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Estate and Gift Taxes: Economic Issues

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Summary

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repeals the estate tax in 2010. During the phase-out period, the new law increases the exempt amount to $3.5 million by 2009 and lowers the top rate to 45% by 2007. The federal gift tax remains though the rate is reduced to the top personal income tax rate and the exemption is separate from the estate tax exemption. After repeal of the estate tax, carryover basis replaces step-up in basis for assets transferred at death. The legislation includes an exemption from carryover basis for capital gains of $1.3 million (and an additional $3 million for a surviving spouse). However, the estate tax provision in EGTRRA automatically sunsets December 31, 2010.

Late in the 109th Congress, two Senate compromise proposals were reported in the press, but were not introduced. One (Senator Kyl) would have set the exemption at $5 million for each spouse and lowered the rate to 15%. The second (Senator Baucus) would have set the exemption at $3.5 million and include a progressive rate schedule beginning at 15% and rising to 35%. Earlier, on July 29, 2006, the House approved H.R. 5970 by a vote of 230-180. The bill would have restored the unified estate and gift tax exclusion and raise the exclusion amount to $5 million per decedent by 2015. Any unused exclusion could have been carried over to the estate of the surviving spouse. The tax rate on taxable assets up to $25 million would have been equal to the tax rate on capital gains. The tax rate on assets over $25 million would have dropped to 30% by 2015. The JCT estimated that the estate tax provisions of H.R. 5970 would have cost $268 billion over FYs 2007-2016.

Supporters of the estate and gift tax cite its contribution to progressivity in the tax system and to the need for a tax due to the forgiveness of capital gains taxes on appreciated assets held until death. Arguments are also made that inheritances represent a windfall to heirs that are more appropriate sources of tax revenue than income earned through work and effort. Critics of the estate tax argue that it reduces savings and makes it difficult to pass on family businesses. Critics also argue that death is not an appropriate time to impose a tax; that much wealth has already been taxed through income taxes; and that complexity of the tax imposes administrative and compliance burdens that undermine the progressivity of the tax.

The analysis in this study suggests that the estate tax is highly progressive, although progressivity is undermined by avoidance mechanisms. Neither economic theory nor empirical evidence indicate that the estate tax is likely to have much effect on savings. Although some family businesses are burdened by the tax, only a small percentage of estate tax revenues are derived from family businesses. Even though there are many estate tax avoidance techniques, it also is possible to reform the tax and reduce these complexities as an alternative to eliminating the tax. Thus, the evaluation of the estate tax may largely turn on the appropriateness of such a revenue source and its interaction with incentives for charitable giving, state estate taxes, and capital gains and other income taxes. This report will be updated as legislative events warrant.

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Estate and Gift Taxes: Economic Issues

The estate and gift tax has been and will continue to be the subject of significant legislative interest. The "Economic Growth and Tax Relief Reconciliation Act of 2001" (EGTRRA, P.L. 107-16) repeals the estate tax after 2009. However, the legislation sunsets after 2010 reverting back to the law as it existed in 2001. Congress could eliminate the sunset provision in EGTRRA, thus making repeal of the estate tax permanent. Repeal of the sunset would retain the EGTRRA changes to the taxation of capital gains of inherited assets and the gift tax.

Immediate repeal of the estate and gift tax in 2001 would have cost up to $662 billion (over 10 years), an amount in excess of the projected estate tax yield of $409 billion because of projected behavioral responses that would also lower income tax revenues (e.g. more life time transfers to donees in lower tax brackets, more purchase of life insurance with deferral aspects, and lower compliance). Repealing the EGTRRA sunset would cost $290.0 billion over the 2006-2015 budget window. Most of the revenue loss is in the "out" years; $9.1 billion over 2006 to 2010 and $280.9 billion over 2011 to 2015.[1] Immediate repeal (as opposed to eventual repeal beyond 2010) would be more expensive.

Toward the end of the 109th Congress, two compromise proposals were reported in the press, but not formally introduced. One, offered by Senator Kyl, would have set the exemption at $5 million for each spouse ($10 million per couple) and lowered the tax rate to 15%. The second, offered by Senator Baucus, would have set the exemption at $3.5 million and include a progressive rate schedule beginning at 15% and rising with the size of the estate to 35%.[2] One independent estimate of the cost of Senator Kyl's proposal projected that it would have cost approximately 84% of full repeal.[3] The relatively low rate of 15% is responsible for most of the revenue loss under the Kyl proposal. No potential revenue loss estimates are available for the Baucus proposal, although it would be less expensive than the Kyl proposal.

Proponents of an estate and gift tax argue that it contributes to progressivity in the tax system by "taxing the rich." (Note, however, that there is no way to objectively determine the optimal degree of progressivity in a tax system). A related argument is that the tax reduces the concentration of wealth and its perceived adverse

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[1] Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 8, the Death Tax Permanency Act of 2005*, JCX-20-05, 109th Congress, April 13, 2005.

[2] Kurt Ritterpusch, "Baucus Proposal could Complicate Effort in senate to Find 60 Votes for Repeal Plan," *Daily Tax Report*, no. 105, June 1, 2006.

[3] Joel Friedman, "Estate Tax 'Compromise' with 15 Percent Rate is Little Different Than Permanent Repeal," *Center on Budget and Policy Priorities*, May 31, 2006.

consequences for society.[4] Moreover, while the estate and gift tax is relatively small as a revenue source (yielding $24.7 billion in 2005 and accounting for 1.2% of federal revenue), it raises a not insignificant amount of revenue — revenue that could increase in the future due to strong performance of stock market and growth in intergenerational transfers as the baby boom generation ages. Eliminating or reducing the tax would either require some other tax to be increased, some spending program to be reduced, or an increase in the national debt.

In addition, to the extent that inherited wealth is seen as windfall to the recipient, such a tax may be seen by some as fairer than taxing earnings that are the result of work and effort. Finally, many economists suggest that an important rationale for maintaining an estate tax is the escape of unrealized capital gains from any taxation, since heirs receive a stepped-up basis of assets. Families that accrue large gains through the appreciation of their wealth in assets can, in the absence of an estate tax, largely escape any taxes on these gains by passing on the assets to their heirs.

The estate tax also encourages giving to charity, since charitable contributions are deductible from the estate tax base. Since charitable giving is generally recognized as an appropriate object of subsidy, the presence of an estate tax with such a deduction may be seen as one of the potential tools for encouraging charitable giving.

Critics of the estate and gift tax typically make two major arguments: the estate and gift tax discourages savings and investments, and the tax imposes an undue burden on closely held family businesses (including farms). In the latter case, the argument is made that the estate tax forces the break-up of family businesses without adequate liquidity to pay the tax. Critics also suggest that the estate and gift tax is flawed as a method of introducing progressivity because there are many methods of avoiding the tax, methods that are more available to very wealthy families (although this criticism could support reform of the tax as well as repeal). A related criticism is that the administrative and compliance cost of an estate and gift tax is onerous relative to its yield (again, however, this argument could also be advanced to support reform rather than repeal). In general, there may also be a feeling that death is not a desirable time to impose a tax; indeed, the critics of the estate and gift tax often refer to the tax as a death tax. Critics also argue that some of the wealth passed on in estates has generally already been subject to capital income taxes.

The remainder of this report, following a brief explanation of how the tax operates, analyzes these arguments for and against the tax. The report concludes with an inventory and discussion of alternative policy options.

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[4] Possible consequences that have been discussed include concentrations of political power, inefficient investments by the very wealthy, and disincentives to work by heirs (often referred to as the Carnegie conjecture, reflecting a claim argued by Andrew Carnegie).

How the Estate and Gift Tax Works

The unified estate and gift tax is levied on the transfer of assets that occurs when someone dies or gives a gift. Filing an estate tax return can be difficult depending on the value and complexity of the estate. The purpose here is to outline the mechanics of the estate and gift tax. The first section begins with a brief review of the general rules accompanied with a numerical example. There are some minor provisions of the law that are not discussed here, however, such as the phase out of the graduated rates and the credit for taxes on property recently transferred.[5] The second section summarizes the special rules for farms and small businesses. And, the final section briefly describes the generation skipping transfer tax. The appendix of this report provides detailed data from returns filed in 2005, the latest year for which data are available.

General Rules

Filing Threshold. In 2007, estates valued over $2.0 million must file an estate tax return. The applicable credit, which is identical to the filing threshold, effectively exempts from taxation the portion of the estate that falls below the filing threshold. (The filing threshold is lower, however, if gifts have already been made.) Table A1 in the appendix reports the current filing requirement and the unified credit equivalent for 2004 through 2011.

Gross Estate Value. The gross estate value, which was $178.1 billion for returns filed in 2005, is the total value of all property and assets owned by decedents. Table A2 in the appendix provides the gross estate value for the returns filed in 2005 by wealth category. The data represent the returns filed in 2005, not the decedents in that year. Thus, a portion of the returns filed in 2005 are from estates valued in years before 2005.

Allowable Deductions. Deductions from the estate reduce the taxable portion of the gross estate and in turn the number of taxable returns. In 2005, $83.1 billion was deducted from estates. The most valuable deduction is for bequests to a surviving spouse, $53.7 billion; the most prevalent (though smallest reported) deduction is for funeral expenses, $326.4 million. Appendix table A3 lists the deductions in greater detail for returns filed in 2005. Beginning in 2005, estates may deduct state estate taxes paid. Before 2005, taxpayers received a federal credit for state death taxes paid. That credit was phased out incrementally from 2002 through 2004.

Taxable Estate. After subtracting allowable deductions, the remainder of the estate is the taxable estate. Taxable estate value was $91.5 billion in 2005. Adjusted taxable gifts are then added to the taxable estate to arrive upon the *adjusted* taxable estate. An individual is allowed to exclude $12,000 in gifts per year per donee from

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[5] For a history of the estate and gift tax as well as a detailed explanation of current law, see the following CRS reports by John R. Luckey: CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law*, and CRS Report 95-444, *A History of Federal Estate, Gift, and Generation-Skipping Taxes*.

taxable gifts. Thus, only the amount exceeding the $12,000 limit is added back to the taxable estate. Only 8,589 returns filed in 2005 included taxable gifts, adding approximately $6.3 billion to the total estate value. Thus, adjusted taxable estates were worth $101.3 billion in 2005. Generally, the adjusted taxable estate represents the base of estate tax.

Rates and Brackets. After establishing the value of the taxable estate, the executor calculates the tentative estate tax due.[6] The tax due is tentative because the executor has not redeemed the *applicable credit amount*.[7] As noted earlier, the credit for state estate and inheritance taxes was repealed and replaced with a deduction beginning in 2005.

A Numerical Example. The remaining steps in calculating the estate and gift tax are most easily exhibited through numerical example. To accomplish this, we first assume a decedent, who dies in 2007, has an estate worth $5 million and leaves $2 million to his wife and contributes $400,000 to a charitable organization. We also assume the decedent has not made any taxable gifts leaving $2.6 million in his estate after deductions. This simple example is exhibited below.

Table 1. Numerical Example
(2007 rules)

Gross Estate Value	$5,000,000
— Less: hypothetical marital deduction	$2,000,000
— Less: hypothetical charitable contribution deduction	$400,000
Taxable Estate	**$2,600,000**

The taxable estate is valued at $2.6 million after the allowable deductions have been subtracted from the gross estate value.[8] The tax is applied to the $2.6 million in increments of estate value as provided for in the tax code. For example, the first increment of $10,000 is taxed at 18%, the second increment of $10,000 is taxed at 20%, the third increment of $20,000 is taxed at 22%, etc. This process continues until the entire $2.6 million is taxed. The last increment of estate value, that from $1.5 million to $2.6 million, is taxed at a 45% rate. Thus, even though this estate is in the 45% bracket, only a portion ($1.1 million) of the estate is taxed at the 45% rate.

Tentative Estate Tax. In 2005, the aggregate tentative estate tax after deductions and before credits was $42.7 billion. Returning to our example, the $2.6

[6] 26 I.R.C. 2001(c)

[7] The federal credit for state death taxes paid was repealed beginning in 2005. See Table A4 in the appendix for the old credit for state death taxes paid schedule.

[8] We have dropped the modifier "adjusted" from taxable estate for the benefit of the reader. The taxable estate and the adjusted taxable estate are identical in the absence of taxable gifts.

million taxable estate yields a tentative estate tax of $1,050,800. Recall, however, we have not yet considered the "applicable credit."

The Applicable Credit (Unified with Gift Tax before 2004). For decedents dying in 2007, the applicable credit is $780,800, which leaves an estate tax due in our example of $270,000. The applicable credit reduced the tentative estate tax by $20.6 billion in 2005.

Federal Credit for State Death Taxes (Eliminated in 2005). The state death tax credit reduced the federal estate tax due by $1.8 billion in 2005.[9] This tax credit is determined by yet another tax rate schedule. The taxable estate value, which is $2.6 million in our example, is reduced by a standard exemption of $60,000 and the credit rate schedule applies to the remainder. EGTRRA reduces and eventually repeals the credit for state death taxes. In 2004, the credit was 25% of what the credit would have been before EGTRRA. In 2005, the credit was repealed and estates were allowed to deduct state death taxes paid. Table A5 of the appendix reproduces the now-repealed credit schedule for state death taxes. For our hypothetical estate filed in 2007, the credit is not available and thus state death taxes would be deductible. In many states, however, the state estate tax is repealed along with the federal credit.

Net Federal Estate Tax. The net estate tax due was $21.5 billion in 2004.[10] This is the final step for the estate executor. After all exemptions, deductions, and credits, the $5 million dollar estate we began with must now remit $270,000 to the federal government.

All of the steps described above are included in **Table 2**. Also, an estimate of the average estate tax rate is presented in the bottom row. The federal rate is calculated as the federal estate tax due divided by the gross estate value.

Table 2. Numerical Example Continued with Taxes and Credits
(2007 rules)

Gross Estate Value	$5,000,000
— Less: hypothetical marital deduction	$2,000,000
— Less: hypothetical charitable contribution deduction	$400,000
Taxable Estate	**$2,600,000**
Tentative Estate Tax (from the rate schedule)	$1,050,800
— Less: Applicable Credit Amount (in 2007)	$780,800
Net Federal Estate Tax	**$270,000**
Average Effective Federal Estate Tax Rate	**5.40%**

[9] The data are from those estates that filed in 2005, thus many estates followed the 2004 rules which still included the credit for state death taxes.

[10] This is slightly greater than the tentative estate tax less credits because of rounding.

Special Rules for Family Owned Farms and Businesses

There are primarily two special rules for family owned farms and businesses. The first special rule (26 I.R.C. 6166) allows family owned farm and business estates to pay the tax in installments over a maximum of 10 years after a deferment of up to five years. The farm or business must comprise at least 35% of the adjusted gross estate value to qualify for the installment method. A portion of the deferred estate tax is assessed an annual 2% interest charge.

The second special rule (26 I.R.C. 2032A) allows family farms and businesses that meet certain requirements to value their land as currently used rather than at fair market value. To avoid a recapture tax, heirs must continue to use the land as designated in the special use notice for at least 10 years following the transfer. The market value can be reduced by a maximum $750,000 in 1998. After 1998, the maximum is indexed for inflation, rounded to the next lowest multiple of $10,000. In 2006, the maximum was $900,000.

The Generation Skipping Transfer Tax

Generally, the generation skipping transfer (GST) tax is levied on transfers from the decedent to grandchildren. The tax includes a $2,000,000 exemption per donor in 2007 that is pegged to the general estate tax exclusion. Married couples are allowed to "split" their gifts for an effective exemption of $3,000,000. The rate of tax is the highest estate and gift tax rate or 45% in 2007. These transfers are also subject to applicable estate and gift taxes. The GST exemption rises to $3.5 million in 2009. Very few estates pay a generation skipping transfer tax because the high rate of tax discourages this type of bequest.

Economic Issues

As noted in the introduction, the principal arguments surrounding the estate and gift tax are associated with the desirability of reducing the concentration of wealth and income through the tax and the possible adverse effect of the tax on savings behavior and family businesses. There are a number of other issues of fairness or efficiency associated with particular aspects of the tax (e.g. marital deductions, charitable deductions, effects on small businesses, interaction with capital gains taxes) , and the possible contribution to tax complexity. These issues are addressed in this section.

The Distributional Effect of the Estate and Gift Tax

Distributional effects concern both vertical equity (how high income individuals are affected relative to low income individuals) and horizontal equity (how individuals in equal circumstances are differentially affected). Note that economic analysis cannot be used to determine the optimal degree of distribution across income and wealth (vertical equity).

Vertical Equity. The estate tax is the most progressive of any of the federal taxes; out of the approximately 2.4 million deaths in 2004, only 1.3% of estates paid any estate tax.[11] This percentage can be contrasted with the income tax where most families and single individuals file tax returns and about 70% of those returns owe tax. In addition, out of the 1.3% of decedents whose estates pay tax, about 70% of these had gross estates valued between $1 million and $2.5 million in 2004, which are the smallest (based on gross estate value) taxable estates.

Evidence suggests that the average effective tax rate rises with the size of the estate except for the highest tax rate bracket, as shown in Table 1 [columns (f) and (g)]. Column (f) reports 2005 effective tax rates for the decedent before the credit for state death taxes and column (g) shows the actual amount paid to the federal government after all credits. Estates valued at less than the exemption amount, of course, pay no taxes and the tax rate rises and then falls with the very largest estates, despite the fact that the rates are graduated.

Columns (b), (c), and (d) show the deductions from the estate as a percentage of gross estate value. Charitable deductions are the primary reason for the lower tax rate in the highest levels of the estate tax. The charitable deduction accounts for 11.0% of estates on average but 24.3% in the highest wealth bracket. The deduction for bequests left to spouse also rises as a portion of the gross estate as estate size increases. The progressivity of the estate tax for the estates valued at less than $10 million is the result of the unified credit and the graduated rate structure.

The data in **Table 3** may actually overstate the amount of rate progression in the estate tax. Tax planning techniques, such as gift tax exclusions or valuation discounts, reduce the size of the gross estate and are more common with larger estates. These techniques reduce the size of the estate but do not appear in the IRS data, thus, the effective tax rates may be overstated for larger estates.

Despite the lack of progressivity through all of the estate size brackets, the principal point for distributional purposes is that the estate and gift tax is confined to the wealthiest of decedents and to a tiny share of the population. For example, estates over $5 million accounted for 19.5% of taxable estates, but accounted for 63.0% of estate tax revenues in 2005. Thus, to the extent that concentration of income and wealth are viewed as undesirable, the estate tax plays some role, albeit small — because few pay the tax — in increasing income and wealth equality.

Note also an effect that contradicts some claims made by opponents of the tax. The Carnegie conjecture suggests that large inheritances reduce labor effort by heirs.[12] Thus, the estate tax, which reduces inheritances, could increase output and economic growth because heirs work more (increase their labor supply) if their inheritance is reduced. Although, for very large inheritances, the effect of one individual on the labor supply may be small relative to the effect on saving.

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[11] Mortality data for 2004 is the latest year available.

[12] For more see Douglas Holtz-Eakin, David Joulfaian, and Harvey Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, v. 108, May 1993, pp. 413-435.

Table 3. Estate Tax Deductions and Burdens, 2005

Size of Gross Estate ($ millions)	Percent of Gross Estate			Tax as a Percent of Net Estate[a]		
	Expenses	Bequests to Spouse	Charity	Before Credit	After Unified Credit	After All Credits[b]
(a)	(b)	(c)	(d)	(e)	(f)	(g)
1.5-2.5	5.15%	19.77%	3.93%	28.89%	-0.28%	4.04%
2.5-5.0	5.97%	28.66%	5.14%	27.07%	10.61%	11.64%
5.0-10.0	6.46%	34.09%	7.03%	25.91%	17.76%	17.09%
10.0-20.0	5.85%	38.31%	8.51%	24.05%	20.06%	18.66%
over 20.0	4.39%	34.41%	24.30%	18.53%	17.73%	16.10%
Total	5.40%	30.14%	10.99%	24.53%	12.28%	12.77%

Source: CRS calculations from Statistics of Income, *Estate Tax Returns Filed in 2005*, IRS, SOI unpublished data, November 2006.

a. Net estate is estate value less expenses. Expenses include funeral expenses, attorney's fees, executors' commissions, other expenses/losses, and debts and mortgages.
b. This includes any gift taxes that are owed by an estate, which could increase the total taxes owed by an estate.

Horizontal Equity. Estate and gift taxes can affect similar individuals differentially for a variety of reasons. Special provisions for farmers and family businesses (discussed subsequently) can cause families with the same amount of wealth to be taxed differentially. The availability and differential use of avoidance techniques (also discussed subsequently) can lead to different tax burdens for the same amount of wealth. Moreover, individuals who accumulate similar amounts of wealth may pay differential taxes depending on how long they live.

Effect on Saving

Many people presume that the estate tax reduces savings, since the estate and gift tax, like a capital income tax, applies to wealth. It may appear "obvious" that a tax on wealth would reduce wealth. However, taxes on capital income do not necessarily reduce savings. This ambiguous result arises from the opposing forces of an income and substitution effect. An investment is made to provide future consumption; if the rate of return rises because a tax is cut, more consumption might be shifted from the present to the future (the substitution effect). This effect, in isolation, would increase saving.

However, the tax savings also increases the return earned on investment and allows higher consumption both today and in the future. This effect is called an income effect, and it tends to reduce saving. Its effect is most pronounced when the savings is for a fixed target (such as a fund for college tuition or a target bequest to an heir). Thus, saving for precautionary reasons (as a hedge against bad events) is less likely to increase when the rate of return rises than saving for retirement. Empirical evidence on savings responses, while difficult to obtain, suggests a small effect of uncertain sign (i.e. either positive or negative). Current events certainly

suggest that savings fall when the rate of return rises: as returns on stocks have increased dramatically, the savings rate has plunged.

The same points can generally be made about a tax on estates and gifts, although some analysts suspect that an estate tax, to be paid at a distant date in the future, would be less likely to have an effect (in either direction) than income taxes being paid currently. A reduction in estate taxes makes a larger net bequest possible, reducing the price of the bequest in terms of forgone consumption. This substitution effect would cause savings to increase. At the same time, a reduction in estate taxes causes the net estate to be larger, allowing a larger net bequest to be made with a smaller amount of savings (the income effect). Again, the latter effect is most pronounced when there is a target net bequest; a smaller gross bequest can be left (and less savings required on the part of the decedent) to achieve the net target.

Unfortunately, virtually no empirical evidence about the effect of estate and gift taxes exists, in part because these taxes have been viewed as small and relatively unimportant by most researchers and in part because there are tremendous difficulties in trying to link an estate and gift tax which occurs at the end of a lifetime to annual savings behavior. But a reasonable expectation is that the effects of cutting the estate and gift tax on savings would not be large and would not even necessarily be positive.

Of course, the effect on national saving depends on the use to which tax revenues are put. If revenues are used to decrease the national debt, they become part of government saving, and it is more likely that cutting estate and gift taxes would reduce saving by decreasing government saving, since there may be little or no effect on private saving. If they are used for government spending on consumption programs, or transfers that are primarily used for consumption, then it is less likely that cutting estate and gift taxes would reduce saving because the estate tax cut would be financed out of decreased consumption (rather than decreased saving). In this case, reducing the tax would probably have a small effect on national saving, since the evidence suggests a small effect on private saving. A similar effect would occur if tax revenues are held constant and the alternative tax primarily reduced consumption.

Actually, the estate and gift tax is, in some ways, more complicated to assess than a tax on capital income or wealth. There are a variety of possible motives for leaving bequests, which are likely to cause savings to respond differently to the estate tax. In addition, there are consequences for the heirs which may affect their savings.

Several of these alternative motives and their consequences are outlined by Gale and Perozek.[13] Motives for leaving bequests include (1) altruism: individuals want to increase the welfare of their children and other descendants because they care about them; (2) accident: individuals do not intentionally save to leave a bequest but as a fund to cover unexpected costs or the costs of living longer than expected (thus,

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[13] William G. Gale and Maria G. Perozek. Do Estate Taxes Reduce Savings? April 2000. Presented at a Conference on Estate and Gift Taxes sponsored by the Office of Tax Policy Research, University of Michigan, and the Brookings Institution, May 4-5, 2000.

bequests are left by accident and are in the nature of precautionary savings); (3) exchange: parents promise to leave bequests to their children in exchange for services (visiting, looking after parents when they are sick); and (4) joy of giving: individuals get pleasure directly from giving, with the pleasure depending on the size of the estate. To Gale and Perozek's classifications we might add satiation: when individuals have so much wealth that any consumption desire can be met.

The theoretical effects of these alternative theories on decedents and heirs are summarized in **Table 4**. A discussion of each follows in the text, but it is interesting to see that there is a tendency for estate taxes to increase saving, not decrease it. This effect occurs in part because there are "double" income effects that discourage consumption, acting on both the decedent and the heir.

Altruistic. When giving is motivated by altruism, the effect of the tax is ambiguous, as might not be surprising given the discussion of income and substitution effects. The effects on the parents are ambiguous, while the windfall receipt of an inheritance tends to reduce the need to save by the children. That is, the estate tax reduces the inheritances and thus increases saving by heirs. The outcomes are also partly dependent on whether children think they can elicit a larger inheritance by squandering their own money (which causes them to save even less) and whether the parent sees this problem and responds to it in a way that forestalls it. Interestingly, some parents might respond by spending a lot of their assets before death to induce their children to be more responsible and save more. The cost of doing this is the reduction in welfare of their children from the smaller bequest as compared with the parent's benefit from consumption. The estate tax actually makes the cost of using this method smaller (in terms of reduced bequests for each dollar spent), and causes the parents to consume more. While these motivations and actions of parent and child can become complex, this theory leaves us with an ambiguous effect on savings.

Accidental. In the second case, where bequests are left because parents die before they have exhausted their resources, the estate tax has no effect on the saving of the parents. Indeed, the parents are not really concerned about the estate tax since it has no effect on the reason they are accumulating assets. If they need the assets because they live too long or become ill, no tax will be paid. Bequests are a windfall to children, in this case, and tend to increase their consumption. Thus, taxing bequests, because it reduces this windfall, reduces their consumption and promotes savings. If the revenue from the estate tax is saved by the government, national saving rises. (If the revenue is spent on consumption, there is no effect on savings.) Thus, in this case, the estate tax reduces private consumption and repealing it, reducing the surplus, would increase consumption (reduce savings).

Exchange. In the third case, parents are basically paying for children's services with bequests and the estate tax becomes like a tax on products: the price for their children's attention has increased. Not surprisingly, the savings and size of bequest by the parents depends on how responsive they are to these price changes. If the demand is less responsive to price changes (price inelastic), parents will save and bequeath more to make up for the tax to be sure of receiving their children's services, but if there are close substitutes they might save less, bequeath less, and

purchase alternatives (e.g. nursing home care). In this model, the child's saving is not affected, since the bequest is payment for forgone wages (or leisure).

Table 4. Theoretical Effect of Estate Tax on Saving, By Bequest Motive

Bequest Motive	Effect on Decedent Saving	Effect on Heir Saving
Altruism	Ambiguous	Increases
Accidental	None	Increases
Exchange	Ambiguous	None
Joy of Giving	Ambiguous	Increases
Satiation	None	Increases or None

Joy of Giving. A fourth motive is called the "joy-of-giving" motive, where individuals simply enjoy leaving a bequest. If the parent focuses on the before-tax bequest, the estate tax will have no effect on his or her behavior, but will reduce the inheritance and theoretically increase the saving of children. Thus, repealing the estate tax would reduce private saving. If the parent focuses on the after-tax bequest, the effect on saving is ambiguous (again, due to income and substitution effects).

Satiation. Some families may be so wealthy that they can satisfy all of their consumption needs without feeling any constraints and their wealth accumulation may be a (large) residual. In this case, as well, the estate tax would have no effect on saving of the donor, and perhaps little effect on the donee as well.

Empirical Evidence. Evidence for these motives is not clear but this analysis does suggest that there are many circumstances in which a repeal of the estate tax would reduce savings, not increase it. Virtually no work has been done to estimate the effect of estate taxes on accumulation of assets. A preliminary analysis of estate tax data by Kopczuk and Slemrod found some limited evidence of a negative effect on savings, but this effect was not robust (i.e. did not persist with changes in data sets or specification).[14] This effect was relatively small in any case and the authors stress the many limitations of their results. In particular, their analysis cannot distinguish between the reduction of estates due to savings responses and those due to tax avoidance techniques.

Given the paucity of empirical evidence on the issue, the evidence on savings responses in general, and the theory outlined above, it appears difficult to argue for repeal of the estate tax to increase private saving. Even if the responsiveness to the estate and gift tax is as large as the largest empirical estimates of interest elasticities,

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[14] Wojciech Kopczuk and Joel Slemrod, The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors. April 17, 2000. Presented at a Conference on Estate and Gift Taxes sponsored by the Office of Tax Policy Research, University of Michigan, and the Brookings Institution, May 4-5, 2000.

the effect on savings and output would be negligible and more than offset by public dissaving.[15] Indeed, if the only objective were increased savings, it would probably be more effective to simply keep the estate and gift tax and use the proceeds to reduce the national debt.

Effect on Farms and Closely Held Businesses

Much attention been focused on the effect of the estate and gift tax on family farms and businesses and there is a perception that the estate tax is a significant burden on these businesses. Typically, family farm and business owners hold significant wealth in business and farm assets as well as other assets such as stocks, bonds and cash. Because many business owners are relatively well off and the estate and gift tax is a progressive tax, the probability of a farm or small business owner encountering tax liability is greater than for other decedents.[16]

Opponents of the estate and gift tax suggest that a family business or farm may in fact have to sell assets, often at a discounted price, to pay the tax. In his 1997 testimony, Bruce Bartlett from the National Center for Policy Analysis, stated that

> ...according to a survey, 51% of businesses would have difficulty surviving in the event of principal owner's death and 14% said it would be impossible for them to survive. Only 10% said the estate tax would have no effect; 30% said they would have to sell the family business, and 41% would have to borrow against equity.[17]

Are the data from this survey representative of the country as a whole? And, what are the policy issues associated with this effect? In response to the above testimony, there are two questions to explore. One, is repeal of the estate and gift tax efficiently targeted to relieve farms and small businesses? And two, of the farmer and small business decedents, how many actually encounter estate tax liability?

Target Efficiency. Congress has incorporated into tax law provisions, outlined earlier, that address and reduce the negative consequences of the estate tax

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[15] Interest elasticities have been estimated at no higher than 0.4; that is, a one percent increase in the rate of return would increase savings by 0.4%. Ignoring the effect on the deficit or assuming the revenue loss is made up by some other tax or spending program that has no effect on private savings, this amount is about 40% of the revenue cost, so that savings might initially increase by about $12 billion. Output would rise by this increase multiplied by the interest rate, or about $1 billion (or, 1/100 of 1% of output). In the long run, savings would accumulate, and national income might eventually increase by about one tenth of 1%. (This calculation is based on the following: the current revenue cost of $28 billion accounts for about 1.4% of capital income of approximately 25% of Net National Product; at an elasticity of 0.4, a 1.4% increase in income would lead to a 0.56 % increase in the capital stock and multiplying by the capital share of income (0.25) would lead to an approximate 0.14 increase in the capital stock.)

[16] See CRS Report RL33070, *Estate Taxes and Family Businesses: Economic Issues*, by Jane Gravelle and Steven Maguire.

[17] Statement before the Subcommittee on Tax, Finance, and Exports, Committee on Small Business, June 12, 1997.

on farms and small businesses. These laws are targeted to benefit only farm and small business heirs. In contrast, proposals to repeal the estate and gift tax entirely are poorly targeted to farms and small businesses.

Of the 18,430 taxable returns filed in 2005, 979 (5.3%) included farm assets. Additionally, no more than 8,273 (44.9%) returns included "business assets" in the estate.[18] (Note that some returns are double counted). Together, farm and business owners, by our definition, represent approximately 50.2% of all taxable estate tax returns.[19]

However, this estimate is dramatically overstated, even aside from the likelihood of double counting. The estimate for farms assumes any estate with a farm asset is a farm return thus including part-time farmers or those who may own farm land not directly farmed. The estimate for business assets may include many returns that include small interests (particularly for corporate stock and partnerships). Treasury data for 1998 indicated that farm estates where farm assets accounted for at least half of the gross estate accounted for 1.4% of taxable estates, while returns with closely held stock, non-corporate business or partnership assets equal to half of the gross estate accounted for 1.6%. The same data indicated that farm real estate and other farm assets in these returns accounted for 0.6% of the gross value of estates. Similarly estates with half of the assets representing business assets accounted for 4.1% of estates' gross values. Thus, it is clear that if the main motive for repealing the estate tax or reducing rates across-the-board were to assist farms and small businesses, most of the revenue loss would accrue to those outside the target group.

How Many Farm and Small Business Decedents Pay the Tax? The more difficult question to answer is how many decedent farmers and small family business owners pay the tax. The first step in answering this question is to estimate the number of farmers and business owners (or those with farm and business assets) who die in any given year. We chose 2003 as our base year.

About 2.3 million people 25 and over died in the United States in 2004.[20] Some portion were farm and business owners. To estimate the number of those who died that were farm or business owners, we assume that the distribution of income tax filers roughly approximates the distribution of deaths in any given year. Or, the portion of farm individual income tax returns to total income tax returns in 2004 approximates the number farm deaths to total deaths. The same logic is used to approximate the number of business owner deaths. (Note that farmers tend to be older than other occupational groups and have somewhat higher death rates, which may slightly overstate our estimates of the share of farmer estates with tax).

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[18] A return is classified as a business return if at least one of the following assets is in the estate: closely held stock, limited partnerships, real estate partnership, other non-corporate business assets. Counting the same estate more than once is likely which significantly overstates the number of business estate tax returns.

[19] See CRS Report RS20593, *Asset Distribution of Taxable Estates: An Analysis*, by Steven Maguire.

[20] Mortality data for 2004 is the latest year available.

In 2004, there were 132.2 million individual income tax returns filed; about 2 million were classified as farm returns and 20.3 million included business income or loss. These returns represent 1.5% and 15.3% of all returns respectively. If the profile of individual income tax return filers is similar to the profile of decedents, this implies approximately 35,267 farmers and 356,245 business owners died in 2004.[21]

Recall that the estate tax return data include 979 taxable returns with farm assets and 8,273 taxable returns we classify as business returns. Dividing these two numbers by the estimated number of deaths for each vocation yields an taxable estate tax return rate of 2.8% for farm owner decedents and 2.3% for business owner decedents. Thus, one can conclude that most farmers and business owners are unlikely to encounter estate tax liability.

Other Issues. Liquidity constraints or the inability of farms and small business to meet their tax liability with cash, may not be widespread. A National Bureau of Economic Research (NBER) paper using 1992 data estimated that 41% of business owners could pay estate and gift taxes solely out of narrowly defined liquid assets (insurance proceeds, cash and bank accounts); if stocks (equities) were included in a business's liquid assets, an estimated 54% could cover their estate and gift tax liability; if bonds are included an estimated 58% could cover their tax.[22]

These estimates suggest that only 3 to 4% of family farms and businesses would potentially be at risk even without accounting for the special exemptions; the special exemption suggests a much smaller number would be at risk.[23] If one included other non-business assets that are either not included in these estimates through lack of data (such as pensions) or nonfinancial assets (such as real estate) the estimate would be even higher. For many businesses a partial sale of assets (e.g. a portion of farm land) might be made or business assets could be used as security for loans to pay the tax. Finally, some estates may wish to liquidate the business because no heir wishes to continue it. Given these studies and analysis, it appears that only a tiny fraction, almost certainly no more than a percent or so, of heirs of business owners and farmers would be at risk of being forced to liquidate the family business to pay estate and gift taxes.

Effects of the Marital Deduction

One of the most important deductions from the estate tax is the unlimited marital deduction, which accounted for 30.1% of the gross value of all estates, and over 35% for larger estates (see **Table 3**; larger estates may be more likely to reflect

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[21] The percentages are multiplied by the 2,374,781 deaths of those 25 years old and over. If the age were higher then the pool of decedents would be smaller and the percentage that paid estate taxes incrementally higher.

[22] Holtz-Eakin, Douglas, John W. Philips, and Harvey S. Rosen, "Estate Taxes, Life Insurance, and Small Business," *National Bureau of Economic Research*, no. 7360, September 1999, p. 12.

[23] Of course, if all heirs do not wish to continue ownership in the family business, these liquid assets might need to be used to buy them out; that, however, is a choice made by the heirs and not a forced sale.

the death of the first spouse). An individual can leave his or her entire estate to a surviving spouse without paying any tax and getting step-up in basis (which permits no tax on accrued gains). The arguments for an unlimited marital deduction are obvious: since spouses tend to be relatively close in age, taxing wealth transferred between spouses amounts to a "double tax" in a generation and also discourages the adequate provision for the surviving spouse (although this latter objective could be met with a large, but not necessarily unlimited, marital deduction). (There is, however, a partial credit for prior transfers within a decade which could mitigate this double taxation within a generation.) Moreover, without an exclusion for assets transferred to the spouse, a substantial amount of planning early in the married couple's life (e.g. allowing for joint ownership of assets) could make a substantial difference in the estate tax liability.

Nevertheless, the unlimited marital deduction causes a certain amount of distortion. If a spouse leaves all assets to the surviving spouse, he or she forgoes the unified credit, equivalent to an exclusion that is currently $2.0 million and will eventually reach $3.5 million in 2009. In addition, because the estate tax is graduated, leaving all assets to a spouse can cause the couple to lose the advantage of going through the lower rate brackets twice. A very wealthy donor would leave enough to children (or to the ultimate beneficiary after the second spouse's death) to cover the exemption and to go through all of the rate brackets; then when the second spouse dies, another exemption and another "walk through the rate brackets" will be available. Donors can try to avoid the loss of these benefits and still provide for the surviving spouse by setting up trusts to allow lifetime income to the spouse and perhaps provide for invasion of the corpus for emergencies. These methods, of course, require pre-planning and may not be perfect substitutes for simply leaving assets to the surviving spouse, who would not have complete control.

Under other circumstances, the unlimited marital deduction can cause a decedent to leave more wealth to his or her spouse than would otherwise be preferable. For example, a decedent with children from a previous marriage might like to leave more assets to the children but the unlimited marital deduction may make it more attractive to leave assets to a spouse. One way of dealing with this problem is to leave a lifetime interest to the spouse and direct the disposal of the corpus of the trust to children. Indeed, the tax law facilitates this approach by allowing a trust called a Qualified Terminable Interest Property (QTIP) trust. Nevertheless, this approach also requires planning and is not a perfect substitute for directly leaving assets to children (particularly if the spouse has a long prospective life).

The point is that these provisions, whether deemed desirable or undesirable, distort the choices of a decedent and cause more resources to be devoted to estate planning than would otherwise be the case.

A Backstop for the Income Tax

Capital Gains. One reason frequently cited by tax analysts for retaining an estate tax is that the tax acts as a back-up for a source of leakage in the individual income tax — the failure to tax capital gains passed on at death. Normally, a capital gains tax applies on the difference between the sales price of an asset and the cost of

acquiring it (this cost is referred to as the basis). Under current law, accumulated capital gains on an asset held until death will never be subject to the capital gains tax because the heirs will treat the market value at time of death (rather than original cost) as their basis. Assuming market values are estimated correctly, if heirs immediately sold these assets, no tax would be due. This treatment is referred to as "step-up in basis." It is estimated that 36% or more of gains escape taxes through step-up.[24]

The estate and gift tax is not a carefully designed back-up for the capital gains tax. It allows no deduction for original cost basis, it has large exemptions which may exclude much of capital gains from the tax in any case (including the unlimited marital deduction), and the tax rates vary from those that would be imposed on capital gains if realized. In particular, estate tax rates can be much larger than those imposed on capital gains (the current capital gains tax is capped at 20%, while the maximum marginal estate tax rate is 45%).

If the capital gains tax were the primary reason for retaining an estate and gift tax, then the tax could be restructured to impose capital gains taxes on a constructive realization basis. Alternatively, one could adopt a carry-over of basis, so that the basis remained the original cost, although this proposal could still allow an indefinite deferral of gain.

Owner-Occupied Housing, Life Insurance, and Other Assets. Owner occupied housing and life insurance also escape income taxes on capital gains accrued through inside build-up (for the most part). Owner-occupied housing also escapes income tax on implicit rental income. There are practical economic and administrative reasons for some of these tax rules. It is administratively difficult to tax implicit rental income and taxing capital gains could potentially impede labor mobility. There are other assets as well that escape the income tax (such as tax exempt bonds). The estate and gift tax could also be seen as a backstop for these lapses in the individual income tax.

Effects of the Charitable Deduction

One group that benefits from the presence of an estate and gift tax is the non-profit sector, since charitable contributions can be given or bequeathed without paying tax. As shown in **Table 3**, estates that filed returns in 2005 donated 11.0% of total assets to charities; estates that occupy the highest wealth class ($20 million or greater) donated 24.3% of total assets to charity. Although one recent study found that charitable bequests are very responsive to the estate tax, and indeed that the charitable deduction is "target efficient" in the sense that it induces more charitable contributions than it loses in revenue, other studies have found a variety of responses,

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[24] See Poterba, James M. and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized capital Gains at the Time of Death," *National Bureau of Economic Research*, no. 7811, July 2000, p. 36.

both small and large.[25] One problem with these types of studies is the difficulty in separating wealth and price effects.

An individual would have even greater tax benefits if charitable contributions were made during the lifetime, since they are deductible for purposes of the income tax, thereby reducing not only income tax but also, because the eventual estate is reduced, the estate tax as well. On the other hand, under the income tax charitable gifts are limited to 50% of income (30% for private foundations) and there are also restrictions on the ability to deduct appreciated property at full value. Despite this effect, a significant amount of charitable giving occurs through bequests and one study estimated that total charitable giving through bequests would fall by 12% if the estate tax were eliminated.[26] This reduction is, however, less than 1% of total charitable contributions.[27]

Charitable deductions play a role in some estate planning techniques described in the next section. In addition, some charitable deductions allow considerable retention of control by the heirs, as in the case of private foundations. Unlike the case of the income tax, there are no special restrictions on bequests to private foundations. (Under the income tax system, deductibility as a percent of income is more limited for gifts to foundations; there are also more limitations on gifts of appreciated property to foundations).

Efficiency Effects, Distortions, and Administrative Costs

A number of tax planning and tax avoidance techniques take advantage of the annual gift exclusion, the charitable deduction, the unlimited marital deduction, and issues of valuation. Because choices made with respect to these techniques can affect total tax liability, these planning techniques complicate compliance on the part of the taxpayer and administration on the part of the IRS. They may also induce individuals to arrange their affairs in ways that would not otherwise be desirable, resulting in distortions of economic behavior.

The most straightforward method of reducing estate and gift taxes is to transfer assets as gifts during the lifetime (inter-vivos transfers) rather than bequests. Gifts are generally subject to lower taxes for two reasons. First, assets can be transferred without affecting the unified credit because of the $12,000 annual exclusion. The exclusion was designed to permit gifts (such as wedding and Christmas presents) without involving the complication of the gift tax. This annual exclusion can, however, allow very large lifetime gifts. For example, a couple with two children, who are both married, could make $96,000 of tax-free gifts per year (each spouse

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[25] See David Joulfaian, Estate Taxes and Charitable Bequests by the Wealth, National Bureau of Economic Research Working Paper 7663, April 2000. This paper contains a review of the econometric literature on the charitable response. Note that, in general, a tax incentive induces more spending than it loses in revenue when the elasticity (the percentage change in spending divided by the percentage change in taxes) is greater than one.

[26] Ibid.

[27] Bruce Bartlett, Misplaced Fears for Generosity, *Washington Times*, June 26, 2000, p. A16.

could give $12,000 to each child and the child's spouse). Over 10 years, $960,000 could be transferred tax free (and without reducing the lifetime credit). Moreover, the estate is further reduced by the appreciation on these assets.

The effective gift tax is also lower than the estate tax because it is imposed on a tax-exclusive basis rather than a tax-inclusive basis. For example, if the tax rate is 45%, a taxable gift (beyond the $12,000 limit) of $100,000 can be given with a $45,000 gift tax, for an out-of-pocket total cost to the decedent of $145,000. However, if the transfer were made at death, the estate tax on the total outlay of $145,000 would be 45% of the total, or $65,250. Despite these significant advantages, especially from the annual exclusion, relatively little inter-vivos giving occurs.[28] There are a number of possible reasons for this failure to take advantage of the gift exclusion, and one is that the donee does not wish to relinquish economic control or perhaps provide assets to children before they are deemed to have sufficient maturity to handle them. There are certain trust and other devices that have been developed to allow some control to be maintained while utilizing the annual gift tax exclusion.[29] The annual gift exclusion can also be used to shift the ownership of insurance policies away from the person whose life is insured and out of the gross estate.

One particular method that allows a potentially large amount of estate tax avoidance is a Crummey trust. Normally, gifts placed in a trust are not eligible for the $12,000 exclusion, unless the trust allows a present interest by the beneficiary. The courts have held that contributions to a trust that allows the beneficiary withdrawal rights, even if the individual is a minor, and even if withdrawal rights are available for only a brief period (e.g. 15 or 30 days), can be treated as gifts eligible for the annual exclusion. This rule has been used to remove insurance assets from an estate (by placing them in a trust and using the annual $12,000 gift exclusion to pay the premiums without incurring tax). Under the Crummey trust, a large number of individuals (who may be children or other relatives of the primary beneficiaries) can be given the right (a right not usually exercised) to withdraw up to $12,000 over the limited time period. (Under lapse of power rules, however, this amount is sometimes limited to $6,000). All of these individuals are not necessarily primary beneficiaries of the trust but they expand the gift exclusion aggregate. In one case, a Crummey trust with 35 donees was reported.[30]

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[28] See James Poterba. "Estate and Gift Taxes and Incentives for *Inter Vivos* Giving in the United States," forthcoming *Journal of Public Economics*. Even at high income levels, Poterba found that only about 45% of households take advantage of lifetime giving. He also found that those with illiquid assets (such as family businesses) and those with large unrealized capital gains are less likely to make inter-vivos gifts.

[29] For a more complete discussion of this and other techniques, see Richard Schmalbeck, Avoiding Wealth Transfer Taxes, paper presented at the conference Rethinking Estate and Gift Taxation, May 4-5, 2000, Office of Tax Policy Research, University of Michigan, and the Brookings Institution and Charles Davenport and Jay Soled. Enlivening the Death-Tax Death-Talk. *Tax Notes*, July 26, 1999, pp. 591-629.

[30] See Davenport and Soled, *op cit*.

There is, however, one disadvantage of inter vivos gifts: these gifts do not benefit from the step-up in basis at death that allows capital gains to go unrecognized, so that very wealthy families with assets with large unrealized gains might prefer bequests (at least after the annual exclusion is used up).[31]

Individuals can also avoid taxes by skipping generations; although there is a generation skipping tax, there are large exemptions from the tax ($2.0 million per decedent in 2007, the same as the general estate tax exemption amount). Generation skipping may be accomplished through a direct skip (a decedent leaves assets to grandchildren rather than children) or an indirect skip (assets are left in a trust with income rights to children, and the corpus passing to the grandchildren on the children's death). The generation skipping tax rate is 45%. Relatively little revenue has been collected from the generation skipping tax because the tax has been successful in eliminating generation skipping transfers that are above the limit.[32]

Charitable deductions can also be used to avoid estate and gift taxes (and income taxes as well). For example, if a charity can be given rights to an asset during a fixed period (through a fixed annuity, or a fixed percentage of the asset's value), with the remainder going to the donor's children or other heirs, estate taxes can be avoided if the period of the trust is overstated (by being based on a particular individual life that is likely to be shorter than the actuarial life). Although restrictions have now been applied to limit reference persons to related parties, in the past so-called "vulture trusts" that recruited a completely unrelated person with a diminished life expectancy were used to avoid tax.[33]

Assets can also be transferred to charity while maintaining control through private foundations. Private foundations allow an individual or his or her heirs to direct the disposition of funds in the foundations for charitable purposes and continue to exercise power and control over the assets.

As noted earlier, some estate planning techniques are used to provide maximum benefits of the marital deduction plus the exclusion and lower rates; these approaches can also involve the use of trusts, such as the Qualified Terminable Interest Property (QTIP). These plans may permit the invasion of the corpus for emergency reasons.

Finally, a significant way of reducing estate taxes is to reduce the valuation of assets. A lower valuation can be achieved by transferring assets into a family partnership with many interests so that one party is not technically able to sell at a "market price" without agreement from the other owners to sell, a circumstance that the courts have seen as lowering the value of even obviously marketable assets, such as publicly traded stocks (the minority interest discount). Undervaluation can also be

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[31] See David Joulfaian, Choosing Between Gifts and Bequests: How Taxes Affect the Timing of Wealth Transfers. U.S. Department of Treasury Office of Tax Analysis Paper 86. May 2000.

[32] For a description see CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law*, by John R. Luckey.

[33] See Schmalbeck, *op cit*. The reference individual cannot be terminal (have a life expectancy of less than a year), however.

argued through the claim that a sale of a large block of stock (a "fire sale") would reduce asset value or, with a family-owned business, that the death of the owner (or a "key man") lowers the value substantially. A fractional interest in a property (such as real estate) may also qualify for a discount. Discounts may also be allowed for special use property whose market value may be higher than the value of the property in its current use.

Estate planning techniques complicate the tax law, increase the resources in the economy devoted to planning and also increase the administrative burden on the IRS especially when such cases go to court. Some claims have been made that the administrative costs and costs to taxpayers comprise a large part of the revenues. However, a recent study set the costs of complying with the estate tax at 6 to 9% of revenues. Moreover, an interesting argument was also made in that study that the inducement to settle affairs provided by the existence of an estate tax may be beneficial as it encourages individuals to get their affairs in order and avoid costly and difficult disputes among heirs.[34]

Of course, the administrative and compliance costs are, themselves, in part a consequence of the design of the tax. If the estate tax were revised to mitigate some of the need for tax planning, the administrative and compliance costs might be lower.

The high tax rates for some estates and the lack of third-party reporting mechanisms suggest that compliance may be a problem, although a large fraction of returns with large estates are audited. Estimates of the estate "tax gap," or the fraction of revenues that are not collected, have varied considerably; a recent estimate suggests about 13% of estates and gift taxes are not collected, although the authors suggest that this measure is very difficult to estimate.[35]

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[34] See Davenport and Soled, *op cit*. This study also reviewed a variety of other studies of estate tax compliance costs.

[35] See Martha Eller, Brian Erard and Chih-Chin Ho, *The Magnitude and Determinants of Federal Estate Tax Noncompliance*, Rethinking Estate and Gift Taxation, May 4-5, 2000, Office of Tax Policy Research, University of Michigan, and the Brookings Institution.

Repeal of Federal Credit for State Estate and Inheritance Taxes

In theory, the federal credit for state death taxes eliminated the incentive for states to "race to the bottom" of state estate tax rates and burden. Lower state liability simply increased federal liability by an equal amount. In short, the state credit was simply a federal transfer to states contingent upon the state's maintenance of an estate tax. The credit also reduced the federal tax burden of the estate and gift tax. The highest effective credit rate was of 16% of the gross estate value which reduced the highest federal rate of 55% to 39% (before EGTRRA).

In 2005, the "credit for state death taxes" was eliminated and replaced with a deduction for those taxes. Many states have relied on the federal credit for their estate tax and will need to modify their tax laws to continue collecting their estate and inheritance taxes. Under current state laws, "... there will be 29 states that have no state death tax in 2005."[36]

Policy Options

Repealing the Estate and Gift Tax

One option is to eliminate the estate tax. This approach has been taken in the 2001 tax cut bill, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). However, the legislation sunsets after 2010, reverting to what the law would have been in 2011 if not for EGTRRA. During the phase-out period, the estate tax will still generate revenue, thus understating the full fiscal impact (revenue loss) of complete repeal. Immediate repeal of the estate and gift tax would cost up to $662 billion, whereas the estimated 10-year revenue cost of the temporary repeal of the estate tax under EGTRRA was $138 billion.

The Bush Administration's FY2007 budget proposal contained a proposal to permanently repeal the estate and gift tax beginning in 2010 by repealing the EGTRRA sunset. The revenue loss from that proposal would be $369.3 billion over the 2006-2016 budget window. Most of the revenue loss accrues in the out years of the proposal; from 2011 to 2016, the proposal would cost $334.1 billion in lost federal revenue.

Increasing the Credit, Converting to an Exemption, and/or Changing Rates

The two compromise proposals that were described earlier in this report would both increase the exemption (eliminating the credit structure) amount and lower the rate. Recall that the Kyl proposal from the 109th would set the exemption at $5

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[36] Harley Duncan, "State Responses to Estate Tax Changes Enacted as Part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)," *State Tax Notes*, Dec. 2, 2002, p. 615.

million for each spouse ($10 million per couple) and lower the tax rate to 15%. The Baucus proposal would set the exemption at $3.5 million and include a progressive rate schedule beginning at 15% and rising with the size of the estate to 35%. The relatively low rate of 15% is responsible for most the revenue loss under the Kyl proposal. No potential revenue loss estimates are available for the Baucus proposal, although it would be less expensive than the Kyl proposal given the graduated rate structure.

Under H.R. 5970, as passed in the 109th Congress, the tax rate on taxable estates up to $25 million would be equal to the tax rate on capital gains (currently 15% but scheduled to revert to 20% in 2011). The tax rate on estates valued over $25 million would drop to 30% by 2015. The JCT estimated that the estate tax provisions of H.R. 5970 would cost $268 billion over FYs 2007-2016, or about 69% of total repeal.[37]

For the same revenue cost, increasing the exemption would favor individuals with small estates and rate reductions would favor large estates. Indexing exemptions for inflation would preserve the value of the exemption against erosion by price inflation.

Taxing the Capital Gains of Heirs vs. the Estate Tax

In 2010, the estate tax will be replaced by a tax on the capital gains of heirs when an inherited asset is sold. The new law includes an exemption from carryover basis for capital gains of $1.3 million (and an additional $3 million for a surviving spouse). There are efficiency losses to taxing capital gains of heirs on inherited assets because such taxation would increase the lock-in effect. The lock-in effect occurs when potential taxpayers hold onto their assets because the anticipated tax on the gain. If the asset value grows from generation to generation, the lock-in effect becomes stronger and stronger. Some analysts have suggested that the result of the lock-in effect will be familial asset hoarding. Legislation that repeals the EGTRRA sunset would retain this treatment of capital gains.

Both taxation of gains at death and carry-over basis may be complicated by lack of information by the executor on the basis of assets (some of which may have been originally inherited by the decedent). Indeed, a proposal in the 1970s to provide carry-over basis was never put into place because of protests, some associated with the problem of determining the basis. This problem may be less serious for EGTRRA because of the carry-over of basis exemption.

Allowing constructive realization or carryover basis may further complicate estate planning if an exemption were allowed, because it would be advantageous to pick those assets with the largest amounts of appreciation for the exclusion or carryover basis. In addition, since the tax arising from carryover basis would depend

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[37] Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 5970, The "Estate Tax and Extension of Tax Relief Act of 2006 ('ETETRA')," as introduced in the House of Representatives on July 28, 2006*, JCX-34-06, 109th Congress, July 28, 2006.

on the heir's income tax rates, revenues could be saved by allocating appreciated assets to heirs with the lowest expected tax rates.

Changing from the current step-up basis for inherited assets to a carryover basis, as enacted by EGTRRA, will also affect the life insurance choices of taxpayers. Generally, EGTRRA will likely encourage taxpayers to invest more in life insurance than other investments. Under current tax law, the appreciation of assets held in life insurance policies is not subject to capital gains taxes. Also, the payout from these policies, usually in cash to heirs, is not subject to income taxes and effectively receives a stepped up basis. The switch to carryover basis at death would then favor life insurance policies over other assets that are subject to capital gains taxes at death (assuming the heir liquidates the assets). The anticipated change to more assets held in life insurance policies will likely reduce the revenue generated by capital gains taxes.

Concerns of Farms and Family Businesses

If the estate tax is not repealed, farms and family businesses may be targeted for further relief by increases in the special exemptions for farm and business assets.[38] Because of the asset distribution of estates, almost all decedents with significant farm or business assets would likely not pay an estate tax. While this approach would be effective at targeting family farms and businesses for relief, it would exacerbate a general concern with the estate and gift tax — the unfairness of a differential treatment of owners of these business and farm assets compared to those with other forms of assets. Why should a wealthy individual whose assets are in a closely held corporation escape estate and gift tax on his or her assets, while an individual who holds shares in a publicly traded corporation pay a tax?

Larger exemptions also encourage wealthy decedents to convert other property into business or farm property to take advantage of the special exemptions. An incentive already exists to shift property into this exempt form and it would have been exacerbated by an expansion of the exemption.

Reform Proposals and Other Structural Changes

Many pre-EGTRRA proposals were intended to modify rather than completely repeal the estate tax. Some of these proposals may be revisited as the subset provision in EGTRRA nears. The proposed revisions would have focused on eliminating estate tax avoidance schemes or at fixing current inconsistencies in the estate tax law. The issues presented here are still relevant for the near term for two reasons. One, during the phase-out period, the estate and gift is still part of the tax code. Two, the gift tax is retained even after eventual repeal of the estate tax.

Phase out of Unified Credit for Largest Estates. This provision would allow for a phase out of the unified credit as well as the lower rates, by extending the

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[38] For more on the estate tax and its effect on family businesses, see CRS Report RL33070, *Estate Taxes and Family Businesses: Economic Issues*, by Jane Gravelle and Steven Maguire.

bubble. This provision would cause all assets in large estates to be taxed at the top rate of 47%.

Impose Consistent Valuation Rules. Analysts have proposed that valuation of assets be the same for income tax purposes as for estate tax purposes. Basically, it is advantageous to *overvalue* assets for purposes of the income tax, so as to minimize any future capital gains tax liability. Conversely, its advantageous to *undervalue* assets to minimize estate tax liability. In addition to requiring consistency in valuation, some have proposed that donors report the basis of assets given as gifts. Currently, assets transferred by gift and then sold do not benefit from step-up in basis even though the donor is not required to report the basis to the donee.

Modify the Rules for the Allocation of Basis. Under current law, a transaction that is part gift and part sale assigns a basis to the asset for the donee that is the larger of the fair market value or the amount actually paid. The donor pays a tax on the difference between amount paid and his basis and may frequently recognize no gain. This proposal would allocate basis proportionally to the gift and sale portions.[39]

Eliminate Stepped up Basis on Survivor's Share of Community Property. Under present law, in common law states, half of property held jointly by a married couple is included in the first decedent's gross estate and that half is thus eligible for step-up in basis for purposes of future capital gains. In community property states, however, where all properties acquired during marriage are deemed community property, a step up in basis is available for all community property, not just the half that is allocated to the decedent spouse. The reason for this rule, which is quite old, was the presumption in the past that property in a common law state would have been held by the husband (who would have acquired it) and thus would all have been eligible for step-up, while only one half of property in community property states would have been deemed to be held by the husband and be eligible for step up. This older treatment, it is argued, was made obsolete by changes in 1981 that determined that only half of any jointly held property would be included in the estate regardless of how the property was acquired, and thus made the step up apply to only one half of this type of property. Thus, currently couples in community property states are being treated more favorably than those in common law states.

A reservation with this treatment is that property that could be allocated to one spouse in a common law state may not be able to escape the community property treatment in a community property states, and common law states may now be favored if these assets in common law states tend to be held by the first decedent. However, couples in community property states may be able to convert to separate

[39] For example, suppose an asset with a basis of $50,000 but a market value of $100,000 is sold to the donee for $50,000. The donor would realize no gain and the gift amount would be $50,000, with the donee having a basis of $50,000. Eventually, the gain would be taxed when the donee sold the property, but that tax would be delayed. However, if the asset were divided into a gift of $50,000 with a basis of $25,000 and a sale of $50,000 with a basis of $50,000, the donor would realize a gain of $25,000; the donee would now have a basis of $75,000. Half of the gain would be subject to tax immediately.

property by agreement, and thereby take advantage of the same planning opportunities as those in common law states.

Modify QTIP Rules. Under present law, an individual may obtain a marital deduction for amounts left in trust to a spouse under a Qualified Terminable Interest Property (QTIP) trust, with one requirement being that the second spouse must then include the trust amounts in their own estate. In some cases the second estate has argued that there is a defect in the trust arrangement so that the trust amount is not included in the second spouse's estate (even though a deduction was allowed for it in the first spouse's estate). This provision would require inclusion in the second spouse's estate for any amount excluded in the first spouse's estate.

Eliminate Non-Business Valuation Discounts. This provision would require that marketable assets be valued at the fair market value (i.e., there would be no valuation discounts for holding assets in a family partnership or for "fire-sale" dispositions).

Eliminate the Exception for a Retained Interest in Personal Residences from Gift Tax Rules. Under current law, when a gift is made but the grantor retains an interest, that retained interest is valued at zero (making the size of the gift and the gift tax larger). In the case of a personal residence, however, the retained interest is valued based on actuarial tables. In general, retained interests are only allowed to be deducted from the fair market of the gift (reducing gift taxes) if they can be objectively valued (and hence are allowed for certain types of trusts, such as those that pay an annuity).

Disallow Annual Gift Taxes in a Crummey Trust. As noted earlier, the annual gift exclusion is not available for gifts placed in trust unless certain rules are met, but a Crummey trust, which allows some right of withdrawal, is eligible. This revision would allow gifts in trust to be deductible only if the only beneficiary is the individual, and if the trust does not terminate before the individual dies, the assets will be in the beneficiary's estate. These rules are similar to generation skipping taxes.

Reduce the Annual Gift Tax Exclusion. The annual gift tax exclusion allows significant amounts to be transferred free of tax and also plays a role in transferring insurance out of the estate (by using the annual gift tax exclusion to pay the premium). While some gift tax exclusion is probably desirable for simplification purposes, the $12,000 exclusion's role in estate tax avoidance could be reduced by reducing its size. An alternative change that would limit the use of the annual exclusion in tax avoidance approaches would be a single exclusion per donor (or some aggregate limit per donor), to prevent the multiplication of the excluded amount by gifts to several children and those children's spouses and the use of techniques such as the Crummey trust.

Allow Inheritance of Marital Deductions or Lower Rates. One of the complications of estate planning is maximizing the use of the exemption and lower rate brackets by a married couple. In this case, while it may be economically and personally desirable to pass the entire estate (or most of the estate) to the surviving spouse, minimizing taxes would require passing to others at least the exemption

amount and perhaps more to take some advantage as well of the lower rate brackets. Such complex situations could be avoided by allowing the surviving spouse to inherit any unused deduction and lower rate brackets so that the couple's full deductions and lower rates could be utilized regardless of how much was left to the surviving spouse.

Allow Gift Tax Treatment Only on Final and Actual Transfer. Many of the tax avoidance techniques with charitable gifts involve over-valuation of a deductible interest. For example, a gift may be made of the remainder interest after an annuity has been provided to a charitable organization . The larger the value of the charitable annuity, the smaller the value of the gift (and the gift tax). One way to over-value an annuity is to allow the annuity to extend to a particular individual's lifetime, when that individual has a shorter life than the actuarial tables indicate. Similarly, a way to transfer income via the gift tax exclusion without the recipient having control over it is to place it in a Crummey trust. Even if the individual is able to exercise withdrawal rights, the expectation of not receiving future gifts if the assets are withdrawn in violation of the donor's wishes may mean that such rights will never be exercised. A rule that excludes all assets placed in trusts from consideration for the gift tax would eliminate this mechanism.

These types of valuation techniques could be addressed by only allowing the gift tax to be imposed at the time of the actual final transfer. In such a case, no actuarial valuation would be necessary and no trust mechanisms would be available.

Valuation of Assets. One option is to disallow discounts for property that has a market value (such as bonds and publicly traded stock) regardless of the form the asset is held in, as suggested by the administration tax proposals. Such a change would prevent the avoidance technique of placing assets into a family partnership or similar arrangement and then arguing that the property has lost market value because it would require agreement of the heirs to sell it. In addition, other limits on valuation discounts could be imposed. For example, blockage discounts based on "fire sale" arguments could be disallowed. Such a provision might allow for an adjustment if the property is immediately sold at such a lower price.

Include Life Insurance Proceeds in the Base. Some tax avoidance techniques are associated with shifting life insurance proceeds out of the estate by shifting to another owner.

Switch to an Inheritance Tax. Some authors have suggested that an inheritance tax should be substituted for the estate tax. Some states have inheritance taxes. An estate tax applies to the total assets left by the decedent. An inheritance tax would be applied separately to assets received by each of the heirs. If tax rates are progressive, smaller taxes would be applied the greater the number of beneficiaries of the assets. One reason for such a change would, therefore, be to encourage more dispersion of wealth among heirs, since taxes would be lower (assuming exemptions and graduated rates) if split among more recipients. In addition, under an inheritance tax the tax rate can be varied according to the status of the heir (son vs. cousin, for example). At the same time, one can see more avoidance complications arising from an inheritance tax.

Conclusion

The analysis in this report has suggested that some of the arguments used for and against maintaining the estate tax may be questioned or of lesser import than is popularly assumed. For example, there is little evidence that the estate tax has much effect on savings (and therefore on output); indeed, estate taxes could easily increase rather than reduce savings. Similarly, only a tiny fraction of farms and small businesses face the estate and gift tax and it has been estimated that the majority of those who do have sufficient non-business assets to pay the tax. Moreover, only a small potion of the estate tax is collected from these family owned farms and small businesses, so that dramatically reducing estate tax rates or eliminating the tax for the purpose of helping these family businesses is not very target efficient.

Although the estate tax does contribute to the progressivity of the tax system, this progressivity is undermined, to an undetermined degree, by certain estate tax avoidance techniques. Of course, one alternative is to broaden the estate tax base by restricting some of these estate planning techniques. At the same time progressivity could be achieved by other methods.

On the other hand, arguments that the estate tax is a back-up for the income escaping the capital gains tax, would not support the current high rates of the estate tax, which should be lowered to 20% or less to serve this purpose.

More intangible arguments, such as the argument that inheritances are windfalls that should be taxed at higher rates on the one hand, or that death is an undesirable time to levy a tax and that transferred assets have already been subject to taxes, are more difficult to assess but remain important issues in the determination of the desirability of estate and gift taxes.

Appendix: Estate and Gift Tax Data

Table A1. The Filing Requirement and Unified Credit

Year of Death	Filing Requirement or Equivalent Exemption	Unified Credit
2004 and 2005	$1,500,000	$555,800
2006 through 2008	$2,000,000	$780,800
2009	$3,500,000	$1,525,800
2010	estate tax repealed	estate tax repealed
2011 and after	$1,000,000	$345,800

Table A2. Gross Estate Value of Taxable Returns Filed in 2005

Size of Gross Estate	All Returns	Taxable Returns	Gross Estate Value (in 000s)	Gross Taxable Estate Value (in 000s)	Percent Taxable Estate Tax Returns
All Returns	39,482	18,430	192,635,099	101,771,906	46.68%
$1.5 to $2.5 million	21,347	8,668	70,145,137	16,866,733	40.61%
$2.5 to $5.0 million	11,895	6,162	36,984,942	20,763,258	51.80%
$5.0 to $10.0 million	4,122	2,280	25,957,237	15,590,318	55.31%
$10.0 to $20 million	1,358	822	17,906,950	11,251,943	60.53%
over $20.0 million	760	498	41,640,833	37,299,654	65.53%

Source: Internal Revenue Service, Statistics of Income, *Estate Tax Returns Filed in 2005*, IRS, SOI unpublished data, November 2006.

Table A3. Allowable Deductions on 2005 Returns

(Sorted by Total Value)

Deduction	Returns with Deduction		Value of Deductions (in millions)	
	Total	Taxable	Total	Taxable
Total deductions	$39,445	$18,396	$83,082,614	$28,508,260
Bequests to surviving spouse	$18,224	$1,708	$53,679,406	$8,915,127
Charitable deductions	$8,074	$4,344	$19,563,951	$13,532,457
Debts and mortgages	$29,108	$16,244	$6,311,729	$3,176,059
Executor's commissions	$13,691	$11,192	$1,081,099	$957,111
Other expenses and losses	$24,284	$15,822	$1,022,600	$893,681
Attorney's fees	$24,061	$15,964	$869,710	$685,026
Funeral expenses	$34,356	$17,599	$326,382	$161,877
State death taxes paid	$673	$400	$119,740	$104,710

Source: Internal Revenue Service, Statistics of Income, *Estate Tax Returns Filed in 2005*, IRS, SOI unpublished data, November 2006.

Table A4. 2007 Estate Tax Rate Schedule

Taxable Estate Value From	to	Current Statutory Rate (in Percent)
$0	$10,000	18
$10,001	$20,000	20
$20,001	$40,000	22
$40,001	$60,000	24
$60,001	$80,000	26
$80,001	$100,000	28
$100,001	$150,000	30
$150,001	$250,000	32
$250,001	$500,000	34
$500,001	$750,000	37
$750,001	$1,000,000	39
$1,000,001	$1,250,000	41
$1,250,001	$1,500,000	43
$1,500,001	and over	45

Table A5. Repealed Credit for State Death Taxes

Note: In 2005, the credit was repealed and replaced with a deduction.

Taxable Estate Value (less the $60,000 exemption)	to	Current Statutory Credit Rate (in Percent)
$0	$40,000	0
$40,001	$90,000	.8
$90,001	$140,000	1.6
$140,001	$240,000	2.4
$240,001	$440,000	3.2
$440,001	$640,000	4.0
$640,001	$840,000	4.8
$840,001	$1,040,000	5.6
$1,040,001	$1,540,000	6.4
$1,540,001	$2,040,000	7.2
$2,040,001	$2,540,000	8.0
$2,540,001	$3,040,000	8.8
$3,040,001	$3,540,000	9.6
$3,540,001	$4,040,000	10.4
$4,040,001	$5,040,000	11.2
$5,040,001	$6,040,000	12.0
$6,040,001	$7,040,000	12.8
$7,040,001	$8,040,000	13.6
$8,040,001	$9,040,000	14.4
$9,040,001	$10,040,000	15.2
$10,040,001	and over	16.0

Table A6. Wealth Distribution of Taxable Returns Filed in 2005

Size of Gross Estate	Taxable Returns	Gross Taxable Estate Value (millions)	Net Estate Tax (millions)	Percent of Taxable Estate Returns	Percent Federal Estate Tax Value
All Returns	$18,430	$101,771,906	$21,520,989	100.00%	100.00%
1.5 to 2.5 million	$8,668	$16,866,733	$1,550,048	47.03%	16.57%
2.5 to 5.0 million	$6,162	$20,763,258	$4,393,227	33.43%	20.40%
5.0 to 10.0 million	$2,280	$15,590,318	$4,477,023	12.37%	15.32%
10.0 to 20 million	$822	$11,251,943	$3,275,972	4.46%	11.06%
over 20.0 million	$498	$37,299,654	$7,824,719	2.70%	36.65%

Source: Internal Revenue Service, Statistics of Income, *Estate Tax Returns Filed in 2005*, IRS, SOI unpublished data, November 2006.