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On the Centennial Anniversary of the Estate Tax

This year we celebrate the 100th anniversary of the federal estate tax, the tax everyone loves to hate. This is a good time to reflect on the history and purpose of the tax, the role it plays in our progressive tax system, and what the future might hold for it.

The modern federal estate tax was enacted into law on 9/8/1916.[1] Although Congress had previously imposed various tariffs on death, primarily to fund specific war efforts, the exactments had all been temporary. The circumstances that led to the enactment of the modern estate tax in 1916 were unique in the history of the U.S. First, the boom in industrialization and manufacturing led to concentrated wealth in the hands of a small number of businessmen. This was the era of Andrew Carnegie, John D. Rockefeller, and Andrew Mellon, to name a few. President Theodore Roosevelt advocated for an estate tax to address the growing inequalities in wealth in the U.S. In Roosevelt's words: "The man of great wealth owes a peculiar obligation to the State because he derives special advantages from the mere existence of government."[2]

As Roosevelt implied, there was a sense that the wealthy benefited most from the stability provided by the government. Those who owned property relied on the army and navy to protect their interests, while the poor had less to defend.

Politicians also put forth economic arguments for the estate tax. On the verge of World War I, the U.S. needed revenue. The income tax was already in effect. An estate tax was another way to raise revenue and add to the overall progressivity of the tax system.

Evolution of the estate tax

The estate tax as enacted in 1916 provided an exemption for the first $50,000 of wealth for residents, but no exemption for nonresidents who owned U.S. property. The tax rates ranged from 1% to 10%, with the 10% rate applying to estates in excess of $5 million. In 1917, the estate tax raised $6 million in revenue.

In the intervening 100 years, the estate tax has been modified repeatedly. The base was broadened in 1918 to include exercised general powers of appointment and life insurance payable to the estate.[3] That act also added a charitable contribution deduction. In 1924, Congress added a state death tax credit (equal to 80% of the federal tax!) and also enacted a gift tax.[4] The gift tax got off to a rocky start: It was repealed in 1926[5] after a mere two years in effect, and then reenacted in 1932.[6] The second time, it stuck. The gift tax was needed as a backstop to the estate tax, because, without it, the estate tax could be avoided by making lifetime gifts.

After the harsh experience of the stock market crash of 1929, Congress in 1935 added an alternate valuation date election.[7] As originally enacted, the estate could opt to use the value of assets one year after the decedent's death if asset values had declined.

In 1948, a marital deduction was added to the estate tax for the first time.[8] The marital deduction provision allowed a deduction for up to one-half of a decedent's adjusted gross estate for property (other than community property) passing to a surviving spouse. This provision was intended to level the playing field between community property and non-community property states. A similar marital deduction provision was also added to the gift tax. The concept of gift-splitting was also introduced in 1948.

The next major changes to the estate tax occurred in 1976, when

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From the Editor

With the completion of this column, Beth Shapiro Kaufman is retiring from her position as the *Washington Watch* columnist for Estate Planning. Ms. Kaufman's insights have been gracing our pages for the past decade. Over this time, the scope of her coverage has been impressive, providing perspectives on a wide range of estate planning issues arising in our nation's capital. We appreciate her excellent work and wish her the best in future endeavors.

the tax was 60 years old. The Tax Reform Act of 1976[9] "unified" the estate and gift taxes, applying a single exemption, to be used against either lifetime gifts or bequests, and a single run up the brackets applicable to both taxes. The annual exclusion from gift tax was set at $3,000. Special provisions were added to the Code to benefit farms and small businesses. The special-use valuation provisions allowed property to be valued at its current-use value rather than its highest and best-use value. In addition, certain small businesses were allowed to pay estate tax in installments to try to avoid the need to sell a closely held business in order to raise funds to pay estate taxes.

The Tax Reform Act of 1976 also included two important but ill-fated provisions. First, the Act put into place a carryover basis system, creating a general rule that property inherited from a decedent would keep the decedent's basis in the hands of the heir or legatee. After postponement of the effective date for carryover basis, the provision was finally repealed retroactively in 1980, such that it never actually went into effect. Second, the Act included the system's first generation-skipping transfer tax. This tax applied to transfers that benefitted the "child" generation without causing inclusion in the child's estate (i.e., gifts in trust), but did not apply to what we would now call "direct skips." The tax applied at the time of the child's death.

The Economic Recovery Tax Act of 1981[10] also introduced significant changes, most notably the unlimited marital deduction and the creation of qualified terminable interest trusts. Along with those changes, the Act also automatically included in the estate one-half of property jointly owned with a spouse, without regard to which spouse contributed to purchase the property. In addition, the annual exclusion from gift tax was increased to $10,000.

The generation-skipping transfer tax enacted in 1976 was retroactively repealed in 1986.[11] Lore has it that the tax was so easy to avoid that only a handful of taxpayers had ever paid it, and the government refunded all of the tax that had ever been collected. Our current generation-skipping transfer tax was enacted in its place, differing from its predecessor in that the tax applies to "direct skips" to the grandchild generation (as well as gifts in trust and gifts that benefit both the people who are assigned to a generation only one below that of the donor and people who are more than one generation younger than the donor) and at the top marginal rate of the estate tax.

By 1988, Congress had second thoughts about the unlimited marital deduction for all spouses. Since the unlimited marital deduction acts as a tax deferral mechanism delaying the payment of estate taxes until the second spouse dies, Congress feared that if non-citizen spouses remained eligible for the unlimited marital deduction, they could leave the U.S. without paying any tax. To eliminate that risk, Congress enacted new legislation[12] denying the marital deduction when the surviving spouse is not a U.S. citizen, but allowing the estate tax to be deferred if the assets are held for the benefit of the surviving spouse in a "qualified domestic trust."

New Chapter 14 was added to the Code in 1990,[13] attacking popular estate tax freeze techniques. This legislation eliminated grantor retained income trusts, but codified grantor retained annuity trusts and grantor retained unitrusts, along with personal residence trusts.

In 1997, Congress indexed several important transfer tax parameters, including the annual exclusion, the special-use valuation, and the GST exemption, but notably not including the exemption from estate and gift tax.[14]

The new century started off with the most successful bid yet to repeal the estate tax. The 2001

1 The Revenue Act of 1916, Act of September 8, 1916, 39 Stat. 756.

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

3 The Revenue Act of 1918, Act of February 24, 1919, 40 Stat. 1057.

4 The Revenue Act of 1924, Act of June 2, 1924, 43 Stat. 253.

5 The Revenue Act of 1926, Act of February 26, 1926, 44 Stat. 9.

6 The Revenue Act of 1932, Act of June 6, 47 Stat. 169.

7 The Revenue Act of 1935, Act of August 30, 1935, 49 Stat. 1014.

8 The Revenue Act of 1948, Act of April 2, 1948, 62 Stat. 110.

9 The Tax Reform Act of 1976, P. L. 94-455, 94th Cong., 2nd Sess. (1976).

10 The Economic Recovery Act of 1981, P. L. 97-34, 97th Cong., 1st Sess. (1981).

11 The Tax Reform Act of 1986, P. L. 98-369, 98th Cong., 2nd Sess. (1984).

12 The Technical and Miscellaneous Revenue Act of 1988, P. L. 100-647, 100th Cong., 2nd Sess. (1988).

13 The Omnibus Budget Reconciliation Act of 1990, P. L. 101-508, 101th Cong., 2nd Sess. (1990).

14 The Taxpayer Protection Act of 1997, P. L. 105-34, 105th Cong., 1st Sess. (1997).

Act[15] called for the phase out and repeal of the estate and GST taxes (but kept the gift tax as a "backstop" to the income tax). Under applicable budgetary rules, however, the legislation did not have a sufficient number of votes to allow it to have any budget impact beyond a ten-year window. That was the genesis of the one-year repeal of the estate tax for 2010 only. As a trade off for having no estate tax, Congress also generally required carryover basis for inherited property, with an allowance of "additional basis" that could be allocated to assets held at death to increase their basis (but not above fair market value on the date of death).

When the one-year repeal was enacted in 2001, it was widely believed that Congress would enact further legislation that would either void the one-year repeal or make repeal permanent. Despite significant support for permanent repeal, however, other events intervened, a compromise was never reached, and 2010 arrived without any change in law, triggering the one-year repeal of the estate and GST taxes! With the ten-year sunset of the legislation in effect, the law was set to revert to 2001 parameters on 1/1/2011. In the final days of 2010, Congress enacted a law that made optional whether 2010 decedents' estates took advantage of the one-year estate tax repeal.[16]

As a result, the estate of a 2010 decedent could elect out of the estate tax and be subject to the modified carryover basis rules, or, if the estate did not make such an election, it would be subject to the estate tax but allowed a $5 million exemption from estate tax. Thus, for any taxable estate of $5 million or less (which included over 99% of 2010 decedents), it generally would be advantageous to remain "subject" to the estate tax but eligible for a $5 million exemption and "step up" in basis to the fair market value as of the date of death. For very large estates, however, it was often more advantageous to elect out of the estate tax and accept carryover basis.

The legislation passed at the end of 2010 contained several other taxpayer-favorable provisions. Congress left the $5 million estate and GST tax exemptions in place for 2011 and 2012. Congress also increased the gift tax exemption to $5 million for those two years (it had previously been held at $1 million while the estate tax exemption increased over the period from 2001 to 2009). Finally, the bill added portability of the estate and gift tax exemption, so that if one spouse did not use all or his or her exemption at death, the remaining portion could be transferred to the surviving spouse for his or her use against lifetime gifts or at death. The 2010 legislation also indexed the estate and gift tax exemption so that it would continue to rise from its $5 million level. The indexing provision caused the exemption to rise to $5.12 million in 2012.

In the most recent change to the estate tax, at the end of 2012 Congress made the adoption of portability and the increases in exemption level permanent.[17] So until further changes are made, the estate, gift, and GST exemptions are unified at $5 million indexed from 2010. Unused estate tax exemption is portable to a surviving spouse, but unused GST exemption is not.

Exemptions and rates

Throughout the 100-year history of the transfer taxes, there have been numerous changes to rates and exemption amounts.[18] The exemption level generally has increased over time. The initial exemption amount from 1916 was $50,000. Other than a brief increase to $100,000 in the period from 1926 to 1931, and a brief decrease to $40,000 from 1935 to 1941, the exemption remained the same until 1942. In 1942, the exemption was bumped up to $60,000, where it remained through 1976. Finally, the 1976 Act put into place annual increases, which brought the exemption level up to $175,000 in 1981. Further legislation increased the exemption amount to $600,000 over the period from 1981 through 1987, and legislation enacted in 1997 scheduled additional increases slated to bring the exemption up to $1 million in 2006. However, the 2001 Act preempted the prior legislation and jumped the exemption level to $1 million in 2002, while at the same time scheduling further increases up to $3.5 million in 2009 and then repeal in 2010.[19]

To put these amounts into perspective, a $50,000 exemption in 1916 would be a $1.15 million exemption in 2016 dollars, while a $600,000 exemption in 1987 would be a $1,285,000 exemption in 2016 dollars. In other words, the current $5.45 million (indexed) exemption is quite high by historic standards.

15 The Economic Growth and Tax Relief Reconciliation Act of 2001, P. L. 107-16, 107th Cong., 1st Sess. (2001).

16 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P. L. 111-312, 111th Cong., 2nd Sess. (2010).

17 The American Taxpayer Relief Act of 2012, P. L. 112-240, 112th Cong., 2nd Sess. (2013).

18 Joulfaian, "The Federal Estate Tax: History, Law, and Economics," Office of Tax Analysis, U.S. Department of the Treasury (2013), Table 2.1 Historical Features of the Estate Tax.

19 Both President Obama and Democratic presidential nominee Hilary Clinton point to the $3.5 million exemption amount from 2009 as an appropriate exemption amount.

20 Joulfaian, *supra* note 18.

21 "SOI Tax Stats—Historical Table 17: Taxable Estate Tax Returns as a Percentage of Adult Deaths, Selected Years," available at www.irs.gov/uac/soi-tax-stats-historical-data-tables (last visited on 7/5/2016).

22 *Id.*

23 IRS Statistics on Income, available at www.irs.gov/uac/soi-tax-stats-estate-tax-statistics-filing-year-table-1 (last visited on 7/5/2016).

24 *Internal Revenue Service Data Book, 2015*, "Table 1: Collections and Refunds, By Type of Tax, Fiscal Years 2014 and 2015," page 3, available at www.irs.gov/pub/irs-soi/15databk.pdf (last visited on 7/5/2016).

While the exemption level has generally increased over the years, the top marginal estate and gift tax rate has generally fallen over the past 35 years.[20] While the estate tax had a modest 10% rate at its inception in 1916, the top marginal rate climbed rapidly during the world wars, and remained high until 1981. A top rate of 70% was put in place in 1935, although it only applied to estates in excess of $50 million. Over the next few years, the top rate climbed further to 77%, and the estates to which the top rate applied declined to $10 million in 1941 and to $5 million in 1977.

The trend of increasing top marginal rates turned the corner in 1982. The top rate plateaued at 55% for the period from 1984 through 2001, and then it began to decline again under the 2001 tax act. The top rate reached its low point in recent history at 35% in 2010 through 2012, but increased somewhat to 40% in 2013. Because of the large exemption amount, the graduated rate table has no consequence to U.S. estates and the tax is imposed at a flat 40%. Only certain non-U.S. estates, which still have only a $60,000 estate tax exemption, are exposed to the graduated rate table.

Who pays estate tax

While we do not have good data for the first 20 years the estate tax was imposed, we know that from the mid-1930s to the mid-1950s 1% to 2% of decedents owed estate taxes at death. With the exemption level relatively stagnant, the percentage of estates subject to estate tax crept up through the 1960s and 1970s to peak at over 7% in 1976. Increased exemptions over the next 20 years kept that percentage to around 2% until the large increases in exemption came into effect in the early 2000s, and those subject to the estate tax fell to about 1% of decedents.[21] In recent years, the percentage of decedents subject to estate tax has fallen to about two tenths of a percent (0.2%). Unless indexing is repealed, the percentage of estates subject to estate tax is likely to remain around 1% or less.

Revenue

In absolute terms, the revenue from the estate tax peaked in the period between 1999 and 2006, at over $25 billion per year.[22] Recent changes to rates and exemptions reduced the estate tax revenue to less than $12 billion in fiscal year 2012, but that revenue amount is depressed due to the one-year repeal of the estate tax in calendar year 2010. Revenue was back up to over $17 billion in 2014, the most recent fiscal year for which data is available.[23]

The receipts from estate and gift taxes make up only a small portion of overall federal tax revenues. For fiscal year 2015, the estate and gift taxes supplied only 0.7% of federal tax revenue, as compared to 49.8% from the individual, trust, and estate income taxes, and 35.2% from employment taxes.[24] Nevertheless, because only the wealthiest individuals pay estate and gift taxes, these taxes still aid the overall progressivity of the federal tax system.

A misunderstood tax

While the estate and gift taxes are very progressive and clearly accomplish some degree of wealth redistribution, polls indicate that the public does not perceive the taxes that way. In a 2002 survey conducted by NPR, the Kaiser Foundation, and the Harvard Kennedy School, 57% surveyed favored eliminating the federal estate tax, while only 15% favored keeping the tax. (The remaining 28% said they did not know enough to express an opinion.)[25] However, 49% surveyed thought that most families had to pay the estate tax, when in fact in 2002 about 1% of decedents paid estate tax.[26]

A series of Gallop polls in 2015 and 2016 illustrate a similar misunderstanding. In one poll, 63% of those surveyed in 2015 thought that money and wealth should be distributed more evenly in the U.S.[27] In another, 63% favored eliminating tax deductions and loopholes for the rich when polled in

25 National Public Radio/Kaiser Family Foundation/Kennedy School of Government.National Survey of Americans' Views on Taxes, available at www.npr.org/news/specials/polls/taxes2003/20030415_taxes_survey.pdf (last visited on 7/5/2016).

26 *Id.*

27 Newport, "Americans Continue to Say U.S. Wealth Distribution is Unfair," Gallop (5/4/2015), available at www.gallup.com/poll/182987/americans-continue-say-wealth-distribution-unfair.aspx (last visited on 7/5/2016).

2016. At the same time, 54% said they would favor eliminating the estate tax, while only 19% opposed elimination of the estate tax.[28]

This misunderstanding could be responsible for some of the unpopularity of the modern estate tax. Another explanation is that Americans dream of becoming wealthy enough to be subject to the estate tax, and they do not want to be taxed on their wealth if they do.

The next hundred years

Even with its low popularity rate, there is reason to believe that a tax at death will persist in one form or another. Given all of the changes we have seen in the estate tax's first 100 years, it would not be surprising to see further changes, even substantial changes, such as a shift to taxing bequests and gifts as income, or taxing capital gains at death in lieu of taxing overall wealth. However, because of the growing inequality of wealth in the U.S. and the ability to temper that growth through taxation, some sort of tax at death will likely continue to play a role in our tax system. ■

[28] Newport, "Americans React to Presidential Candidates' Tax Proposals," Gallup (3/17/2016), available at www.gallup.com/poll/190067/americans-react-presidential-candidates-tax-proposals.aspx (last visited on 7/5/2016).