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Visions of Tax Reform Without Estate Tax Changes

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It must be spring because proposals for overhaul of the tax system are blooming. The newspaper is brimming with suggestions, some serious and well thought out, others glib and hostile.

In recent weeks, Rep. David Camp (R-MI), chairman of the Ways and Means Committee, released a discussion draft of a roadmap for tax reform. Interestingly, it includes no reform of the estate tax. The proposals are focused on the income tax, both for individuals and for corporations. In some ways reminiscent of the Tax Reform Act of 1986, Camp's proposal seeks to lower rates and broaden the tax base. On the individual side, he proposes to have three tax brackets-10%, 25%, and 35%-and no alternative minimum tax (AMT). To pay for the reduced rates, he would eliminate the deduction for state and local taxes, limit the mortgage interest deduction to interest on $500,000 of debt, and subject charitable contribution deductions to a 2% floor. Corporate income tax rates would be reduced to 25%. Revenue raisers on the corporate side would include repealing accelerated depreciation and LIFO accounting rules, and requiring research and advertising expenses to be amortized. He would also overhaul the tax system for multinational companies.

Even the proposal of Sen. Ted Cruz (R-TX) is silent on the estate tax. Cruz says simply that "we need to abolish the IRS" and we should replace the income tax with a flat tax so that everyone can file their taxes

on a postcard. (I guess he has not heard about e-filing.)

It seems that the estate tax debate is limited to rates and exemptions. Over its nearly 100 years of existence, the estate tax has had rate or exemption changes in over 30 years. The first estate tax was enacted in 1916 after discussion over the course of a decade. President Theodore Roosevelt argued for an estate tax as early as 1906. As support for enactment of an estate tax, Roosevelt turned to one of the traditional arguments for taxes on wealth: "The man of great wealth owes a peculiar obligation to the State because he derives special advantages from the mere existence of government." 1 Similarly, the House Report from the 1916 enactment of the first estate tax stated, "It is therefore deemed proper that, in meeting the extraordinary expenditures for the Army and Navy, our revenue system should be more evenly and equitably balanced and a larger portion of our necessary revenues collected from the income and inheritances of those deriving the most benefit and protection from the Government." 2

Purpose of the estate tax

Historically, taxes at death were motivated by a collection of economic and philosophical factors. The country needed funds to finance the military through World War I. Although an income tax had been imposed after enactment of the 16th Amendment to the Constitution, additional revenues were needed. Economically it made sense to try to collect those revenues from those who were most able to pay, the wealthy.

The addition of an estate tax also added to the overall progressivity of the tax system. Philosophically, an estate tax burdened those who were thought to benefit the most from the existence of government, and it served to redistribute wealth at the end of a lifetime to avoid accumulation of the rewards from the industrial revolution in the hands of a few families.

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Historical rates and exemptions

The first estate tax imposed tax at rates ranging from 1% to 10%. The first $50,000 of wealth was exempt, and the top bracket-a 10% tax rate-applied to estates greater than $5 million. The tax raised about $6 million of revenue in its first fiscal year. The $50,000 exemption from 1916 would be worth about $1.131 million in 2014 dollars, and the $5 million threshold for the top bracket would be the equivalent of the top bracket applying to estates of $113 million and over in today's dollars.

The exemption amount stayed relatively fixed through 1976. Tax acts in 1976, 1981, 1997, and 2001 phased in increases in the exemption amount, and legislation in 2012 permanently indexed the exemption for inflation. In real dollars, the increases have greatly exceeded inflation. (See Exhibit 1.)

Exhibit 1. Estate Tax Exemption Amount

Years	Exemption Amount
1916-1925	$ 50,000
1926-931	100,000
1932-1934	50,000
1935-1941	40,000
1942-1976	60,000
1977	120,000
1978	134,000
1979	147,000
1980	161,000
1981	175,000
1982	225,000
1983	275,000
1984	325,000
1985	400,000
1986	500,000
1987-1997	600,000
1998-2001	625,000
1999	650,000
2000-2001	675,000
2002-2003	1,000,000
2004-2005	1,500,000
2006-2008	2,000,000
2009	3,500,000
2010-2014	5,000,000 (indexed)

Source: Internal Revenue Service, SOI Bulletin.

Federal estate tax rates were modest in 1916, but increased quickly to finance wars. In 1917, the top rate rose from 10% to 25%. In 1932, the top rate was 45%, but it was increased again to 60% in 1934 and to 70% in 1935. The top marginal rate of 70%, however, applied only to estates in excess of $50 million, the equivalent of $832 million today. The top marginal rate remained at 70% or more until 1981, when it started a gradual decline that has now brought the top rate down to 40%. (See Exhibit 2).

Exhibit 2. Top Estate Tax Rate and Bracket Threshold

Years	Top Marginal Rate	Top Bracket Starts At
1916	10.0	$ 5,000,000

1917-1923	25.0	10,000,000
1924-1925	40.0	10,000,000
1926-1931	20.0	10,000,000
1932-1933	45.0	10,000,000
1934	60.0	10,000,000
1935-1940	70.0	50,000,000
1941-1976	77.0	10,000,000
1977-1981	70.0	5,000,000
1982	65.0	4,000,000
1983	60.0	3,500,000
1984-2001	55.0	3,000,000
2002-2003	50.0	2,500,000
2003	49.0	2,500,000
2004	48.0	2,000,000
2005	47.0	2,000,000
2006	46.0	1,500,000
2007-2009	45.0	1,500,000
2010-2012	35.0	500,000
2013-2014	40.0	1,000,000

Source: Internal Revenue Service, SOI Bulletin.

The increases in exemption have had a profound impact on the percentage of decedents subject to the estate tax. Over most of its lifetime, the estate tax burden has fallen upon 1% to 2% of decedents. However, with increased inflation in the 1960s and 1970s (not accompanied by increases in exemption), the percentage of decedents subject to estate tax climbed to a peak of 7.65% in 1976, a year in which 139,115 estates filed returns showing estate tax due. A series of increases in the exemption amount starting in 1977, along with the enactment of an unlimited marital deduction in 1981, reversed the trend. In 2011, 3,270 taxable returns were filed, representing 0.13% of decedents. Since the exemption is now indexed, the number of returns and percentage of decedents paying tax are likely to remain well under 1%. (See Exhibit 3.)

Exhibit 3. Frequency of Taxable Returns

Year	Number of Taxable Returns	As a Percentage of Deaths
1934	8,655	.88
1944	13,869	1.12
1954	25,143	1.89
1965	67,404	4.27
1976	139,115	7.65
1984	30,436	1.55
1994	32,565	1.47

1999	53,819	2.30
2002	28,074	1.17
2004	19,294	0.82
2006	15,449	0.65
2009	6,100	0.25
2012	3,737	0.14

Source: Internal Revenue Service, SOI Bulletin.

Alternatives to the estate tax

If policy makers wanted to do more than tinker with rates and exemptions, what might they consider? There is no need to reinvent the wheel. We can see several possible models in the laws of other countries.

Inheritance tax. Many European countries have an inheritance tax rather than an estate tax. Typically inheritances taxes differ from estate taxes in that inheritance taxes are imposed on the recipient rather than on the estate. Taxing the recipient enables the government to base the tax rate on the relationship between the decedent and the heir. It is common for the rate to be lowest (often zero) for a spouse, somewhat higher for children, higher yet for grandchildren, and highest for collateral relatives or non-related persons. Rates varying with consanguinity could take the place of a generation-skipping transfer tax.

Query whether an inheritance tax has any advantages over an

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estate tax. Part of the answer depends on whether redistribution of wealth is considered a significant purpose of a tax at death. In other words, should the tax burden be different if a decedent has an estate of $10 million and leaves it to one child as opposed to an estate of $10 million split among five children? The redistribution argument supports a lower tax in the latter situation.

Taxing capital gains at death. Canada repealed its inheritance tax in 1972 in favor of taxing capital gains at death. Under the current Canadian system, the taxes can be deferred if the property passes to a spouse (or a qualified trust for the spouse's benefit), to a minor child, or to a disabled person. There is also an exemption for the decedent's residence. Otherwise, the net capital gains (capital losses are subtracted from capital gains) are included on the decedent's last income tax return and taxed at one-half the rate of ordinary income.

The typical complaint about taxing capital gains at death is that death is not a liquidity event, and the estate may not have sufficient liquid assets to pay the tax. However, this complaint is equally valid for the current estate tax. Some provision similar to our extension of time to pay estate tax attributable to

interests in closely held businesses could be adopted for the capital gains tax. Canada has adopted such a provision.

Carryover basis. An alternative system that does not impose a tax when there is no liquidity event is the Australian carryover basis regime. When Australia abolished its estate tax in 1979, it also got rid of the step up in basis at death. Typically the Australian capital gains tax applies to any change in ownership, but an exception is made for transfers from the decedent to the personal representative or the beneficiary, and from the personal representative to a beneficiary. With these exceptions in place, the heir receives the property with a carryover basis, and does not have to pay the capital gains tax on inherited property until it is sold.

Carryover basis is strongly disfavored in the U.S., even though it has much to recommend it. Congress has twice enacted carryover basis. The first time, in 1976, it was repealed retroactively. The second time, in 2001, it took effect for a single year and only for a vast minority of decedents. Carryover basis does present a disincentive to selling inherited property. On the positive side, however, it addresses complaints of double taxation and illiquidity.

Treat gifts and inheritances as income. Another system similar to the Canadian law would be to repeal **Section 102** and include gifts and bequests in income. The beauty of that system is that it would be fully integrated with the income tax, and would not require any additional returns to be filed for gift or estate tax. In addition, because the gifts and bequests would be included in the recipient's income, the tax would function like an inheritance tax, in that the rate would depend on the recipient's income. With either this proposal or a carryover basis regime, a significant exemption would need to be created in order to avoid a loss of progressivity to the tax system.

An overhaul of the U.S. tax system really should consider these alternatives to the estate tax, to determine whether any of them would better serve the modern purposes of an estate tax.

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Administration's legislative proposals

The Administration's budget proposals do not contain any global revision of the estate tax, but various proposals are of interest to estate planners. Many of the proposals this year are repeats from last year, but two new proposals are included. [3]

One of the new proposals would change the annual exclusion from gift tax. The proposal would eliminate the ability to give multiple people *Crummey* powers in order to multiply the available annual exclusions. Instead, the annual exclusion would be available for only outright gifts and gifts in trust that satisfy the GST requirements for annual exclusion: The trust must have a single beneficiary and the assets of the trust must be included in that beneficiary's estate at death. The proposal would also create a new annual exclusion that does not require a present interest. This new exclusion would allow $50,000 per donor per

year to be transferred in trust, via transfers of interests in pass-through entities, or transfers of other restricted interests. This aspect of the proposal amounts to a limited reversal of the government victories in *Hackl*, **4** *Fisher*, **5** and *Price.* **6** Overall, taxpayers who are not relying on *Cristofani* **7** to multiply annual exclusions might find this proposal a positive development.

The other new proposal expands the scope of the definition of "executor" under the Code. Under current law, the term "executor" is defined only for purposes of the estate tax. Through its experience with the offshore voluntary disclosure program, the government has concluded that it would be useful to have "executor" defined for all purposes under the Internal Revenue Code. This proposal would expand the applicability of the existing definition. It would allow an executor to take any action with respect to pre-death tax liabilities that the decedent could have taken during life. In addition, the proposal would give the Treasury the power to adopt rules resolving conflicts among multiple persons who all satisfy the statutory definition of executor.

The other estate and gift tax proposals in the Administration's budget this year include the following proposals that were also put forward last year:

> (1) Restoring the estate, gift, and generation-skipping transfer tax rates and exemption levels to those in effect in 2009.
> (2) Requiring that recipients of gifts and bequests use the donor's basis (in the case of a gift), adjusted for certain gift tax paid, or the date of death value as determined for estate tax purposes (in the case of a bequest) as their basis for income tax purposes.
> (3) Requiring a minimum term of ten years and a maximum term of the life expectancy of the annuitant for GRATs.
> (4) Causing the GST exemption allocated to a trust to expire after 90 years.
> (5) Coordinating the income tax and transfer tax treatment when the owner of a grantor trust engages in a sale-type transaction with the grantor trust.
> (6) Extending the estate tax lien to 14 years where the estate makes an election to pay the estate tax on a closely held business interest over 14 years.
> (7) Modifying the GST provision for distributions for health and education so that it applies only to payments made directly by the donor and not to distributions from a trust. **8**

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The fate of these proposals is not likely to be different from last year. As has been typical in recent years, the Administration's tax proposals were declared "dead on arrival" at Congress, and were never even put into legislative form. Nevertheless, these proposals could be picked up by any congressperson who is working on tax legislation as a means of paying for other tax law changes.

Of the provisions that seek to prevent transactions of interest to the government, the one that has garnered the most media attention is the proposal to require grantor retained annuity trusts (GRATs) to have a minimum term of ten years. Several news articles have been published recently outlining how wealthy individuals have transferred billions of dollars in assets to family members without payment of gift

tax through zeroed-out GRATs. **9** Media attention to this issue increases the possibility that legislation could be introduced to limit the use of GRATs.

In all other respects, it appears to be business as usual in Washington. My general sense is that Congress is done adjusting rates and exemptions for now. No one is advocating for big picture reform of the estate tax. Rather, the Administration's proposals seem either targeted against transactions that the government finds distasteful or aimed at providing administrative help to the IRS.

1

T. Roosevelt, "State of the Union Address" (12/3/1906).

2

H. Rep't. No. 64-922, at 3 (1916).

3

Complete descriptions of these proposals are available in the *General Explanation of the Administration's Fiscal Year 2015 Revenue Proposals*, Department of the Treasury, March 2014, available online at
http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf.

4

118 TC 279 (2002), *aff'd* 92 AFTR2d 2003-5254 335 F.3d 664 (CA-7, 2003).

5

105 AFTR 2d 2010-1347 , 2010-1 USTC ¶60588 (DC Ind., 2010)

6

TC Memo 2010-2 , RIA TC Memo ¶2010-002 .

7

97 TC 74 (1991).

8

Most of these repeat proposals were discussed in this column in June 2013. See Kaufman , "Transfer Tax Certainty Is Here! What Now?" 40 ETPL 39 (June 2013).

9

See, e.g., Mider, "Accidental Tax Break Saves Wealthiest Americans $100 Billion," Business Week (12/17/2013), available on line at
http://www.businessweek.com/news/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion.

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