PRESENT LAW AND BACKGROUND RELATING TO ESTATE AND GIFT TAXES

Scheduled for a Public Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on January 28, 1998

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on estate and gift taxes on January 28, 1998. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and legislative history and background data and analysis on estate and gift taxes.[2]

Part I of the document is a description of present law and legislative history. Part II provides background data on Federal estate and gift taxes, a comparison of transfer taxation in the United States and other countries, and an analysis of economic issues related to transfer taxation.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Background Relating to Estate and Gift Taxes (JCX-2-98), January 27, 1998.

[2] See also Joint Committee on Taxation, Description and Analysis of Tax Proposals Relating to Savings and Investment (Capital Gains, IRAs, and Estate and Gift Tax) (JCS-5-97), March 18, 1997 (Part IV. Estate and Gift Taxation).

I. PRESENT LAW AND LEGISLATIVE HISTORY

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.[3] Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers[4] 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 million and the amount necessary to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[5]

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.

A marital deduction generally is permitted for the value of property transferred between spouses.

Unified credit

A unified credit is available with respect to taxable transfers by gift (sec. 2505) and at death (sec. 2010). From 1987 to 1997, the unified credit amount was $192,800, which effectively exempted a total of $600,000 in cumulative taxable transfers from the estate and gift

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

[4] Due to the operation of the unified credit, the first $625,000 in cumulative taxable transfers is effectively exempt from estate and gift tax. For transfers in excess of $625,000, estate and gift tax rates begin at 37 percent.

[5] Thus, if a taxpayer has made cumulative taxable transfers in excess of this amount, his or her average transfer tax rate is 55 percent.

tax. The Taxpayer Relief Act of 1997 increased the effective exemption to $625,000 in 1998, $650,000 in 1999, $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year (sec. 2503). For gifts made after 1998, the $10,000 exclusion will be increased annually for inflation occurring after 1997. 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. For decedents dying after 1998, the $750,000 maximum reduction in value will be indexed annually for inflation occurring after 1997.

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 passes to a qualified heir;[7] (5) such real property was owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there was 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 of the 8 years

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[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.

immediately preceding the decedent's death.[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.

Qualified family-owned business interests

An executor may elect to exclude certain qualified "family-owned business interests" from the estate if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met (sec. 2033A). The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million.

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

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

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

[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.

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 depends upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business between the date of the decedent's death and the date of the recapture event. 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 is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under section 2032A, however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

Exclusion for land subject to permanent conservation easement

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). If the value of the conservation easement is less than 30 percent of the value of the land without the easement (reduced by the value of any retained development rights), then the exclusion percentage is reduced.

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

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

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 reach nearly 80 percent.

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. A special 2-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in taxable value of the closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on estate taxes deferred under section 6166 is not deductible for estate or income tax purposes.

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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).

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 until the fifth year) nor the special 2-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.

State death tax[10] credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State (or the District of Columbia) with respect to any property included in the decedent's gross estate (sec. 2011). The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "make-up" estate tax equal to the difference between the maximum State death tax credit and any inheritance or other succession taxes the State imposes. The effect of the "pick-up" tax is to ensure maximum revenues for the State without increasing the total tax burden on the estates of its residents.

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[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.

B. Legislative History

Federal death taxes before World War I

While States extensively used death taxes, 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 first estate tax in 1898, which remained in effect until its repeal in 1902.[14] While prior death taxes were primarily imposed to finance warfare, President Theodore Roosevelt proposed, in 1906, a progressive tax on all lifetime gifts and death time bequests to limit the amount that one individual could transfer to another, although no legislation immediately resulted from such proposal.[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.

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[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.

[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, p. 88 (Boston, 1954).

[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.

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

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[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.

[23] Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).

[24] This rule is now contained in section 2036(a) of present law.

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

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[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.

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]

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 and lowering the unified rate structure such that the maximum rate of tax was 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

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[31] Revenue Act of 1948, 62 Stat. 110.

[32] This rule is now contained in section 2042 of present law.

[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.

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.

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.

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[38] These rules are now contained in section 2032A of present law.

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

[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.

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.

<u>1986 and subsequent legislation</u>

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 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 after 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] The Taxpayer Relief Act of 1997[47] provided for gradual increases in the unified credit, new exclusions for qualified family-owned businesses and for certain land subject to permanent conservation easements, and a number of other changes.

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[43] P.L. 99-514.

[44] These rules are now contained in sections 2601 through 2654 of present law.

[45] These rules are contained in sections 2701 through 2704 of present law.

[46] P.L. 103-66.

[47] P.L. 105-34.

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, 1977-1997.

Table 1.--Annual Gift Exclusion Amount, Exemption Value of Unified Credit for Taxable Transfers, Threshold Level of Highest Statutory Tax Rate, and Highest Statutory Tax Rate Applicable to Taxable Transfers, Selected Years, 1977-1997

Year	Annual gift exclusion single/joint (dollars)	Exemption value of unified credit (dollars)	Threshold of highest statutory tax rate (dollars)	Highest statutory tax rate (percent)
1977	3,000/6,000	120,667	5 million	70
1982	10,000/20,000	225,000	4 million	65
1983	10,000/20,000	275,000	3.5 million	60
1984	10,000/20,000	325,000	3 million	55
1985	10,000/20,000	400,000	3 million	55
1986	10,000/20,000	500,000	3 million	55
1987	10,000/20,000	600,000	3 million	55
1989	10,000/20,000	600,000	3 million	55[1]
1991	10,000/20,000	600,000	3 million	55[1]
1993	10,000/20,000	600,000	3 million	55[1]
1995	10,000/20,000	600,000	3 million	55[1]
1997	10,000/20,000	600,000	3 million	55[1]

Source: Joint Committee on Taxation.

Note: 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. After 1997, the $21,040,000 threshold will be increased as increases in the unified credit are phased in.

II. BACKGROUND AND ANALYSIS

A. Background Data Relating to Estate and Gift Taxation

<u>Estates subject to the estate tax</u>

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	67,404[2]	3.90
1970	1,796,940	93,424[2]	5.20
1973	1,867,689	120,761[2]	6.47
1977	1,819,107	139,115[2]	7.65
1982	1,897,820	41,620[2,3]	2.19
1983	1,945,913	35,148[2,3]	1.81
1984	1,968,128	31,507[2,3]	1.60
1985	2,086,440	30,518[2,3]	1.46
1986	2,105,361	23,731	1.13
1987	2,123,323	21,335	1.00
1988	2,167,999	18,948	0.87
1989[4]	2,150,466	20,856	0.97
1990[4]	2,148,463	23,215	1.08
1991[4]	2,169,518	24,897	1.15
1992[4]	2,175,613	27,187	1.25
1993[4]	2,268,553	27,506	1.21
1994[4]	2,278,994	31,918	1.40
1995[4]	2,312,180[5]	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-1966 data. For later years, the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.
[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.
[4] Taxable estate data from 1989-1995 are 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 increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption largely explains the pattern in Table 2.[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

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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.

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]

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

Table 3 provides summary statistics of the estate and gift tax for selected years. Total estate and gift receipts include taxes paid for estate, gift, and generation-skipping taxes as well as payments made as the result of IRS audits.

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[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.

Table 3.--Revenue from the Estate, Gift, and Generation-Skipping Transfer Taxes, Selected Years, 1940-1997

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
1997	19,845	1.25

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 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 1997 at approximately 8000. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth has more than doubled during the past four 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 ten years. Therefore, during the decade of the 1990s, an increase in estate tax receipts is expected as the result of first-spouse deaths during the 1980s that used the unlimited marital deduction.

Table 4 shows the Joint Committee on Taxation staff present-law estimate of revenues from the estate, gift, and generation-skipping taxes for fiscal years 1998-2007. These estimates are based on the January 1998 baseline forecast for estate, gift, and generation-skipping taxes supplied by the Congressional Budget Office. Table 4 reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

Table 4.--Projections of Taxable Estates and Receipts from Estate, Gift, and Generation-Skipping Transfer Taxes, 1998-2007

Year	Exemption value of unified credit	Number of taxable estates	Percent of deaths	Receipts ($ billions)
1998	$625,000	45,300	1.97	23.0
1999	650,000	49,200	2.12	23.9
2000	675,000	49,300	2.09	24.8
2001	675,000	53,700	2.26	26.4
2002	700,000	56,500	2.35	27.7
2003	700,000	60,900	2.52	29.5
2004	850,000	50,400	2.06	29.4
2005	950,000	44,300	1.79	29.5
2006	1,000,000	44,000	1.76	30.9
2007	1,000,000	47,200	1.86	33.1

Source: Joint Committee on Taxation staff calculations.

B. Comparison of Transfer Taxation in the United States and Other Countries

Among developed countries, an inheritance tax is more common than the type of estate tax that is imposed in the United States. An inheritance tax generally is imposed upon the amount of wealth the transferee or donee receives rather than on the total wealth of the transferor. That is, the funds the heir receives in a bequest determines the tax imposed. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to generations two or more younger than that of the transferee. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on bequests that skip generations. Among developed countries, Australia and Canada impose neither an estate tax nor an inheritance tax.[52]

Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of $625,000 (in 1998) 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.[53] 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.

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[52] For a survey of the transfer tax systems of 28 countries see Joint Committee on Taxation, ("JCT"), 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).

[53] JCT, Issues Presented by Proposals to Modify the Tax Treatment of Expatriation.

The Rosen Ka values range from 25 to 80 percent of fair market value.[54] 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.[55] 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.[56]

Table 5 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (GDP) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among 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] 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.

[55] 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.

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

Table 5.--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 3. 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 5 do not reveal the extent to which estate, inheritance, and gift taxes fall across different individuals within each country. In the United States, as reported in Table 2, above, of the 2.18 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.[57] Accumulated wealth, on the other hand, does not correspond to any ongoing, current economic activity.[58] 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

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[57] 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.

[58] 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.

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.[59]

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.[60] Others question the importance of the bequest motive in national capital formation.[61] Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.[62] Theoretically, it is an

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[59] 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.

[60] 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.

[61] 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.

[62] 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

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 constrained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.[63] 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.[64]

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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).

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

[64] 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 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

Others argue that potential deleterious effects on investment by small or family-owned businesses are limited. As a result of the Taxpayer Relief Act of 1997, certain small businesses can obtain an effective exemption of up to $2.6 million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. Some have argued that estate tax returns report a small fraction of the value of decedents' estates.[65]

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would..."[66] While in theory increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.[67]

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investment that could be made with the funds received.

[65] 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.

[66] 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.

[67] 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.[68] Conventional economic wisdom holds that the Great Depression of the 1930s and the second world war substantially reduced the concentration of wealth in the United States, and that there has been no substantial change in the succeeding decades. Most analysts assign no role to tax policy in the reduction in wealth concentration 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.[69]

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 economic well-being by $500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $1.5 million, so that the gift tax has reduced the son's economic well-being by $500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and donee

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

[69] See Michael K. Taussig, "Les inegalites de patrimoine aux Etats-Unis," in Kessler, Masson, Strauss-Khan (eds.) Accumulation et Repartition des Patrimoines. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolf, 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.

generations may not be important to assessing the fairness of transfer taxes if both the donor and donee have approximately the same income.[70]

[70] 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.