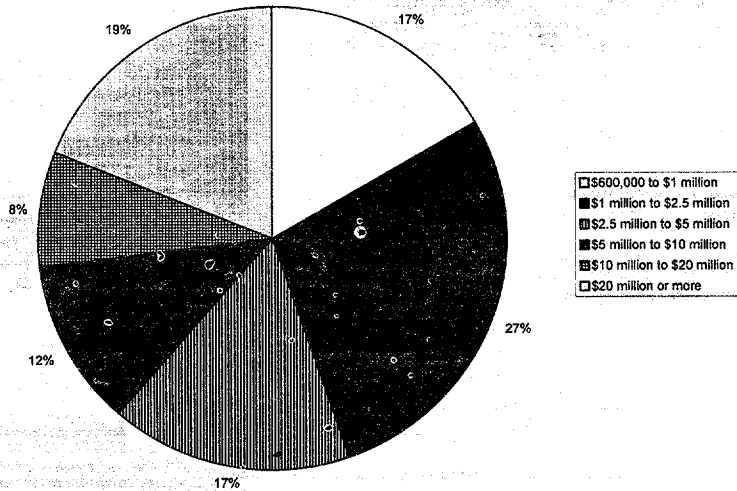
[52] Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," Internal Revenue Service, *SOI Bulletin*, 16, Winter 1996-1997, pp. 8-63.

Figure 1 - Percentage Distribution of Taxable Estates by Size of Estate, 1995



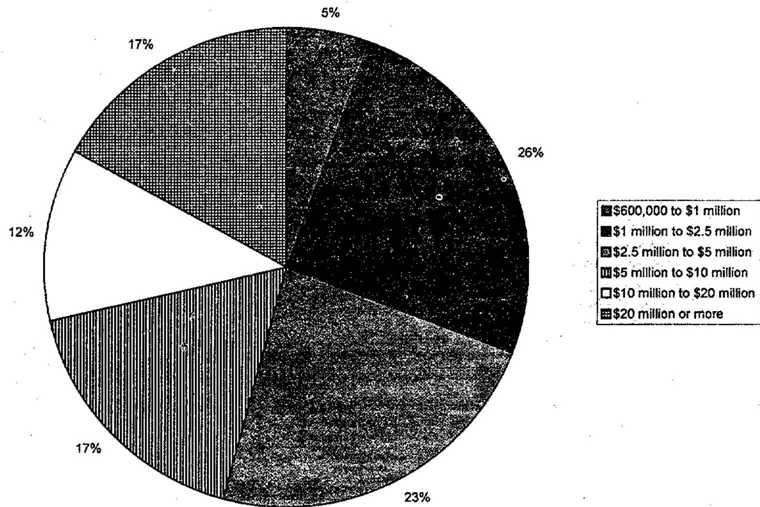
source: Joint Committee on Taxation staff calculations

Figure 2 - Percentage Distribution of Estate Assets by Estate Size, 1995



source: Joint Committee on Taxation staff calculations

Figure 3 - Percentage Distribution of Estate Tax Liability by Size of Estate, 1995



source: Joint Committee on Taxation staff calculations

Revenues from the estate, gift, and generation skipping taxes

Table 4 provides summary statistics of the estate and gift tax from 1940–1996. 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.

Table 4.—Revenue From the Estate, and Generation Skipping Transfer Taxes, Selected Years, 1940–1996

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	15,225	1.21
1995	15,087	1.12
1996	17,189	1.18

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 Bulletin*, Fall 1 Bulletin, Fall 1996, and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 1997*, and prior years.

Since 1993, estate and gift receipts have been averaging double digit rates of growth. There are four 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 are indexed, as explained above, an increasing number of persons are becoming subject to estate and gift taxes. Second, the tremendous increase in value in the stock market over the past three years will

both increase the value of estates that would have already been taxable, and increase the number of estates that will be taxable. For example, the Dow Jones Industrial Average ended 1993 at approximately 3750, and ended 1996 at approximately 6500. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth has nearly doubled during the past three years, one would expect brisk growth in estate tax receipts from this alone. Third, while the overall population of the United States is growing at about a 1 percent annual rate, the number of persons aged 85 and older is growing at a rate of almost 3.5 percent annually. This also should increase the number of estate tax returns filed. 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 10 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.

Table 5 shows the Joint Committee on Taxation staff estimates of estate, gift, and generation-skipping tax revenues for fiscal years 1997–2007. These estimates are based on the baseline forecast for estate, gift, and generation-skipping taxes supplied by the Congressional Budget Office. Table 5 also reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

Table 5.—Projections of Taxable Estates and Receipts From Federal Estate, Gift, and Generation-Skipping Transfer Taxes, 1997–2007

Fiscal year	Number of taxable estates	Receipts ($ billions)	Taxable estates as a percentage of all deaths[1]
1997	37,200	19.2	1.66
1998	40,100	20.6	1.75
1999	43,100	21.9	1.86
2000	46,000	23.3	1.97
2001	49,300	24.7	(2)
2002	43,000	26.2	(2)
2003	56,700	27.8	(2)
2004	61,100	29.5	(2)
2005	65,100	31.4	2.64
2006	69,000	33.3	(2)
2007	73,200	35.3	(2)

[1] This column divides the estimate of taxable estates by U.S. Census Bureau's projections of death rates as reported in Table 4 of U.S. Department of Commerce, Economics and Statistics Administration, Bureau of the Census, Statistical Abstract of the United States, 1995.

[2] Not available, Census projections beyond 2000 are only reported for every fifth year.

Source: Joint Committee on Taxation staff calculations.

B. Comparison of Transfer Taxation in the United States with Transfer Taxation Abroad

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. These two countries, however, provide that certain assets of the decedent with accrued, but unrealized, capital gain are taxed as part of the country's individual income tax.[53]

Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of $600,000

[53] 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).

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.[54] 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.[55] 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.[56] 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 bequest. This legal loophole was said to be widely recognized and exploited by wealthy families.[57]

Table 6 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (GDP) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among the OECD countries, Belgium, Denmark, France, Greece, 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 15 countries collect substantially less revenue from such taxes as a percentage of GDP than does the United States.

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[54] JCT, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation*, p. C–1.

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

[56] 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.

[57] Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," p. 249.

Table 6.—Revenue From Estate, Inheritance and Gift Taxes as a Percentage of Total Tax Revenue and GDP in OECD Countries, 1992

Country	Percentage of total tax revenue	Percentage of GDP
Australia	0.000	0.000
Austria	0.182	0.079
Belgium	0.735	0.334
Canada	0.002	0.001
Denmark	0.555	0.274
Finland	0.456	0.214
France	0.929	0.405
Germany	0.253	0.100
Greece	1.039	0.421
Iceland	0.216	0.072
Ireland	0.304	0.112
Italy	0.138	0.058
Japan	2.006	0.590
Luxembourg	0.320	0.155
Netherlands	0.526	0.247
New Zealand	0.292	0.105
Norway	0.191	0.089
Portugal	0.252	0.083
Spain	0.366	0.131
Sweden	0.166	0.083
Switzerland	0.854	0.264
Turkey	0.111	0.026
United Kingdom	0.584	0.206
United States	0.907	0.267

Note.—Data not directly comparable to data reported in Table 4. The OECD attempts to collect standardized data across member countries. Therefore data in OECD reports for the United States may not perfectly correspond to data as reported by OMB.

Source: Organization for Economic Cooperation and Development, *Revenue Statistics of OECD Member Countries, 1965–1993* (Paris: OECD), 1994.

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 6 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 2.18 million deaths in 1992, only 27,187 or 1.25 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.[58] Accumulated wealth, on the other hand, does not correspond to any ongoing, current economic activity.[59] 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.

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 economic consensus 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 (decreases) in the after-tax return to investments by decreasing (increasing) their saving. Again there is no census in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.[60]

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[58] 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.

[59] 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.

[60] 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.

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. 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.[61] Others question the importance of the bequest motive in national capital formation.[62] Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.[63] 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, some individuals purchase additional life insurance in order to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

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

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

[62] 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.

[63] 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).

strained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.[64] Undercapitalization may be prevalent among small businesses. A recent study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[65]

Others argue that potential deleterious effects on investment by small or family-owned businesses is limited. They note that simple tax planning can create an effective exemption of $1.2 million dollars and that other legitimate tax planning can reduce the burden on such enterprises. Some have argued that returns report a small fraction of the value of decedents' estates.[66]

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 stated 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 . . ."[67] While in theory increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.[68]

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

[65] 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 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 [measured in constant 1982–1985 dollars] raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact o 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.

[66] 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.

[67] 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.

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

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, the transfer taxes may help prevent an increase in the distribution of wealth. There are relatively few analyses of the distribution of wealth holdings.[69] 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 was no substantial change from the second world war through the 1960s. Some suggest that the concentration of wealth declined further in the 1970s and reversed course in the 1980s.[70] Some recent evidence suggests that the concentration of wealth may have declined modestly between 1989 and 1995.[71] Most analysts assign no role to tax policy in the reduction in wealth concentration which 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.[72]

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, the transfer taxes may help promote overall fairness of the U.S. tax system. Others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the transfer taxes' contribution to the overall U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets, 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 tax is assessed on the transferor for 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 eco-

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[69] 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; Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," *The Review of Income and Wealth*, 33, September 1987, Edward N. Wolff, "Trends in Household Wealth in the United States, 1962–83 and 1983–89," *The Review of Income and Wealth*, 40, June 1994, and Edward N. Wolff, *Top Heavy: A Study of the Increasing Inequality of Wealth in America*, (New York: The Twentieth Century Fund Press), 1995.

[70] Wolff, *Top Heavy*. Wolff estimates the share of wealth held by the top one percent of U.S. households. For an opposite view, see John C. Weicher, *The Distribution of Wealth: Increasing Inequality?* (Washington, D.C.: American Enterprise Institute), 1996.

[71] See Arthur B. Kennickell, Martha Starr-McCluer, and Annika E. Sundén, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, 83, January 1997. Kennickell, Starr-McCluer, and Sundén that while the wealth of the median family remainded approximately the same in real dollars ($56,400) between 1989 and 1995, mean family wealth fell modestly (from $216,700 to $205,900). If the median remains the same while the mean falls wealth held by the top 50 percent of families must have declined while wealth held by the bottom 50 percent of families increased.

[72] See Michael K. Taussig, "Les inegalities de patrimoine aux Estatis-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. In *Top Heavy*, Wolff finds the increase in the value of corporate stock compared to the slower growth in the value of housing equity important in explaining the increase in concentration he measures for the 1980s.

nomic 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.[73]

Wealth taxation and charitable bequests

In 1995, of the 69,772 estate tax returns filed, 13,063 made a charitable bequest with total charitable bequests totaling $8.7 billion. Roughly half of the charitable bequests (6,186) were from estates that ultimately had no estate tax liability. Charitable bequests from nontaxable estates totaled $3.7 billion.[74] Theoretically, the deductibility of charitable bequests from the base of the estate tax should increase such bequests beyond what they would be in the absence of the tax. A dollar bequeathed to a friend reduces the net estate[75] by $1. A dollar bequeathed to charity reduces the estate's tax liability by $1 times one minus the estate's marginal tax rate, and the net estate is reduced by $1 times (1-t), where t is the marginal estate tax rate. Economists say that this implies the price of making a bequest to a friend is $1, but the price of making a bequest to charity is (1-t), which is less than $1 for all positive tax rates. Economists argue that, in theory, because it is cheaper to bequeath to charity than to other persons, such bequests will be greater than they would in the absence of the estate tax (which implies a marginal tax rate of zero) or if the marginal estate tax rates were reduced (in which case the "price" of bequeathing to charity would increase). On the other hand, proposals increasing the amount excluded from the estate tax would be predicted to have a smaller theoretical effect on charitable bequests because the increases in the unified credit, while reducing tax liability for most estates, leaves the marginal tax rate (price of bequeathing) unchanged for many estates.

Others argue that, economics aside, taxpayers plan charitable bequests because they do not like their assets "going to the government." Under this motivation, elimination of the estate tax also would cause charitable bequests to decline. There has been relatively little empirical investigation as to whether the estate tax does lead to increased charitable bequests. Most of the empirical work does suggest that the estate tax does have some positive effect on charitable bequests.[76] On the other hand, fewer than one-

[73] 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.

[74] Eller, "Federal Taxation of Wealth Transfer."

[75] "Net estate" is used here to refer to the net amount of assets remaining in the estate after payment of Federal estate taxes.

[76] For a review of this literature, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985. For the most recent effort to investigate the empirical effect of the estate tax on charitable bequests, see David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, 45, June 1991, pp. 169–180. Joulfaian finds that the marginal tax rate is an important determinant of charitable bequests. Joulfaian uses different data to estimate the same model as Thomas Barthold and Robert Plotnick, "Estate

fifth of the estates that filed estate tax returns in 1995 (13,063 out of 69,772) made any charitable bequest. The overall effect of estate tax policy on charitable giving may not be large because charitable bequests accounted for less than eight percent of total charitable giving by individuals in 1994.[77]

Taxation and Other Determinannts of Charitable Bequests," *National Tax Journal*, 37, June 1984 pp. 225–237. Barthold and Plotnick found that while charitable bequests depended strongly on the size of the estate, the marginal tax rate did not appear to matter to the size of the bequest.

[77] *Giving USA, 1995 Edition* (New York: The American Association of Fund Raising Counsel Trust for Philanthropy), 1995, p. 12, reports that in 1994 charitable organizations received $113.86 billion in gifts from individuals and bequests. Of that total, $8.77 billion was via bequest, including bequests from individuals who had estates beneath the filing threshold.

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