HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM

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I. OVERVIEW

The Committee on Finance has scheduled a public hearing for November 14, 2007, entitled "Federal Estate Tax: Uncertainty in Planning Under the Current Law." This document[1] provides a history, description, and analysis of the Federal estate and gift tax rules. The overview presents data about the estate and gift tax, a brief discussion of possible economic effects of the tax, and a short summary of present law estate and gift tax rules.

Data about the Federal estate and gift tax

Revenues generated by the estate and gift tax are a small portion of overall Federal tax revenues. In fiscal year 2006, the IRS collected $27.8 billion in net estate and gift tax revenues. This amount represented 1.2 percent of total net Federal tax collections in 2006. By comparison, the highest post-World War II share of total Federal revenues represented by the estate and gift tax was 2.6 percent in fiscal year 1972.[2]

Relatively few taxpayers are directly affected by the Federal estate and gift tax. In 2004, the most recent year for which final numbers are available, there were 2.4 million deaths in the United States, and 19,294 estate tax returns reporting some tax liability were filed. Thus, taxable estate tax returns represented approximately eight-tenths of one percent of deaths in 2004. By comparison, in the mid-1970s taxable estate tax returns exceeded six percent of all deaths. The number of taxable and non-taxable estate tax returns is projected to decline significantly by 2009 as the estate tax exemption amount increases from its current $2 million level to $3.5 million for decedents dying in 2009.

Economic ramifications of estate taxation

Although the Federal estate and gift tax accounts for a small share of total Federal revenues and directly affects a small percentage of taxpayers, it may have broad economic effects. First, the estate tax might affect aggregate capital formation, but there is not consensus among economists on this issue. Some economists believe that individuals' attitudes toward leaving bequests have a significant effect on overall capital accumulation. The existence of an estate tax may influence these attitudes.

Second, the estate tax may affect individuals' saving behavior. Because the estate tax increases the after-tax cost of leaving a bequest, the existence of the tax may discourage some individuals from saving for a bequest. On the other hand, individuals who want to give a bequest of a certain amount may increase their savings to account for the potential estate tax burden.

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[1] This document may be cited as follows: Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), November 13, 2007. This document is also available on the web at www.house.gov/jct.

[2] Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, "The Estate Tax: Ninety Years and Counting," in Internal Revenue Service, *Statistics of Income Bulletin* (Summer 2007), p. 125.

There has been limited empirical analysis to determine the effect, if any, of the estate tax on individual saving.

Third, the estate tax may have an impact on the amount of investment in small businesses. An estate tax might create cash flow difficulties for small businesses and thereby may cause small business owners to borrow money or to sell or otherwise liquidate businesses to pay estate tax liability. If small businesses are sold, there may be a shift toward less overall investment in small business. If small business owners borrow funds to pay the estate tax, they may reduce their investment in the businesses, and this reduced investment could have deleterious effects on the larger economy. Some observers argue, however, that the present estate tax imposes a limited burden on small business owners because the exemption level has risen to $2 million for estates of individuals dying in 2007 and because special rules allow installment payment of tax liability for estates consisting largely of closely-held business assets.

Current estate and gift tax rules

The estate and gift tax rules are in flux. Under the estate and gift tax rules included in the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax exemption amount increases from 2002 through 2009, and the maximum estate and gift tax rate decreases from 2002 through 2007. The lifetime gift tax exclusion amount remains $1 million during that period. For estates of decedents dying in 2007 and 2008, the estate tax exemption amount is $2 million. For estates of decedents dying in 2009, the exemption amount is $3.5 million. The highest estate and gift tax rate is 45 percent in 2007, 2008, and 2009, a reduction from 50 percent for 2002.

EGTRRA provides full repeal of the estate tax for estates of decedents dying in 2010. The gift tax remains in effect for gifts made in that year, with a $1 million exemption and a 35-percent maximum tax rate.

The estate and gift tax rules of EGTRRA sunset after 2010. Accordingly, the rules in effect immediately before enactment of EGTRRA apply to gifts made and estates of decedents dying in 2011 and thereafter. Under those rules, the estate and gift tax exemption amount is $1 million, and the highest estate and gift tax rate is 55 percent.

The rules for determining the basis of property acquired from an estate change when the estate tax is repealed in 2010. The basis of property acquired from an estate of a decedent dying in 2007, 2008, or 2009 generally is the fair market value of the property on the date of the decedent's death (colloquially referred to as a stepped-up basis). The basis of property acquired from an estate of a decedent dying in 2010 generally equals the decedent's basis in that property (often referred to as a carryover basis). Basis step-up returns for property acquired after the EGTRRA sunset.

Under pre-EGTRRA law, a limited credit against Federal estate tax was allowed for State estate, inheritance, legacy, or succession taxes paid on property included in the decedent's gross estate. This credit was referred to as the State death tax credit. This credit was reduced from 2002 through 2004 and, for estates of decedents dying after 2004, was replaced with a deduction for State estate, inheritance, or similar taxes. After 2010, the State death tax credit in effect immediately before EGTRRA returns.

The transfer tax regime includes special rules for transfers between spouses; conservation easements; the valuation of farms and certain other closely-held businesses; and the installment payment of estate tax for an estate consisting mostly of closely-held business property. Other rules impose tax on certain generation-skipping transfers. These rules are described in detail below.

II. HISTORY OF THE U.S. WEALTH TRANSFER TAX SYSTEM

A. Overview

Wealth transfer taxes have been part of the U.S. Federal tax system since 1797. The present-law Federal wealth transfer tax system consists of three related components: a gift tax, an estate tax, and a generation-skipping transfer tax.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[3] provides for the Federal estate and generation-skipping taxes to be phased out through 2009, principally through increases in exemption amounts and reductions in applicable tax rates, and then repealed in 2010, while a modified gift tax will remain in effect. The repeal of the estate and generation-skipping taxes will be only temporary, however; after 2010, the estate and generation-skipping taxes will return at pre-EGTRRA levels (i.e., with lower exemption amounts and higher marginal tax rates).

B. Federal Taxes on Transfers at Death Before World War I

While States extensively used transfer taxes at death for various purposes, Federal taxes on transfers at death in the United States, for most of its history, were imposed primarily to finance wars or the threat of war. The first Federal tax on such transfers 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.[4] After repeal of the stamp tax,[5] there were no death-related taxes imposed by the Federal government until the Civil War, when the Federal government imposed an inheritance tax[6] between 1862 and 1870.[7] 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.[8]

While prior death-related taxes were imposed primarily to finance warfare, in 1906 President Theodore Roosevelt proposed a progressive tax on all lifetime gifts and death-time bequests specifically for the purpose of limiting the amount that one individual could transfer to

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[3] Pub. L. No. 107-16, Title V (June 7, 2001).

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

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

[6] Inheritance taxes typically are imposed on the recipient of a transfer from a decedent, whereas estate taxes are imposed on a decedent's estate.

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

[8] War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).

another and thereby to break up large concentrations of wealth. No legislation immediately resulted from the proposal.[9]

C. 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[10] 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,[11] transfers not intended to take effect until death,[12] and transfers made in contemplation of death.

The 1916 estate tax, which in many respects was similar to present-day taxes, provided an exemption (in the form of a deduction) of $50,000 with rates from 1 percent on the first $50,000 of transferred assets to 10 percent on transferred assets in excess of $5 million. The next year, the revenue needs from the war resulted in increases in estate tax rates, with a top rate of 25 percent on transferred assets in excess of $10 million.[13]

Estate and gift taxes between World Wars I and II

Following the end of World War I, Congress debated whether an estate tax remained necessary. In the Revenue Act of 1918, the estate tax was retained, but estate tax rates on transfers under $1 million were reduced. At the same time, the tax was extended to life insurance proceeds in excess of $40,000 that were receivable by the estate or its executor and to property subject to a general power of appointment.[14]

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;[15] and (3) allowing a credit for State death-related taxes of up to 25 percent of the Federal tax. In addition, the first gift tax was imposed, using the estate tax rate schedule.

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[9] See quotation in Randolph E. Paul, *Taxation in the United States*, p. 88 (Boston 1954).

[10] Act of September 8, 1916, 39 Stat. 756.

[11] This rule is now contained in section 2043. Except where otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[12] This rule is now contained in section 2037.

[13] Act of March 3, 1917, 39 Stat. 1000.

[14] These rules are now contained in sections 2041 and 2514.

[15] This rule is now contained in section 2038.

In response to opposition to the estate and gift taxes, 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.

With the Depression, revenues from other sources were declining, and the need for new revenues for government projects increased. As a result, in 1932 estate tax rates were increased, with a top rate of 45 percent on transfers over $10 million.[16] The tax was made applicable to lifetime transfers in which the transferor retained a life estate or the power to control who benefits from the property or income from such property.[17] 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 further increased in 1934 with top rates of 60 percent and 45 percent, respectively, on transfers in excess of $10 million and again in 1935 with top rates of 70 percent and 52.5 percent, respectively, on transfers in excess of $50 million.[18] The exemption for both the estate and gift tax was reduced in 1935 to $40,000 each.[19]

In 1940, a10-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.[20] 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.[21]

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, setting the lifetime exemption from gift tax at $30,000, and providing an annual gift tax exclusion of $3,000;[22] and (2) attempting to equate property in community property States with property owned in non-community property States by providing that in both community property States and non-community property States, each spouse would be taxed on

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

[17] This rule is now contained in section 2036(a).

[18] Act of May 10, 1934, 48 Stat. 680.

[19] Act of August 30, 1935, 49 Stat. 1014.

[20] Revenue Act of 1940, 54 Stat. 516.

[21] Act of September 20, 1941, 55 Stat. 687.

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

the portion of jointly-owned or community property that each spouse contributed to that property's acquisition cost.[23]

D. 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.[24]

In 1954, the estate tax treatment of life insurance was changed. Under a new rule, life insurance was subject to estate tax if the proceeds were paid to the decedent's estate or executor or if the decedent retained "incidents of ownership" in the life insurance policy.[25]

The Small Business Tax Revision Act of 1958[26] provided for payment of Federal estate tax on certain closely-held businesses in installments over a 10-year period.[27]

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,[28] Congress substantially revised estate and gift taxes. The Act unified the estate and gift taxes, such that a single graduated rate schedule with a maximum rate of 70 percent applied to transfers during life and at death.[29] As under present law, lifetime gifts were cumulative, with successive gifts potentially subject to higher rates, and transfers at death stacked on top of cumulative lifetime gifts for purposes of determining the applicable marginal rate on such transfers. In addition, the estate and gift tax exclusions were combined into a single "unified credit," which at the time effectively exempted $175,625 of transfers from tax when fully phased in. The 1976 Act also changed the income tax rules applicable to the disposition of inherited assets from a rule that only taxed post-death appreciation (i.e., the basis in the hands of the heir was "stepped up" to its value on the date of the decedent's death) to one that provided that the heir's basis generally would be the same as it

[23] Act of October 21, 1942, 56 Stat. 798.

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

[25] This rule is now contained in section 2042.

[26] Pub. L. No. 85-866 (Sept. 2, 1958).

[27] This rule has been subsequently modified; it is now contained in section 6166.

[28] Pub. L. No. 94-455 (Oct. 4, 1976).

[29] These rules are now contained in sections 2001 and 2501.

was in the hands of the decedent (i.e., the decedent's basis in the property would "carry over" to be the basis to the heir). In addition, the Act provided a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse.

Another significant change in 1976 was the imposition of a new transfer tax on generation-skipping transfers generally equal to the additional estate or gift tax that the decedent's children would have paid if the property had passed directly to the children instead of skipping that generation and passing to, for example, a donor's or decedent's grandchildren.

The 1976 Act also included preferential rules for valuing family farms and small business held in estates. Specifically, the law provided that a farm or other real property used in a closely-held business could be valued at its current-use value rather than its highest and best use value, so long as the heirs continue to use the property for 15 years after the decedent's death.[30]

In 1980, the estate tax carryover basis rules were retroactively repealed and replaced with the step-up basis rules.[31]

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 (the "1981 Act")[32] made a number of changes to the estate and gift tax rules, many of which either had the effect of reducing the number of taxable estates or reduced or eliminated taxes on transfers between spouses. For example, the 1981 Act 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, and reduced the top unified estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982 through 1985). Furthermore, the 1981 Act providing an unlimited deduction for transfers to spouses and permitted such a deduction even when the donee spouse could not control the disposition of the property after that spouse's death, so long as the spouse had an income interest

[30] The present law "special-use valuation" rules are contained in section 2032A, and require heirs to continue to use the property for only 10 years after the decedent's death. The 1976 Act also: (1) changed 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; (2) provided that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly-held property; (3) provided a limited deduction for bequests to children with no living parents (the so-called "orphan's deduction"); (4) provided 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; (5) liberalized the provision that permits installment payments of estate tax on closely-held businesses by providing that only interest need be paid for the first four years after death and by lengthening the period of installment by an additional four years.

[31] Crude Oil Windfall Profits Act of 1980, Pub. L. No. 96-223 (Apr. 2, 1980).

[32] Pub. L. No. 97-35 (Aug. 13, 1981).

in the property and the property was subject to that spouse's estate and gift tax (referred to as "qualified terminable interest property").[33]

The Deficit Reduction Act of 1984 made a number of additional modifications to the estate and gift tax rules.[34]

Legislation from 1986 through 1997

The Tax Reform Act of 1986[35] substantially revised the tax on generation-skipping transfers by applying a single rate of tax equal to the highest estate tax rate (i.e., 55 percent) to all generation-skipping transfers in excess of $1 million and by broadening the definition of a generation-skipping transfer to include direct transfers from a grandparent to a grandchild (i.e., direct skips).

The Omnibus Budget Reconciliation Act of 1987[36] modified the estate and gift tax by: (1) providing special rules under which so-called "estate freeze transactions" will result in the total value of property transferred to be included in a decedent's gross estate; (2) providing a higher estate or gift tax rate on transfers in excess of $10 million in order to phase out the benefit of the graduated rates under 55 percent and the benefit of the unified credit; and (3) again delaying the scheduled reduction in the estate and gift tax rates from 55 percent to 50 percent for five years.

[33] This rule is now contained in section 2056. The 1981 Act also: (1) increased the annual gift tax exemption from $3,000 per year per donee to $10,000 per year per donee; (2) changed the presumption that each spouse equally provided for the acquisition cost of jointly-held property to an irrebuttable presumption; (3) modified the special-use valuation rules by shortening to 10 years the period that heirs who inherit farms or other real property used in a closely held business were required to so use the property, and increased the maximum reduction in value of such property from $500,000 to $750,000; (4) repealed the so-called "orphan's deduction"; (5) delayed the effective date of the generation-skipping transfer tax; and (6) further liberalized and simplified the rules that permit the installment payment of estate tax on closely-held businesses.

[34] Pub. L. No. 98-369 (July 18, 1984). For example, the 1984 Act: (1) delayed for three years the scheduled reduction of the maximum estate and gift tax rates (such that the maximum rate remained at 55 percent until 1988); (2) eliminated the exclusion for interests in qualified pension plans; (3) provided rules for the gift and income tax treatment of below-market rate loans; and (4) extended the rules that permit the installment payment of estate taxes on closely held businesses to certain holding companies.

[35] Pub. L. No. 99-514 (Oct. 22, 1986). The generation-skipping transfer tax rules added by the Tax Reform Act of 1986 are contained in sections 2601 through 2654 of present law.

[36] Pub. L. No. 100-203 (Dec. 22, 1987).

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.[37]

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[38] restored the 55-percent top rate retroactively to January 1, 1993, and made that top rate permanent. The Taxpayer Relief Act of 1997[39] provided for gradual increases in the unified credit effective exemption amount from $625,000 in 1998 to $1 million in 2006 and thereafter. Under a conforming amendment to the 5-percent surtax, the benefit of the graduated rates, but not the benefit of the unified credit, is phased out under present law. A new exclusion for qualified conservation easements and a new deduction for interests in qualified family-owned businesses, in addition to other changes, also were enacted in 1997.

E. The Economic Growth and Tax Relief Reconciliation Act of 2001

EGTRRA signaled an attempt to reduce or eliminate the use of Federal estate and generation-skipping taxes by phasing out and ultimately repealing those taxes. EGTRRA phases out the estate and generation-skipping taxes through 2009 by gradually increasing the lifetime estate tax exemption to $3.5 million and reducing the top estate tax rate to 45 percent. In addition, the credit for State death taxes paid was reduced and, for estates of decedents dying after 2004, replaced by a deduction for such taxes. In 2010, the estate and generation-skipping taxes are repealed, though only for one year. The basis in assets transferred from a decedent who dies in 2010 will no longer be stepped up; instead, a modified carryover basis regime will take effect.

The present-law estate and gift tax rules, as substantially modified under EGTRRA, are described in greater detail in section III, below.

F. Summary

Table 1 provides a summary of the annual gift tax exclusion, the exemption value of the unified credit, the threshold level of the highest statutory estate tax rate, and the highest statutory estate tax rate for selected years, 1977 through 2007.

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

[38] Pub. L. No. 103-66 (Aug. 10, 1993).

[39] Pub. L. No. 105-34 (Aug. 5, 1997).

Table 1.–Estate and Gift Tax Rates and Exemption Amounts, 1977-2007

Year	Annual gift exclusion per donee single/joint	Exemption value of unified credit	Threshold of highest statutory tax rate	Highest statutory tax rate (percent)
1977	$3,000/$6,000	$120,667	$5 million	70
1982	$10,000/$20,000	$225,000	$4 million	65
1983	$10,000/$20,000	$275,000	$3.5 million	60
1984	$10,000/$20,000	$325,000	$3 million	55
1985	$10,000/$20,000	$400,000	$3 million	55
1986	$10,000/$20,000	$500,000	$3 million	55
1987	$10,000/$20,000	$600,000	$3 million	55
1989	$10,000/$20,000	$600,000	$3 million	55[1]
1995	$10,000/$20,000	$600,000	$3 million	55[1]
1997	$10,000/$20,000	$600,000	$3 million	55[1]
1998	$10,000/$20,000	$625,000	$3 million	55[1]
1999	$10,000/$20,000	$650,000	$3 million	55[1]
2000	$10,000/$20,000	$675,000	$3 million	55[1]
2001	$10,000/$20,000	$675,000	$3 million	55[1]
2002	$11,000/$22,000	$1 million	$2.5 million	50
2003	$11,000/$22,000	$1 million	$2 million	49
2004	$11,000/$22,000	$1.5 million	$2 million	48
2005	$11,000/$22,000	$1.5 million	$2 million	47
2006	$12,000/$24,000	$2 million	$2 million	46
2007	$12,000/$24,000	$2 million	$1.5 million	45

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

III. DESCRIPTION OF PRESENT LAW

A. In General

A gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor).

The estate and gift tax law as scheduled to be in effect in the coming years changes from year to year. The estate and generation-skipping taxes are gradually phased out through 2009, temporarily repealed in 2010, and reinstated in 2011 (when the estate and gift tax provisions of the EGTRRA are scheduled to sunset), while the gift tax will remain in force in modified form. At the same time, rules concerning the basis in property received from a decedent, deductions or credits for State death taxes, and other aspects of the transfer tax system will be substantially modified and re-modified.

The following subsections describe the Federal wealth transfer tax laws scheduled to be in effect during (1) the phase-out of the estate and generation-skipping taxes through 2009, (2) the temporary repeal of those taxes in 2010, and (3) the reinstatement of the estate and generation-skipping taxes and most aspects of pre-EGTRRA estate and gift tax law following 2010.

B. Exemption Equivalent Amounts and Applicable Tax Rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death. The amount of the unified credit is computed by using the lowest estate and gift tax rates.

Prior to 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continue to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes is increased above the effective exemption amount allowed for gift tax purposes, as described below.

Under present law in effect through 2009 and after 2010, the generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation-skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation-skipping transfer tax exemption for a given year (prior to repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

Increase in unified credit effective exemption amount and reduction in estate and gift tax rates under EGTRRA

Under EGTRRA, the estate, gift, and generation-skipping transfer taxes are gradually reduced between 2002 and 2009. In 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) increased to $1 million. In 2003, the estate and gift tax rates in excess of 49 percent were repealed. In 2004, the estate and gift tax rates in excess of 48 percent were repealed, and the unified credit effective exemption amount for estate tax purposes increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remained at $1 million in 2004 and later years, as increased in 2002.) In 2005, the estate and gift tax rates in excess of 47 percent were repealed. In 2006, the estate and gift tax rates in excess of 46 percent were repealed, and the unified credit effective exemption amount for estate tax purposes was increased to $2 million. In 2007, the estate and gift tax rates in excess of 45 percent are repealed. In 2009, the unified credit effective exemption amount is increased to $3.5 million.

Repeal of estate and generation-skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation-skipping transfer taxes are repealed for decedents dying and generation-skipping transfers made during 2010. The gift tax remains in effect during 2010, with a $1 million exemption amount and a gift tax rate equal to the top individual income tax rate. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.[40]

The following table summarizes the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes from 2002 through 2010.

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[40] EGTRRA's Conference Report (H.R. Rep. 107-84) states that a transfer in trust will be treated as a taxable gift. Section 411 of the Job Creation and Worker Assistance Act of 2002 includes a technical correction to clarify that the effect of section 511(e) of EGTRRA (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treasury Regulation section 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

Table 2.–Unified Credit Exemption Equivalent Amount and Estate and Gift Tax Rates for 2002-2010

Calendar year	Estate and GST tax transfer exemption	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	N/A (taxes repealed)	35% (gift tax only)

Reinstatement of the estate and generation-skipping transfer taxes for decedents dying and generation-skipping transfers made after December 31, 2010

The estate, gift, and generation-skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation-skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation-skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation-skipping transfer tax rates and exemption amounts as in effect prior to 2002 will apply for estates of decedents dying, gifts made, or generation-skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer by lifetime gift or bequest.

In addition, as a result of the EGTRRA sunset, the modification to the gift tax rules for certain transfers in trust, described above, will not apply for gifts made after December 31, 2010.

C. Basis in Property Received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent who dies before 2010

Under present law in effect through 2009, property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under present law in effect through 2009, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Under present law in effect through 2009, stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Basis in property received from a decedent who dies during 2010

In 2010, upon repeal of the estate tax, the rules providing for stepped-up basis in property acquired from a decedent are repealed, and a modified carryover basis regime is to take effect. Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply.[41] Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

The rules generally allow an executor to increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse can be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As a result of the EGTRRA sunset, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. After that time, the law in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, will apply.

D. State Death Tax Credit; Deduction for State Death Taxes Paid

State death tax credit under prior law

Under prior law, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and

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[41] Sec. 1014(b)(2) and (3).

replaced with a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As a result of the EGTRRA sunset, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 will apply.

E. Selected Exclusions and Deductions

Gift tax annual exclusion

Under present law, donors of lifetime gifts are provided an annual exclusion of $10,000 (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2007 is $12,000) on transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $24,000 in 2007. Unlimited transfers between spouses are permitted without imposition of a gift tax.

Transfers to a surviving spouse

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

Transfers to surviving spouses who are not U.S. citizens.−A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

Tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation easements

Under present law, an executor generally can 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)). The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Prior to 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was 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 had 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. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expands the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As a result of the EGTRRA sunset, the EGTRRA modification to expand the availability of qualified conservation contributions does not apply for decedents dying after December 31, 2010.

F. Provisions Affecting Small and Family-Owned Businesses and Farms

Special-use valuation

An executor can elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2007 is $940,000). Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to $675,000.[42] A qualified family-owned business interest generally was 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 the decedent's 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.

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, at least one qualified heir (or member of the qualified heir's family) was required to have materially participated in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules

[42] The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount is equal to $625,000, increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above such amount in effect for the taxable year. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.

provided a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there was no requirement that the qualified heir (or members of his or her family) continued to hold or participate in the trade or business more than 10 years after the decedent's death. 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.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. However, as a result of the EGTRRA sunset, the qualified family-owned business deduction again will apply to estates of decedents dying after December 31, 2010.

<u>Installment payment of estate tax for closely held businesses</u>

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2006 is $1,200,000) in taxable value of a 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 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As a result of the EGTRRA sunset, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

G. Generation-Skipping Transfer Tax Rules

In general

A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable distribution, generation-skipping transfer tax may be avoided.

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust. The allocation of generation-skipping transfer tax exemption effectually reduces the tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation-skipping transfer tax exemption; the allocation was not automatic. If generation-skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation-skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation-skipping transfer tax was based on the value of the property at the time the allocation of generation-skipping transfer tax exemption was made.

An election to allocate generation-skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

Modifications to the generation-skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation-skipping transfer tax. First, EGTRRA generally provides that generation-skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

Second, EGTRRA provides that, under certain circumstances, generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation-skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation-skipping transfer tax and another of which would be fully subject to generation-skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation-skipping transfer tax rules

As a result of the EGTRRA sunset, the EGTRRA modifications to the generation-skipping transfer tax rules described above do not apply for generation-skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 will apply.

IV. BACKGROUND AND ANALYSIS RELATING TO ESTATE AND GIFT TAXATION

A. Background Data

Estates subject to the estate tax

Table 3 details the percentage of decedents subject to the estate tax for selected years since 1935. The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid-1970s. The substantial revision to the estate tax in the mid-1970s 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. The percentage of decedents liable for the estate tax gradually increased until 2001. The increases in the unified credit enacted in 2001 have reduced the percentage of decedents liable for the estate tax.

Table 3.–Number of Taxable Estate Tax Returns Filed as a Percentage of Deaths, Selected Years, 1935-2004

		Taxable estate tax returns filed[1]	
Year	Deaths	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
1984	1,968,128	31,507[2,3]	1.60
1986	2,105,361	23,731	1.13
1988	2,167,999	18,948	0.87
1990[4]	2,148,463	23,215	1.08
1992[4]	2,175,613	27,187	1.25
1994[4]	2,278,994	31,918	1.40
1996[4]	2,314,690	37,711	1.63
1998[4]	2,337,256	47,483	2.03
2000[4]	2,403,351	51,159	2.12
2002[4]	2,443,387	28,074	1.15
2004[4]	2,397,615	19,294	0.80

[1] Estate tax 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 1989-2004 are from Internal Revenue Service, *Statistics of Income*.

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

The increasing percentage of decedents liable for estate tax in the period from 1940 through the mid-1970s and the similar increasing percentage from 1989 to 2000 are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth. The amount of wealth exempt from the Federal estate tax always has been expressed at a fixed nominal value. If the general price level in the economy rises from one year to the next and asset values rise to reflect this inflation, the "nominal" value of each individual's wealth will increase. With a fixed nominal exemption, annual increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption largely explains the pattern in Table 3.[43] The fixed nominal exemption was increased effective for 1977, again between 1982 and 1987, and a series of increases was enacted in 2001. 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.[44] 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.[45]

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

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

Between 1990 and 1999, estate and gift tax receipts averaged double digit rates of growth. There are three possible reasons for the rapid growth in these receipts. First, because

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[43] 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 II.D, 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.

[44] The analysis of the text 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.

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

neither the amount of wealth exempt from the estate and gift taxes nor the tax rates were indexed, as explained above, an increasing number of persons became subject to estate and gift taxes. Second, the substantial increase in value in the stock market during the decade of the 1990s increased the value of estates that would have already been taxable, and increased the number of estates that became taxable. For example, the Dow Jones Industrial Average ended 1989 at approximately 2,750 and ended 1999 at approximately 11,000. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth more than tripled during the decade, one would expect brisk growth in estate tax receipts from this alone. Finally, the unlimited marital deduction included in the 1981 Act delayed the payment of estate tax, in most cases, until the surviving spouse died. On average, spouses survive their mates by about ten years. Therefore, during the decade of the 1990s, an increase in estate tax receipts is expected as the result of first-spouse deaths during the 1980s that used the unlimited marital deduction.

Table 4.–Revenue from the Estate, Gift, and Generation-Skipping Transfer Taxes, Selected Fiscal Years, 1940-2006

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
1980	6,389	1.2
1985	6,422	0.9
1990	11,500	1.1
1995	14,763	1.1
1996	17,189	1.2
1997	19,845	1.3
1998	24,076	1.4
1999	27,782	1.5
2000	29,010	1.4
2001	28,400	1.4
2002	26,507	1.4
2003	21,959	1.2
2004	24,831	1.3
2005	24,764	1.1
2006	27,877	1.2

Sources: Joint Economic Committee, The Federal Tax System: Facts and Problems, 1964; Joseph A. Pechman, Federal Tax Policy (Washington: Brookings Institution), 1987; Office of Management and the Budget.

On the other hand, the 1997 Act and the 2001 Act included provisions that would be expected to reduce the number of estates subject to the estate tax. As explained in Part III.B, above, the exemption equivalent amount provided by the unified credit is to increase to $3.5 million in 2009. The average rate of increase in the exemption amount exceeds the rate of inflation. As explained above, increases in the real value of the unified credit generally would be expected to reduce the number of estates subject to tax. The 1997 Act also provided an additional exemption for certain qualified family-owned business interests and a partial exclusion from the estate tax of the value of land subject to certain conservation easements. While the exemption for qualified family-owned business is no longer operable, these changes reduced the number of estates that would be expected to be subject to tax between 1997 and the present.

Table 5 shows the Joint Committee on Taxation staff present-law estimate of revenues from the estate, gift, and generation-skipping taxes for fiscal years 2007-2016. These estimates are based on the January 2007 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 Estate, Gift, and Generation-Skipping Transfer Taxes, 2007-2016

Year	Exemption value of unified credit	Number of taxable estates	Percent of deaths	Receipts ($ billions)
2007	2,000,000	17,100	0.67	27.0
2008	2,000,000	18,600	0.76	27.1
2009	3,500,000	9,600	0.39	21.8
2010	0	0	0	23.6
2011	1,000,000	61,900	2.48	50.7
2012	1,000,000	68,100	2.7	57.1
2013	1,000,000	72,600	2.85	62.9
2014	1,000,000	76,200	2.96	66.6
2015	1,000,000	82,700	3.18	72.6
2016	1,000,000	89,800	3.42	78.9

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

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

Overview

In 2003 the staff of the Joint Committee on Taxation ("JCT staff") surveyed the estate or inheritance tax and gift tax systems of 38 countries. The countries in this survey included most of the OECD countries, plus certain other countries.[46] Among the countries surveyed, an inheritance tax is more common than an estate tax as is imposed in the United States. An inheritance tax generally is imposed on the transferee or donee rather than on the transferor or donor or the transferor's estate. That is, the heir who receives a bequest is liable for a tax imposed and the tax generally depends upon the size of the bequest received. 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.

The survey generally reveals that the provisions of the U.S. estate and gift tax (1) exempting transfers between spouses, (2) providing an effective additional exemption of $1.0 million through the unified credit,[47] and (3) providing an $11,000 annual gift tax exemption per donee,[48] may result in a larger exemption (a larger zero-rate tax bracket) than many other developed countries. 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. Again, 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.

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[46] Joint Committee on Taxation, *Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003. In addition to member countries of the OECD, the survey included the estate or inheritance tax and gift tax systems of the Bahamas, Belize, Bermuda, Cayman Islands, Costa Rica, Dominican Republic, Hong Kong, Israel, Philippines, Seychelles, Singapore, South Africa and Taiwan.

[47] As explained in Part III.B, above, both the unified credit and the marginal tax rates applicable to taxable transfers are scheduled to change between the present and 2011. The comparisons drawn in the survey are on the basis of the law applicable in 2002.

[48] As explained in Part III.E, the inflation-adjusted annual per donee gift tax exclusion for 2007 is $12,000.

What the survey cannot reveal is 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 has been assessed at less than its fair market value.[49] Also unclear in cross country comparisons based solely upon the legal requirements of various estate and inheritance taxes is the ability of transferors to exploit special tax breaks.

Table 6 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product ("GDP") to attempt to compare the economic significance of wealth transfer taxes in different countries. Among these selected OECD countries, in 2005, Belgium, Finland, France, Japan, the Netherlands, Spain, and the United Kingdom collected more such revenue as a percentage of GDP than did the United States. Denmark, Germany, Ireland, Korea, Luxembourg, and Switzerland collected modestly less revenue from such taxes as a percentage of GDP than did the United States. The remaining 16 countries in Table 6 collected less than half as much revenue as a percentage of GDP from such taxes as did the United States. As a percentage of tax revenue, Belgium, France, and Japan relied more heavily on their estate, inheritance, and gift taxes as a revenue source, although the Netherlands, Spain, and the United Kingdom each collected at least seven-tenths of one percent of total tax revenue from estate, inheritance, and gift taxes.

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[49] 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.

Table 6.–Revenue from Estate, Inheritance and Gift Taxes as a Percentage of Total Tax Revenue and GDP in OECD Countries, 2005

Country	as a percentage of total tax revenue	as a percentage of GDP
Australia	---	---
Austria	0.13	0.06
Belgium	1.30	0.59
Canada	---	---
Czech Republic	0.06	0.02
Denmark	0.40	0.20
Finland	0.70	0.31
France	1.19	0.52
Germany	0.53	0.18
Greece	0.41	0.11
Hungary	0.19	0.07
Iceland	0.20	0.08
Ireland	0.50	0.15
Italy	0.01	0.00(1)
Japan	1.14	0.31
Korea	0.91	0.23
Luxembourg	0.38	0.15
Mexico	---	---
Netherlands	0.86	0.33
New Zealand	0.01	0.00(1)
Norway	0.21	0.09
Poland	0.07	0.02
Portugal	0.05	0.02
Slovak Republic	0.00(1)	0.00(1)
Spain	0.73	0.26
Sweden	0.08	0.04
Switzerland	0.67	0.20
Turkey	0.06	0.02
United Kingdom	0.70	0.26
United States	0.89	0.24

(1) Less than five one-thousandths of one percent.

Source: Organisation for Economic Co-Operation and Development, *Revenue Statistics, 1965-2005*, (OECD, 2007).

The United States is a wealthy country, with higher average household wealth than most of the OECD countries and the other countries in the JCT staff survey. 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 3, above, of the 2.4 million deaths in 2004, only 19,294 or 0.8 percent of decedents, gave rise to any estate tax liability. Similar data were not available for the other countries in this survey.

Perhaps of particular note in light of present law in the United States for persons dying in 2010 is the taxation of decedents in Australia and Canada. For U.S. decedents dying in 2010 present law generally provides that the decedent's basis in capital assets is carried over to be the heir's basis in the assets. Both Australia and, to a lesser degree, Canada have carryover basis regimes for capital assets transferred at death.

Australia.–Australia has no inheritance or gift tax.[50] However, the transfer of capital assets generally is subject to Australia's capital gains tax ("CGT"). Under the CGT, lifetime gifts are taxed similarly to capital assets sold for profit. Testamentary transfers of capital assets, however, generally are not subject to the CGT and consequently there is no realization of gain on assets transferred at the time of death.[51]

In Australia, assets passing to beneficiaries via the administrators of a deceased person's estate generally will not be subject to taxation.[52] Except for assets acquired by the deceased before September 20, 1985, the cost basis of the asset in the hands of the personal representative and the beneficiary is that of the decedent.[53] That is, heirs carry over the basis of the decedent. The decedent's cost basis applies to assets passing under a will, a court order varying a will, the laws of intestacy and a deed of family arrangement (from April 2, 1992). For assets acquired by the decedent prior to September 20, 1985, the asset's basis is deemed to be its market value at the date of death.[54]

[50] Australia repealed its estate and gift taxes in the late 1970s. Jeffrey S. Kinsler, "The Taxation of Gifts and Bequests in Australia: A Prototype for Transfer Tax Reform in the United States?" 6 Pacific Rim Law & Policy Journal 305 (Mar. 1997); see Keith G. Banting, "The Politics of Wealth Taxes," 17 Canadian Public Policy 351, 360 (Sept. 1991); Willard H. Pedrick, "Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia," 35 Tax Lawyer 113 (1981).

[51] One exception to the rule exempting transfers by a decedent from CGT is where an asset is bequeathed to a tax-exempt organization. In such a case, there is a deemed disposition of the asset by the decedent immediately before death for consideration equal to the asset's market value at the time of death, and gain is included in the decedent's estate's income. Income Tax Assessment Act of 1997 ("ITAA"), sec. 160Y(3). Jeffrey S. Kinsler, "The Taxation of Gifts and Bequests in Australia: A Prototype for Transfer Tax Reform in the United States?" 6 Pacific Rim Law & Policy Journal 305, 324 (Mar. 1997).

[52] ITAA Div. 128, available at Australian Government, Australian Taxation Office, at http://law.ato.au (last accessed Nov. 9, 2007).

[53] The beneficiary obtains a cost basis equal to the decedent's indexed cost base.

[54] Tom Toryanik, International Bureau of Fiscal Documentation, Asia-Pacific Taxation, Australia, available at http://checkpoint.riag.com (last accessed Nov. 9, 2007).

Canada.–Canada has no formal gift or inheritance tax.[55] The deemed distribution provisions of Canada's Income Tax Act ("ITA"), however, impose a tax on capital gains of the decedent unrealized at the time of his or her death. In Canada, a decedent is deemed to have disposed of all property owned immediately before death.[56] Depending on the property involved, this deemed disposition may cause the decedent to recognize income, recaptured depreciation, or capital gains.[57] A taxpayer who is deemed to dispose of a capital property is deemed to have made the disposition at fair market value, and a capital gain will arise to the extent that the proceeds of disposition (whether actual or deemed) exceed the taxpayer's cost of the asset and any related costs of disposition. The estate of the decedent generally will be deemed to have acquired the property at a cost equal to the deemed proceeds of disposition.

The ITA provides an exemption from the capital gains tax that otherwise would arise on deemed dispositions for property that passes to the spouse of a decedent. This exemption (termed a "rollover") allows deferral of tax to the extent that certain property of the decedent passes to the decedent's spouse or a qualified spousal trust.[58] That is, the rollover creates a carryover basis regime for property that passes to the spouse of a decedent. Generally, the rollover will also defer recognition of recaptured depreciation that might otherwise arise on the disposition of depreciable capital property. The rollover applies automatically (unless the transferor elects otherwise) and applies whether the transfer occurs during the transferor's lifetime or as a result of death.[59] A rollover also applies on a transfer to a former spouse in settlement of rights arising out of the marriage.

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[55] See Robert Couzin & Mark Novak, Business Operations in Canada, BNA Tax Management Portfolio 955-3rd (noting that with the 1972 introduction of an income tax on capital gains, Canada moved toward a system of taxation on successions by way of an income tax on incremental increases in value and, consequently there are no longer any estate taxes or succession duties levied by either the federal government or the provinces); David G. Duff, "The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand," 3 Pittsburgh Tax Rev. 71, 99 (Fall 2005) (attributing the repeal of the federal gift and estate tax to "the introduction of the capital gains tax at death, the low revenue yield for the federal government, and the disparate effects of federal and provincial occupancy of the field"); see also Richard M. Bird, "Canada's Vanishing Death Taxes," 16 Osgood Hall Law Journal 133 (1978); Meyer Bucovetsky & Richard M. Bird, "Tax Reform in Canada: A Progress Report," 25 National Tax Journal 15 (1975).

[56] ITA sec. 70.

[57] Blair P. Dwyer, International Bureau of Fiscal Documentation, Canada Taxation, sec. 38, available at http://checkpoint.riag.com (last accessed Nov. 9, 2007).

[58] Blair P. Dwyer, International Bureau of Fiscal Documentation, Canada Taxation, secs. 20.7, 38, available at http://checkpoint.riag.com (last accessed Nov. 9, 2007). Deferral of tax is also available in the case of qualifying farm and fishing property that passes to the children of the decedent.

[59] ITA secs. 70(6) and 73(1).

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.[60] Estate and gift taxes are levied on the transfer of accumulated wealth. Accumulated wealth does not result from any ongoing, current economic activity.[61] 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 five 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 five 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.[62]

Wealth taxes, saving, and investment

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns

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[60] 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.

[61] 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.

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

or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their saving. Again, there is no concensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.

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.[63] 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.[64] Others question the importance of the bequest motive in national capital formation.[65] Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.[66] Theoretically, it is an open question whether estate and gift taxes

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

[64] 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 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.

[65] 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.

[66] 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

encourage or discourage saving and there has been limited empirical analysis of this specific issue.[67] By raising the after-tax cost of leaving a bequest, the estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation in order to meet that goal. For example, some individuals purchase additional life insurance in order to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Wealth taxes and small business

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.[68] Undercapitalization may be prevalent among small businesses. One study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[69]

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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).

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

More recently, David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," *National Tax Journal*, 59, June 2006, pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While he emphasizes the sensitivity of the analysis to how individuals' expectations about future taxes are modeled he concludes that "taxable estates are ten percent smaller because of the estate tax."

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

[69] 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-

Others argue that potential deleterious effects on investment by small or family-owned businesses are limited. The present (2007) exemption value of the unified credit is $2 million per decedent. As a result, small business owners can obtain an effective exemption of up to $4.0 million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. Also, as described in Part III.F, above, Code secs. 2031A, 2057,[70] and 6166 are provided to reduce the impingement on small business cash flow that may result from an estate tax liability. Some analysis questions whether, in practice, small businesses need to liquidate operating assets to meet estate tax liabilities. A recent study of 2001 estate returns shows that many estates that claimed benefits under secs. 2032A, 2057, or 6166 held liquid assets nearly sufficient to meet all debts against the estate and that only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under sec. 6166.[71] Others have argued that estate tax returns report a small fraction of the value of decedents' estates thereby mitigating any special burden that the estate tax may impose on small business.[72]

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 that is taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact on their performance: the $150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received. For example, Francisco Perez-Gonzalez, "Inherited Control and Firm Performance," *American Economic Review*, 96, December 2006, pp. 1559-1589, finds that where the incoming CEO is related to the departing CEO, or to a founder, the firm underperforms in terms of profitability and other financial measures.

[70] As discussed in Part III.F, above, section 2057 no longer applies for estates of decedents dying after 2003, but will apply to estates of decedents dying after 2010.

[71] Martha Eller Gangi and Brian G. Raub, "Utilization of Special Estate Tax Provisions for Family-Owned Farms and Closely Held Businesses," *SOI Bulletin*, 26, Summer 2006, pp. 128-145. Gangi and Raub calculate a liquidity ratio, the ratio of liquid assets (cash, cash management accounts, State and local bonds, Federal government bonds, publicly traded stock, and insurance on the life of the decedent) to the sum of the net estate tax plus mortgages and liens. They found that in 2001 this ratio exceeded one for estates of less than $2.5 million claiming benefits of the special deduction for qualified family owned business assets or deferral of tax. Larger such estates had average liquidity ratios of 0.5 or more. Generally all estates claiming special use valuations had an average liquidity ratio of at least one. A liquidity ratio of one implies that the estate has liquid assets sufficient to pay the net estate tax plus pay off all mortgages and liens.

[72] 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 Code. The purpose of chapter 14 is to improve

As described in Part III.F, above, several Code provisions may reduce the burden of the estate tax borne by small or family-owned businesses. Table 7, below, presents data from estate tax returns filed in 2003 on the utilization of these provisions in comparison to all estate tax returns filed. In 2003, approximately 2.4 percent of estates less than $5 million and estates valued at $5 million or more claimed some exemption under section 2057 for qualified family-owned business assets. Among estates valued at less than $5 million approximately 1.0 percent elected deferral under section 6166, while among estates valued at $5 million or more approximately 4.9 percent of estates elected deferral under section 6166.

Table 7.–Estates Claiming an Exemption for Qualified Family-Owned Business Assets, Special Use Valuation, or Electing Deferral of Tax Liability, Returns Filed in 2003

Item	Value of total gross estate less than $5 million	Value of total gross estate is $5 million or greater
Number of returns filed	67,380	5,743
Percentage of all returns filed	92%	8%
Percentage of total taxable gross estate on all taxable returns	58%	42%
Number of taxable returns	29,812	3,484
Number of returns claiming an exemption for assets under sec. 2057	706	83
Number of returns claiming a special use valuation under sec. 2032A	204	14
Number of returns making sec. 6166 election	300	171
Number of returns claiming an exemption under 2057 and special valuation under 2032A	124	13
Number or returns claiming an exemption under 2057, special valuation under 2032A, and deferral under 6166	22	11

Source: JCT staff tabulations from Statistics of Income data.

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reporting of asset values in certain transfers. Nevertheless, planning opportunities remain whereby small business owners can reduce the cash required to meet an estate tax obligation, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05, January 27, 2005. The JCT staff discusses the ability to use valuation discounts and lapsing trust powers to effectively shelter business (and other) assets from the estate tax on pages 396-408.

Table 8, below, reports data on the extent to which estates are comprised of closely held stock or business interests. The data show that approximately 13.8 percent of estate tax returns filed in 2003 reported some holdings of closely held stock. For estates claiming the tax benefits provided by sections 2057, 2032A, or 6166, the holdings of closely held stock exceeded one-third of the taxable estate for estates valued at $5 million or greater and exceeded two-fifths for estates valued less than $5 million. For estates holding closely held stock, but not claiming the tax benefits provided by sections 2057, 2032A, or 6166, closely held stock represented less than 20 percent of the taxable gross estate on average.

Table 8.–Closely Held Stock in Estate Tax Returns Filed in 2003

Item	Value of total gross estate less than $5 million	Value of total gross estate is $5 million or greater
Number of returns filed	67,380	5,743
Taxable gross estate (millions)	$115,698	$84,590
Number of estates with closely held stock	8,170	1,898
Value of closely held stock (millions)	$3,251	$7,327
Number of estates with closely held stock and claiming benefits of secs. 2057, 2032A, or 6166	348	155
Value of closely held stock as a percentage of the taxable gross estate of estates claiming benefits of secs. 2057, 2032A, or 6166	45%	35%
Number of estates with closely held stock not claiming benefits of secs. 2057, 2032A, or 6166	7,822	1,742
Value of closely held stock as a percentage of the taxable gross estate of estates not claiming benefits of secs. 2057, 2032A, or 6166	19%	17%

Source: JCT staff tabulations from Statistics of Income data.

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would...."[73] While, in theory, increases

[73] 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.

in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.[74]

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

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, Federal transfer taxes may help prevent an increase in the concentration of wealth. There are relatively few analyses of the distribution of wealth holdings.[75] Conventional economic wisdom holds that the Great Depression of the 1930s and World War II substantially reduced the concentration of wealth in the United States, and that there had been no substantial change at least through the 1980s. Most analysts assign no role to tax policy in the reduction in wealth concentration that occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since World War II.[76]

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

[75] 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.

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

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

Even if transfer taxes are believed to be borne by the owners of the assets subject to tax, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of $1 million to her son and incurs a gift tax liability of $500,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by $500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $1.5 million, so that the gift tax has reduced the son's economic well-being by $500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the 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.[77]

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because the marginal tax rate under the estate tax is 45 percent, while marginal income tax rates range from 10 to 35 percent, the after-tax cost of a charitable bequest is lower than the after-tax cost of a charitable gift made during one's

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Wojciech Kopczuk and Joel Slemrod, The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior," in William G. Gale, James R. Hines Jr., and Joel Slemrod (eds), *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, find mixed evidence. Using aggregate time series data, Kopczuk and Slemrod find a negative correlation between the share of wealth held by top wealth holders and the estate tax rates. That finding would imply that the estate tax may mitigate the concentration of wealth among top wealth holders. Wojciech Kopczuk and Emmanuel Saez, "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns," *National Tax Journal*, 57, September 2004, pp. 445-487, report a similar result. However, when Kopczuk and Slemrod use pooled cross section analysis to make use of individual estate tax return data, they find at best a weak relationship between estate tax rates and wealth holdings.

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

lifetime.[78] Economists refer to this incentive as the "price" or "substitution effect." In short, the price effect says that if something is cheaper, people will do more of it. Some analysts have suggested that the charitable estate tax deduction creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. The decision to make a charitable bequest arises not only from the incentive effect of a charitable bequest's deductibility, or "tax price," but also from what economists call the "wealth effect." Generally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes net wealth, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.

A number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.[79] Some analysts interpret these findings as implying that reductions in estate taxation

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

[79] For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, 44, June 1991, pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, 59, 1996, pp. 55-68. David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," *National Tax Journal*, 53, September 2000, pp. 743-763, provides a survey of these studies and presents new evidence. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue. In a more recent study, Michael J. Brunetti, "The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records," *National Tax Journal*, 58, June 2005, pp. 165-188, finds price elasticities in excess of 1.2.

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

could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life. On the other hand, some analysts have suggested that a more sophisticated analysis is required recognizing that a taxpayer may choose among bequests to charity, bequests to heirs, lifetime gifts to charity, and lifetime gifts to heirs and recognizing that lifetime gifts reduce the future taxable estate. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.[80]

Table 9, below, documents that a substantial dollar value of charitable bequests are claimed annually. Over the past 20 years, one estate tax return in six, or more, has claimed a deduction for charitable bequests. In 2005, the value of all charitable bequests claimed on estate tax returns exceeded $20.4 billion and represented 11.1 percent of the aggregate value of the gross estates reported on those returns.

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

Table 9.–Number of Returns Claiming Charitable Bequests and Value of Charitable Bequests, Selected Years

Year	1985	1990	1995	2000	2005
Total number of estate tax returns filed	67,961	53,168	69,755	108,322	45,070
Number of returns with charitable bequest	11,713	9,709	13,039	17,999	8,785
Percentage of returns making charitable bequest	17.2%	18.3%	18.7%	16.6%	19.5%
Dollar value of bequests (millions)	$4,543	$5,538	$8,695	$16,781	$20,415
Bequests as percentage of gross estate	7.2%	6.4%	7.4%	7.7%	11.1%

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

Federal transfer taxes and complexity

Critics of Federal transfer taxes document that these taxes create incentives to engage in avoidance activities. Some of these avoidance activities involve complex legal structures and can be expensive to create. Incurring these costs, while ultimately profitable from the donors' and donees' perspective, is socially wasteful because time, effort, and financial resources are spent that lead to no increase in national wealth. Such costs represent an efficiency loss to the economy in addition to whatever distorting effects Federal transfer taxes may have on other economic choices such as saving and labor supply discussed above. In the case of family-owned businesses, such activities may impose an ongoing cost by creating a business structure to reduce transfer tax burdens that may not be the most efficient business structure for the operation of the business. Reviewing more complex legal arrangements increases the administrative cost of the Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.[81] It is difficult to measure the extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.

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

Federal estate tax and basis of transferred assets

As described previously, present law includes two sets of rules for determining the basis of property acquired from a decedent's estate. The basis of property acquired from estates of decedents dying anytime before or after 2010 generally is the property's fair market value at the time of the decedent's death. As a result of this basis step-up (or step-down if property declined in value while owned by the decedent) when a taxpayer sells inherited property, the taxpayer generally does not recognize gain or loss attributable to appreciation or depreciation in the property that occurred during the decedent's holding period. Present law provides a different rule for property acquired from estates of decedents dying in 2010. For this property, there is no Federal estate tax, but heirs generally take a carryover basis. This carryover basis preserves in the hands of an heir taxable gain or loss attributable to increases or decreases in the value of property during the decedent's holding period. The one-year change from an estate tax coupled with basis step-up (or step-down) to estate tax repeal with carryover basis raises several behavioral and administrative issues. A few significant issues are described below.

Carryover basis may affect a taxpayer's willingness to sell an appreciated asset. In general, a realization-based tax system creates "lock-in," a behavioral distortion that may be described as the reluctance of an individual to sell property and thereby incur tax on the recognition of accrued appreciation in the property. This lock-in reduces the mobility of capital. Proponents of carryover basis argue that allowing inherited property to receive a basis step-up accentuates lock-in: Because income taxes on accrued appreciation can be avoided entirely if the basis of property that passes at death is stepped up to its fair market value at the time of death, an individual may choose not to sell appreciated property before death. Under this argument, carryover basis would reduce lock-in because holding assets until death would not permit avoidance of income tax liability on pre-death appreciation when assets eventually are sold by heirs. Conversely, opponents of carryover basis argue that it perpetuates lock-in because income tax liability for pre-death gains carries over to the heir. Thus, under carryover basis the decedent's beneficiary also may refrain from selling an asset because of the adverse income tax consequences from sale. Opponents of carryover basis argue that the stepped-up basis rule removes the lock-in effect once each generation.

Under carryover basis, taxpayers will be required to establish a decedent's historical cost basis in inherited assets. Commentators have argued that establishing this historical cost basis may be difficult in many cases.[82] The difficulty may be acute in part because the decedent is no longer available to remember the history of assets and where records of transactions affecting basis might be located. This problem may be especially troublesome in the case of personal residences for which there may be many transactions that affect basis; personal effects such as jewelry; assets such as classic cars that appreciate in value and to which many improvements

[82] Nonna A. Noto, "Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal," CRS Report for Congress RL30875, p. 9 (updated Apr. 20, 2001). The report notes that practitioners raised this concern when a previous attempt to institute carryover basis was enacted (and repealed before taking effect) by the Tax Reform Act of 1976. See also AICPA Tax Division, "Reform of the Estate and Gift Tax System," Tax Notes (Apr. 9, 2001), p. 322.

may be made; and unique assets such as paintings and stamp collections. It may be possible to use presumptions to ameliorate the difficulty of establishing historical cost basis. For example, a rule that presumed the decedent purchased an asset at its value on the date of its acquisition would in some cases limit the necessary knowledge to the date the decedent acquired the asset. In the absence of statutory presumptions, if an heir is unable to establish a decedent's basis in property, a question is whether the IRS will consider the heir to have a zero basis in the property.

A related issue under a carryover basis regime is the role of the executor of an estate in determining the decedent's basis in the assets over which the executor has control.[83] When carryover basis rules were adopted in 1976, the executor was required to obtain information about basis and to provide that information to heirs. No such requirement was included in the carryover basis rules adopted in 2001. If rules required executors to provide basis information to beneficiaries or if executors provided information in the absence of a requirement, a question would be whether beneficiaries would be permitted to rely on the information and whether executors would be subject to penalties for failure to report correct or complete information. Although the 2001 rules do not require an executor to provide basis information to beneficiaries, they do provide that an executor must allocate the permitted basis increases (the $1.3 million and $3 million amounts described previously) among estate assets, and they permit broad discretion in making the allocation (subject to a prohibition on using basis additions to create a built-in loss in any single asset). This broad discretion may create difficulties for executors concerned about fiduciary obligations and may create uncertainty for beneficiaries if an executor fails to make an allocation.

Change from a step-up basis rule to a carryover basis regime raises a question whether the change should be accompanied by transition rules. Some individuals may have purchased and held appreciating or depreciable property with the expectation that the basis of the property would be stepped-up upon the individuals' deaths. These individuals may argue that it would be unfair to repeal the stepped-up basis rule at least with respect to amounts of appreciation that have occurred before the time of the rule change. The carryover basis rules adopted in 1976 provided a grandfather rule under which the basis of an inherited asset could not be less than its value on December 31, 1976. Establishing the value of all assets that could be inherited proved to be a difficult and time consuming exercise. EGTRRA's carryover basis rules do not provide a grandfather for pre-carryover basis appreciation.

[83] AICPA Tax Division, supra note 82, p. 326; Task Force on Federal Wealth Transfer Tax, Report on Reform of Federal Wealth Transfer Taxes 72 (2004); Karen C. Burke & Grayson M.P. McCouch, "Estate Tax Repeal: Through the Looking Glass," 22 Virginia Tax Review 187, 220 (2002).