



# **A History and Overview of Estate Taxes in the United States**

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**January 1994  
Washington, D.C.**

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More than 50 years later, in a radically different public arena, the Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

The Tax Foundation's research record has made it an oft-quoted source in Washington and state capitals, not as the voice of left or right, not as the voice of an industry or even of business in general, but as an advocate of a principled approach to tax policy, based on years of professional research.

Today, farsighted individuals, businesses, and charitable foundations still understand the need for sound information on fiscal policy. As a nonprofit, tax exempt 501(c)(3) organization, the Tax Foundation relies solely on their voluntary contributions for its support.

## Executive Summary

The federal government imposes taxes on wealth transfers through its unified transfer tax system. The unified system is comprised of three parts: an estate tax, a gift tax, and a generation-skipping tax. An estate tax is paid on the contents of decedents' estates. Transfers of wealth between living persons are subject to a gift tax. Transfers to grandchildren or more distant descendants are subject to a generation-skipping transfer tax.

The federal government did not rely on transfer taxes as a permanent source of revenue for most of the nation's history. Rather, such levies were used as temporary sources of revenue during national emergencies. This pattern changed in 1916 when, along with instituting the income tax, the federal government enacted an estate tax. Sixteen years later, largely to prevent avoidance of the estate tax, it enacted a gift tax.

A series of legislation passed in 1976, 1981, and 1986 overhauled and modified the federal transfer tax system. Portions of the separate estate and gift tax systems were unified and levies were imposed on generation-skipping transfers. These Acts also lowered marginal transfer tax rates and significantly reduced the number of transfer tax returns filed each year by raising the filing requirements.

Prior to the 1976 Act, estate taxes were paid by approximately seven percent of estates in any given year. After 1987, the estate tax was paid by no more than three-tenths of one percent in a given year.

Two recent tax Acts have partially reversed some of the changes made by the 1976, 1981, and 1986 Acts. The Omnibus Budget Reconciliation Act of 1987 extended until 1992 the top marginal rate of 55 percent. This rate had been scheduled to fall to 50 percent. By enacting an additional 5 percent tax on transfers between \$10 million and \$21.04 million, the Act also phased out the benefits of the unified credit and graduated rate schedule over this range. These provisions had expired on December 31, 1992. They were retroactively reinstated, however, when President Clinton signed the Omnibus Budget Reconciliation Act of 1993.

With the exception of the mid-1930's, transfer taxes have never represented a significant share of federal revenue. In 1992 the U.S. government collected \$11.1 billion in transfer taxes, predominately estate taxes, representing about 1 percent of total federal revenue.

In 1993, the combined effect of the unified credit, graduated rate schedule, and benefit phase out rule was to create a range of effective marginal and average transfer tax rates that differed markedly from the statutory schedule. For example, while the statutory marginal tax rate on transfers between \$600,000 and \$1 million was 37 percent, the effective average tax rate on such transfers ranged from 0 percent to 15.3 percent.

An examination of estate tax returns filed for 1989 decedents, the latest year for which such data is available, reveals that estate taxes paid by estates whose gross value exceeded \$1 million accounted for nearly 96 percent of the total federal estate tax receipts, though they represented less than one half of all such returns filed.

The value of the wealth reported on the estate tax returns filed for 1989 decedents totaled almost \$87.7 billion. The lion's share of this wealth, 31 percent, or slightly over \$27.2 billion, was held by estates valued between \$1 million and \$2.5 million. The next largest share, 22.8 percent or \$19.9 billion, was held by estates valued at between \$600,000 and \$1 million. Estates valued over

\$20 million held 14.1 percent of this wealth, or \$12.3 billion.

About 250 large estates (estates with over \$20 million) file with the IRS each year. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses. This implies that, very often, most of the wealth held in large estates is the life work of successful entrepreneurs and farmers, what might safely be termed "first generation wealth." These estates pay the highest tax rates and most tax per estate. Because many of the largest estates primarily comprise first generation wealth, and these estates pay the highest estate tax rates, it appears that it is here that the transfer tax system has its most deleterious effect on the economy by falling most heavily on the estates of successful entrepreneurs, some of the nation's most economically productive citizens.

## Introduction

The federal government imposes taxes on wealth transfers through its unified transfer tax system. The unified system is comprised of three parts: an estate tax, a gift tax, and a generation-skipping tax. An estate tax is paid on the contents of estates. Transfers of wealth between living persons are subject to the gift tax. Transfers to grandchildren or more distant descendants are subject to the generation-skipping transfer tax.

In 1992 the United States government collected \$11.1 billion in transfer taxes, about 1 percent of total federal revenue. Transfer tax rates ranged from 18 percent on transfers less than \$10,000 to 55 percent on those over \$3 million.

During most of the nation's history, the federal government did not rely on transfer taxes as a permanent source of revenue. Rather, such levies were used as temporary sources of revenue during national emergencies, such as major wars, when the nation would call on the heirs of its more affluent citizens to make exceptional contributions to the national defence. The transfer tax was usually repealed shortly after the emergency passed.

In 1916 the federal government instituted the income tax. At the same time, it enacted a permanent estate tax. Sixteen years later, largely to prevent avoidance of the estate tax, it enacted a gift tax. During 1976 and 1986, in still further efforts to thwart avoidance of transfer taxes, the federal government imposed levies on generation-skipping transfers.

There has always been opposition to transfer taxes in this country. When they were first proposed late in the 18th century, critics charged that they added to the grief of the bereaved and that they were intrusive into the private affairs of individuals and families. More recently, transfer taxes have been suspected of creating strong disincentives to save, to create new wealth, or to preserve family businesses and farms. These adverse effects may outweigh any advantages of transfer taxes as a revenue source or any sense of fairness with which they may imbue the overall federal tax system.

Until recently, the federal transfer tax system was largely ignored except by those paying the taxes and those adjusting the system further to raise additional revenues. In its current form, the system has been in effect for about 70 years, allowing sufficient time to review its operation and its implications for economic growth. This paper is intended to be the first in a series of studies on the federal transfer tax system, providing the background and foundation for the work to follow. The first section of this paper provides a brief overview of the history of federal transfer taxation. The second section presents the 1993 effective transfer tax rates. The third section investigates the federal estate tax burden by estate size. The final section looks at the composition of estates.

### I. The History of Federal Transfer Taxation in the United States

The nation's first transfer tax was enacted in the final years of the eighteenth century when strained trade relations with France compelled the United States to develop a powerful navy. This force was funded by the Stamp Act of 1797, which required that federal tax stamps be purchased when transferring property from an estate. The cost of the stamp required to transfer property depended on the value of the estate and the size of the transfer. This effectively created the nation's first estate tax. This tax was repealed in 1802.

The federal government resorted once again to transfer taxes in the 1860's when the Civil War

and subsequent reconstruction forced Congress to look for additional federal revenue. A series of Acts passed in 1862, 1864, and 1866 created and refined the first federal inheritance tax.<sup>1</sup> In 1870 Congress repealed this tax as demands for federal revenue eased. When the Spanish-American War flared-up in 1898, Congress again relied on a transfer tax, this time an estate tax, to defray some of the costs of the conflict. This tax was repealed in 1902.

In each case, the nation called on the heirs of its more affluent and prosperous citizens to make an exceptional financial contribution to the defense of the nation and, in each case, the additional levy was repealed once the crisis had passed.

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Table 1  
The Modern History of Estate and Gift Tax Exemptions and Exclusions  
(1916 – Present)

Year	Estate Tax Exemption	Gift Tax Exemption	Gift Tax Exclusion
1916	\$50,000	<sup>1</sup>	<sup>1</sup>
1924	—	\$50,000	\$500
1926	100,000	<sup>1</sup>	<sup>1</sup>
1932	50,000	50,000	5,000
1935	40,000	40,000	—
1938	—	—	4,000
1942	60,000	30,000	3,000
1977	120,667 <sup>2</sup>	120,667	—
1978	134,000	134,000	—
1979	147,333	147,333	—
1980	161,563	161,563	—
1981	175,625	175,625	—
1982	225,000 <sup>3</sup>	225,000 <sup>3</sup>	10,000
1983	275,000	275,000	—
1984	325,000	325,000	—
1985	400,000	400,000	—
1986	500,000	500,000	—
1987	600,000	600,000	—

<sup>1</sup> No gift tax.

<sup>2</sup> The Tax Reform Act of 1976 replaced the exemption with a unified credit. Initially this credit was set at \$30,000, then it increased to \$34,000 in 1978; \$38,000 in 1979; \$42,500 in 1980; and \$47,000 in 1981. This credit translates into the exemption amounts shown above.

<sup>3</sup> The Economic Recovery Tax Act of 1981 increased the unified credit to \$62,800 in 1982; \$79,300 in 1983; \$96,300 in 1984; \$121,800 in 1985; \$155,800 in 1986; and \$192,800 in 1987. These credits translate into the exemption amounts shown above.

Source: House Ways and Means Committee, 1993.

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<sup>1</sup> An inheritance tax differs from an estate or gift tax in that it is levied on the recipient of a wealth transfer. It is calculated based on the size of the individual transfer.

### *The Revenue Act of 1916 - Estate Taxes Become a Permanent Source of Federal Revenue*

Transfer taxes became a permanent source of federal revenue with the passage of the Revenue Act of 1916. The estate tax it created was similar in basic design to the income tax also created by this Act. The gross value of a decedent's estate at time of death was determined and a number of allowable deductions were made to arrive at the net value of the estate. A general exemption was taken and the amount of tax due was then calculated using a schedule of progressive rates.

The 1916 Act granted a \$50,000 exemption to exclude relatively small estates from taxation. Table 1 describes how the exemption evolved in the following years.

The 1916 Act also prescribed a rate schedule ranging from 1 percent on estates of less than \$50,000, to 10 percent on estates over \$5 million. Figure 1 illustrates the marginal estate tax rate ranges from 1916 to the present.

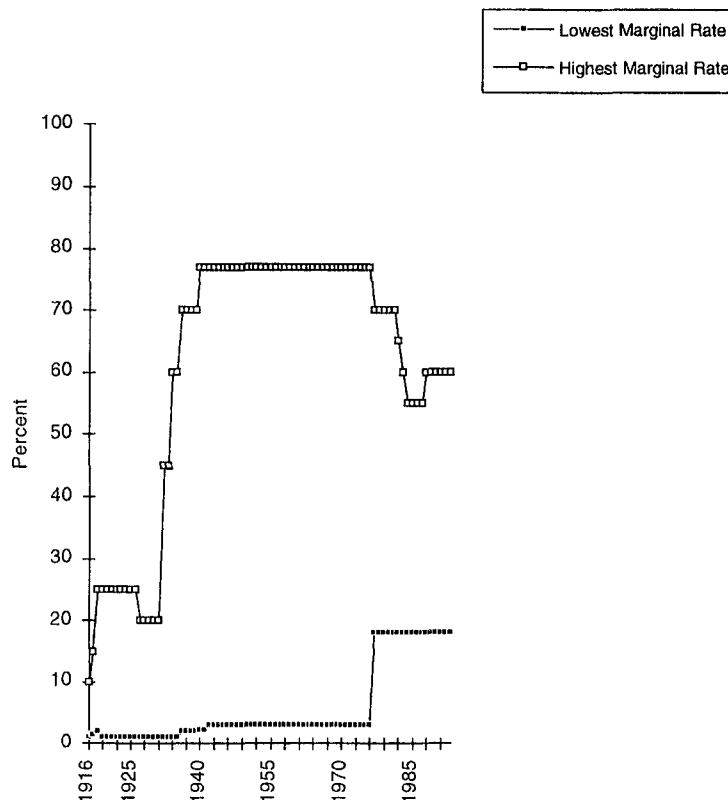
Initially, there was tepid public support for the estate tax, and at the conclusion of the First World War Congress debated repealing it. A compromise of lowering the rates on estates of less than \$1 million was eventually reached.

In the face of the estate tax, taxpayers when planning their estates realized that they could legally avoid much of the tax by making gifts to eventual heirs, thereby shrinking the size of their taxable estates. In response, the first federal gift tax was enacted in 1924 to prevent avoidance of the estate tax. Growing opposition to both it and the estate tax, however, led to its repeal and a lowering of estate tax rates in 1926. The gift tax was replaced with a provision which treated all gifts made during the last two years of life as part of a decedent's estate.

### *The Revenue Act of 1932 - Gift Taxes Join Estate Taxes as a Permanent Source of Revenue*

The Great Depression reduced federal revenues and increased the demand for federal programs. As had been the case during past national emergencies, Congress looked to transfer taxes

Figure 1  
Estate Tax Marginal Rate Ranges  
(1916 – Present)

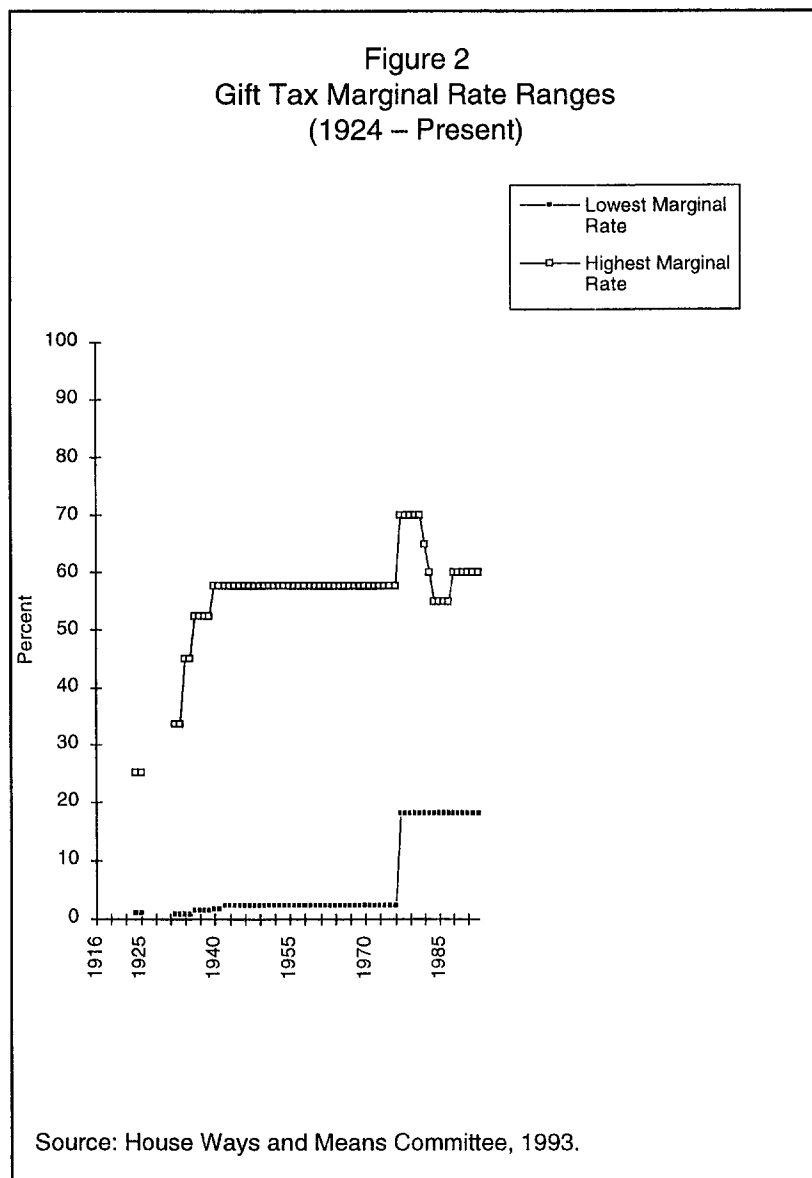


Source: House Ways and Means Committee, 1993.

as one source of additional revenue. In 1932 Congress reinstituted the gift tax and raised estate tax rates. The federal gift tax has been in effect ever since.

The gift tax created by the 1932 Act was very similar in design to the income and estate taxes. The tax was due annually. The exemption amount and marginal tax rate used in any particular year was determined by cumulative gifts since June 6, 1932, the effective date of the 1932 legislation. Annual tax free transfers of relatively small amounts of wealth were also permitted. Initially this annual per donee exclusion was set at \$5,000. It was lowered to \$4,000 in 1938 and to \$3,000 in 1942. The gift tax enacted in 1924 granted a \$50,000 exemption. When Congress reinstated the gift tax in 1932, it once again set the exemption amount at \$50,000. Table 1 depicts how the exemption amount has changed over time.

The original gift tax set the top rate at 25 percent and the bottom rate at 1 percent. When the gift tax was reinstated in 1932, marginal tax rates were set at three-quarters those applicable to estates. This provision remained in effect until 1976 when estate and gift tax rates were unified. Figure 2 illustrates gift tax ranges from 1924 to the present.



### *Transfer Taxes 1932 - the Present*

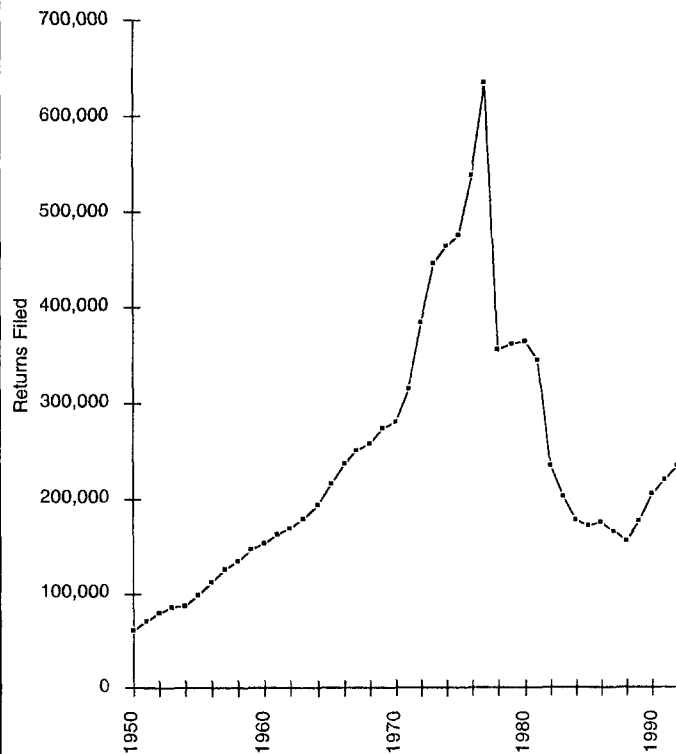
The continuing depression coupled with preparations for possible U.S. entry into the Second World War led to additional revenue demands throughout the 1930s and early 1940s. Congress responded by passing a series of revenue acts which lowered exemption amounts and raised transfer tax rates. The period from 1932 to 1941 was the high water mark for federal transfer tax receipts. During this period, transfer taxes accounted for as much as 9.7 percent of federal receipts.

The nation's entry into the Second World War did not spur Congress to increase the estate tax. Consequently, the massive increase in federal taxes that was raised from other sources to finance this conflict diminished the importance of transfer taxes as a source of federal revenue. By the end of the war, transfer taxes accounted for 1.4 percent of total federal revenue.

There was very little change in



Figure 3  
Total Transfer Tax Returns Filed  
(1950 – Present)



Source: Internal Revenue Service.

transfer tax law during the 34 year period from 1942 to 1976. The top rates remained at their relatively high wartime levels and exemption amounts were unchanged.

The one important change in estate tax law that occurred in this period dealt with the different treatment of property in community and noncommunity property states. Community property states treat the property held by married persons as one estate. The property of a married couple in noncommunity property states is treated as two estates. This effectively doubles the benefit of the unified credit and graduate rate schedule for persons in noncommunity property states. In an effort to correct this situation, Congress in 1948 created a marital deduction for estate and gift tax purposes. It also allowed spouses to "split gifts" between themselves to third parties. This effectively doubled the exemption amount available and allowed for potentially lower rate schedules.

### *The Tax Reform Act of 1976 - Unification of the Estate and Gift Tax Systems and Enactment of a New Generation-Skipping Tax*

The Tax Reform Act of 1976 overhauled transfer taxation in the United States. Provisions of this Act unified portions of the estate and gift tax systems, further corrected the inequalities faced by residents of community property and noncommunity property states, attempted to mitigate the harmful effects of transfer taxes on small businesses and family farms, and levied a new transfer tax on certain generation-skipping transfers.

#### *Unification of the Estate & Gift Tax Systems*

While the 1976 Act did not replace the two separate transfer systems with a single system, it unified many of their provisions. The separate estate and gift tax exemptions were replaced with a single unified tax credit. Over the five year period from 1977 to 1981, the legislation gradually increased the value of this credit from \$30,000 to \$47,500, equal in value to exemptions of \$120,667 and \$175,625, respectively. The Act also made both types of transfer subject to the same progressive rate schedule, setting marginal tax rates from 18 percent on transfers less than \$10,000 to 70 percent for transfers over \$5 million. Unification of these provisions kept the cumulative nature of the gift tax and treated distributions from a decedent's estate as the final transfer.

The 1976 Act also attempted to deal with the nagging problem of unequal transfer tax treatment of residents in community and noncommunity property states. It did so by raising the marital deduction for estate tax purposes to the higher of one-half the estate or \$250,000. The marital deduction for gift tax purposes was set at 100 percent for the first \$100,000 and one-half the amount over \$200,000.

### *Relief for Small Businesses & Farms*

One of the concerns raised most often about transfer taxes is their effect on entrepreneurial activity. During the establishment and operation of a small business or farm, total federal, state, and local taxes account for as much as one-third of total expenses. Upon the death of the proprietor or transfer of the enterprise, its assets become subject to transfer taxation. Many feel that such heavy taxation discourages the formation and creates a disincentive to the expansion of new enterprises.

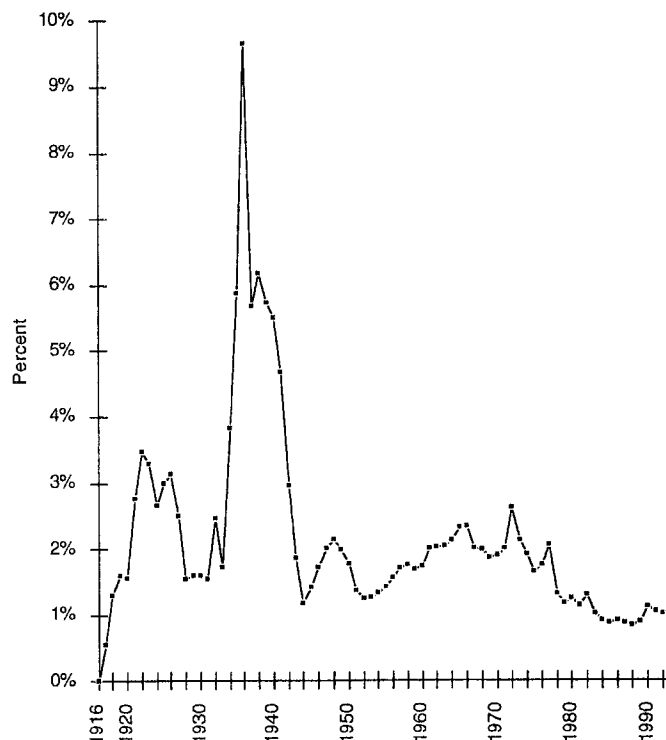
More importantly, the heavy financial burden created by the estate tax can compel these small and medium-sized businesses to close their doors even though they are otherwise productive and viable businesses.

The 1976 Act attempted to mitigate these problems by providing favorable valuation rules for small businesses and farms and by deferring the payment of taxes on estates composed largely of such enterprises. For estates comprised largely of interests in a small business or family farm, the Act allowed real estate holdings to be valued at their current use rather than at their highest or best use. This provision reduced the value of some estates by as much as \$500,000 for estate tax purposes. To reduce the cash flow pressure on the enterprise from the estate tax, the Act also spread the payment of the estate tax burden for such estates over a fifteen year period. During the first five years of this period, only interest payments were due. The estate tax and interest charges were due in equal installments during the remaining ten years.

### *The Generation-Skipping Tax*

At one time, a common complaint about transfer taxes was that they were easily avoided through careful estate planning. Critics went so far as to say that the taxes were "voluntary."<sup>1</sup> The

Figure 4  
Transfer Taxes as a Percent of Federal Receipts  
(1916 – Present)



Source: Internal Revenue Service.

<sup>1</sup> See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, D.C.: The Brookings Institution, 1977).

1976 Act attempted to deal with much of the tax avoidance by instituting a generation-skipping tax on trusts and similar arrangements which had been used to avoid paying transfer taxes.

A trust is a legal institution that an individual, the grantor, can use to administer wealth. There are two types of beneficiaries of a trust. The recipients of the income from a trust are known as life beneficiaries. There can be any number of life beneficiaries and they can be members of different generations. The trust terminates when the last life beneficiary dies, at which time ownership of the assets in the trust is turned over to individuals or institutions designated by the original grantor as remaindermen.

Prior to the 1976 Act, trusts provided a means of avoiding at least one generation of transfer tax. This was possible because, while the initial transfers to a trust were subject to transfer taxes, the subsequent transfers from the trust to life beneficiaries and remaindermen were not. This made it possible for well-planned trusts to transfer wealth to several generations of beneficiaries without being subject to transfer taxes.

The 1976 Act attempted to prevent such avoidance by taxing so-called generation-skipping trusts and similar arrangements. A generation-skipping trust is one which transfers wealth (trust income or remainder assets) to individuals who are two or more generations below that of the grantor of the trust. For example, a parent could “skip” a generation of transfer taxes by transferring his or her wealth directly to grandchildren, rather than first giving this wealth to his or her children and then allowing it to be transferred to the grandchildren. The 1976 Act was able to prevent such tax avoidance by, in effect, treating property held in trusts as though it were part of the estates of life beneficiaries; and taxing it at the applicable marginal transfer tax rates.

### *The Economic Recovery Tax Act of 1981 - Building on the 1976 Act*

The Economic Recovery Tax Act of 1981 built on many of the provisions of the 1976 legislation by raising the unified credit, lowering the top transfer tax rate, further liberalizing the laws pertaining to interspousal transfers, raising the annual per donee exclusion, and providing additional relief to small businesses and farms.

The 1976 Act significantly reduced the number of gift and estate tax returns filed. As Figure 3 illustrates, the number of transfer tax returns filed dropped by over 45 percent from 1977 to 1981, from 635,118 to 344,237. This occurred because increases in the unified credit effectively raised the amount of the exemption nearly six-fold during this period. The 1981 Act further trimmed estate tax rolls by gradually raising the unified credit to \$192,800 by 1987. As noted in Table 1, this is equivalent to raising the exemption from \$175,625 to \$600,000. Prior to the 1976 Act, the estate tax applied to approximately seven percent of estates in any given year. After 1987, the estate tax was paid by no more than three tenths of one percent of estates in a given year.

The 1981 Act planned to lower the top transfer tax rate from 70 percent to 50 percent in 5 percentage point increments in each year from 1981 to 1985. The Deficit Reduction Act of 1984 subsequently froze the maximum rate at the 1984 level of 55 percent until 1988, when it was due to fall to 50 percent.

In response to continuing concerns that transfer taxes were excessively burdensome to the nation’s small businesses, the rules pertaining to small businesses and farms were also further liberalized by the 1981 Act. The Act made it easier for estates comprised primarily of small businesses or farms to qualify for the 15 year extension for the payment of estate taxes. Also, the complex marital deduction rules enacted by the 1976 Act were replaced with an unlimited marital deduction by the 1981 Act. It also raised the gift tax’s annual per donee exclusion to \$10,000.

## *The Tax Reform Act of 1986 - The Broadening of the Generation-Skipping Tax*

While the Tax Reform Act of 1986 made sweeping changes in the income tax system, it left the transfer tax system largely intact, with the exception that it broadened the generation-skipping tax. While the 1976 legislation had closed some of the opportunities for avoiding transfer taxes through careful estate planning, it was still possible to avoid at least one generation of transfer taxes by simply making outright transfers to grandchildren and great-grandchildren, rather than first passing on wealth to children or using trusts.

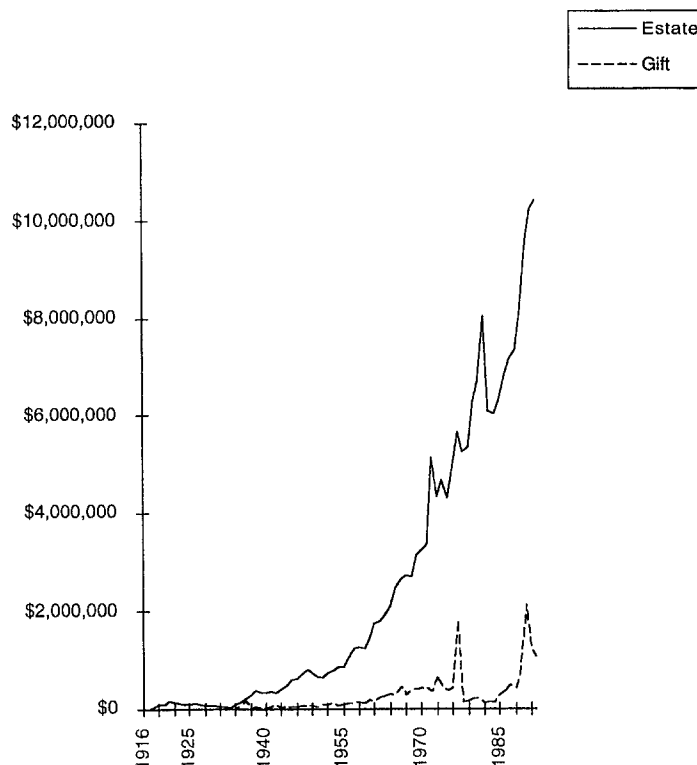
The Tax Reform Act of 1986 attempted to eliminate this possibility by making the generation-skipping tax much more comprehensive. The Act imposed a levy, equal to the highest marginal transfer tax rate, on each "skip" of a transfer. By so doing, the 1986 Act attempted to ensure that wealth was taxed each time it was passed on to a consecutive generation, whatever the method of transfer.

## *The Omnibus Budget Reconciliation Acts of 1987 and 1993*

The Omnibus Budget Reconciliation Act of 1987 (OBRA'87) extended for five years the two top marginal rates of 53 percent on transfers between \$2.5 million and \$3 million and 55 percent on transfers in excess of \$3 million. By enacting an additional 5 percent tax on transfers between \$10 million and \$21.04 million, the Act also phased out the benefit of the unified credit and graduated rate schedule over this range. The extensions contained in OBRA'87 expired December 31, 1992.

The Economic Recovery Tax Act of 1981 had intended to lower all marginal transfer tax rates below 50 percent by 1985. As stated above, the 1984 and 1987 Acts postponed implementation of this provision until January 1, 1993. At this time the 53 and 55 percent marginal tax rates were to be reduced to 50 percent. However the Omnibus Budget Reconciliation Act of 1993, signed by President Clinton on August 10, 1993, retroactively reinstated the 53 and 55 percent rates. Because the generation-skipping transfer tax rate is set equal to the highest maximum federal estate tax rate, this rate was also retroactively

Figure 5  
Estate and Gift Tax Receipts (000s)  
(1916 – Present)



Note: Since 1976, generation-skipping tax receipts are included in estate tax receipts.

Source: Internal Revenue Service.

increased. The Act also reinstated the additional 5 percent tax on transfers between \$10 million and \$21.04 million.

### *Transfer Taxes as a Source of Federal Revenue*

Since becoming a permanent source of federal revenue in 1916, transfer taxes have played a relatively minor role in filling federal coffers. This has been especially true since the end of the Second World War.

In 1918, the first full year of federal transfer taxation since passage of the 1916 Act, estate taxes raised \$47.5 million (\$447.6 million in 1993 dollars), or about 1.3 percent of total federal revenue. Estate tax collections as a percent of total federal revenue rose to 3.5 percent in 1922 and then fell to 1.6 percent by the end of the decade.

The reinstatement of the gift tax in 1932 coupled with increased rates on both gifts and estates caused transfer tax receipts to soar during the mid-1930s. Transfer tax collections went up more than ten fold between 1933 and 1936, from \$34.3 million to \$378.8 million. As Figure 4 illustrates, transfer tax receipts went from 1.7 percent of total federal revenues in 1933 to 9.7 percent in 1936. During the latter half of the decade, however, these receipts gradually fell to 5.7 percent of federal revenue in 1939.

Increased reliance on other sources of revenue, particularly the individual tax, to fund the rapidly rising defense expenditures resulting from the country's entry into World War II further diminished the importance of transfer taxes as a source of federal revenue. Transfer tax revenue fell from 5.5 percent of total federal revenue in 1940 to 1.2 percent in 1944. Since the end of the Second World War, transfer tax receipts as a percent of total federal revenues have ranged from a high of 2.6 percent in 1972 to a low of 0.8 percent in 1988.

### *The Respective Contribution of Each Type of Tax to Total Federal Receipts*

In 1992 the U.S. Treasury collected almost ten times as much estate tax revenue as it did gift tax revenue. Figure 5 illustrates that this disparity between estate and gift tax collections has been growing since the permanent enactment of the gift tax in 1932, at which time estate taxes raised \$29.7 million while gift taxes raised \$4.6 million in revenue (\$308.6 million and \$47.8 million, respectively, in 1993 dollars), for a ratio of 6 to 1. In 1940, estate taxes raised over 11 times as much revenue as gift taxes, \$330.9 million as compared \$29.9 million. This ratio had increased to 14 to 1 by 1950. At the beginning of the next three decades this ratio was 8 to 1, 7 to 1, and 29 to 1, respectively.

## **II. Tax Collections and Effective Transfer Tax Rates—The Effect of the Unified Credit, Graduated Rate Schedule, and Phase Out Rule**

In 1993, the combined effect of the graduated rate schedule, unified credit, and phase out rule was to create a range of effective transfer tax rates that differed markedly from the statutory schedule. This effect is illustrated in Table II. There were 17 marginal transfer tax rates ranging from 18 percent on taxable transfers less than \$10,000 to 55 percent on transfers exceeding \$3 million. The federal tax code also included a unified transfer tax credit of \$192,800.

There is also a rule which gradually phases out the benefit of the unified credit and progressive rate schedule by imposing an additional 5 percent tax on that portion of a transfer in excess of \$10

Table 2  
Marginal and Effective Transfer Tax Rates (1993)

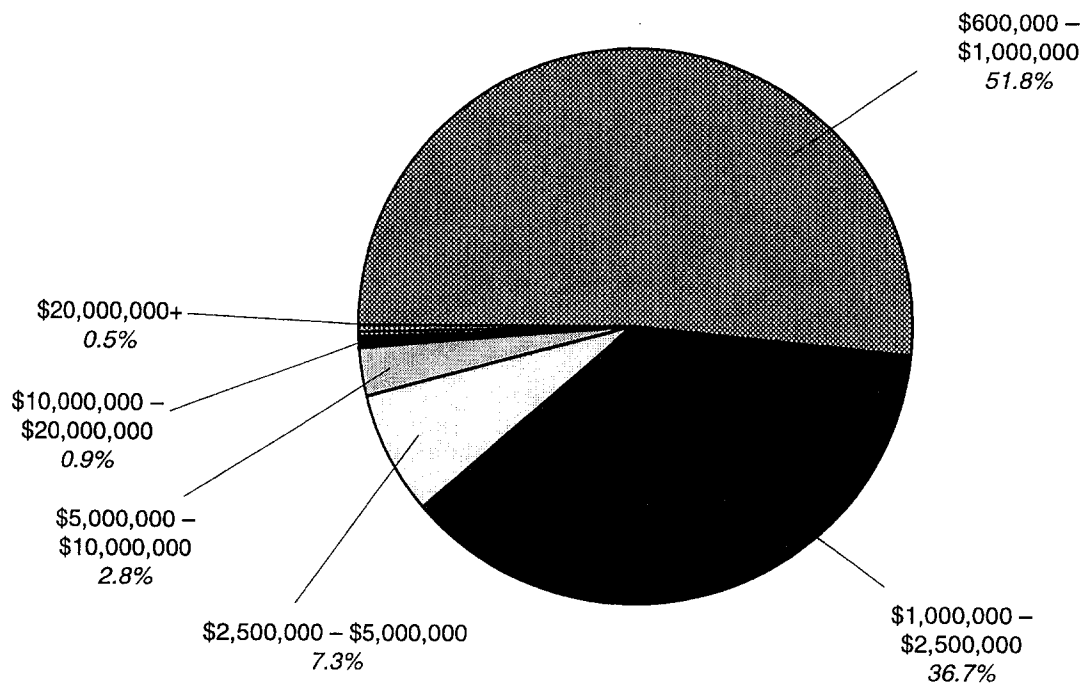
Taxable Transfer (000s)	Statutory Marginal Tax Rate	Marginal Pre-credit Tax	Cumulative Pre-credit Tax	Cumulative Tax-Unified Credit	Effective Marginal Tax Rate	Effective Average Tax Rate
\$10	18%	\$1,800	\$1,800	\$0	0%	0%
20	20	2,000	3,800	0	0	0
40	22	4,400	8,200	0	0	0
60	24	4,800	13,000	0	0	0
80	26	5,200	18,200	0	0	0
100	28	5,600	23,800	0	0	0
150	30	15,000	38,800	0	0	0
250	32	32,000	70,800	0	0	0
500	34	85,000	155,800	0	0	0
600	37	37,000	192,800	0	0	0
750	37	92,500	248,300	55,500	37	7.40
1,000	39	97,500	345,800	153,000	39	15.30
1,250	41	102,500	448,300	255,500	41	20.44
1,500	43	107,500	555,800	363,000	43	24.20
2,000	45	225,000	780,800	588,000	45	29.40
2,500	49	245,000	1,025,800	833,000	49	33.32
3,000	53	265,000	1,290,800	1,098,000	53	36.60
4,000	55	550,000	1,840,800	1,648,000	55	41.20
5,000	55	550,000	2,390,800	2,198,000	55	43.96
10,000	55	2,750,000	5,140,800	4,948,000	55	49.48
21,040	55	6,624,000	11,764,800	11,572,000	55	55.00
30,000	55	4,928,000	16,692,800	16,500,000	55	55.00
40,000	55	5,500,000	22,192,800	22,000,000	55	55.00
50,000	55	5,500,000	27,692,800	27,500,000	55	55.00
100,000	55	27,500,000	55,192,800	55,000,000	55	55.00

Source: Internal Revenue Service

million but less than \$21.04 million. The column labeled marginal pre-credit tax in Table II shows that the first \$10,000 of a taxable transfer gives rise to \$1,800 in pre-credit tax. A marginal tax rate of 20 percent is assessed on the next \$10,000 of transfer, yielding a pre-credit tax of \$2,000. A marginal rate of 22 percent is assessed on the following \$20,000 of transfer, yielding a pre-credit tax of \$4,400.

Once the cumulative pre-credit tax is determined, taxpayers may reduce the transfer tax liability by taking the unified credit which, in most instances, eliminates any transfer tax liability. This is illustrated in the cumulative tax-unified credit column. No tax is due until the cumulative tax exceeds the \$192,800 credit, which at current tax rates means that the first \$600,000 of transfer is exempt from taxation. The unified credit, therefore, creates an effective average tax rate of zero for taxable transfers up to \$600,000, 7.4 percent for taxable transfers of \$750,000, 15.3 percent for taxable estates of \$1 million, and 49.48 percent for taxable estates valued at \$10 million. An additional 5 percent tax is assessed on transfers between \$10 million and \$21.04 million, effectively phasing out the benefit of the unified credit and graduated rate schedule. Transfers over \$21.04 million, there-

Figure 6  
Distribution of Estate Tax Returns by Size  
(1989 Estates)



Source: Tax Foundation.

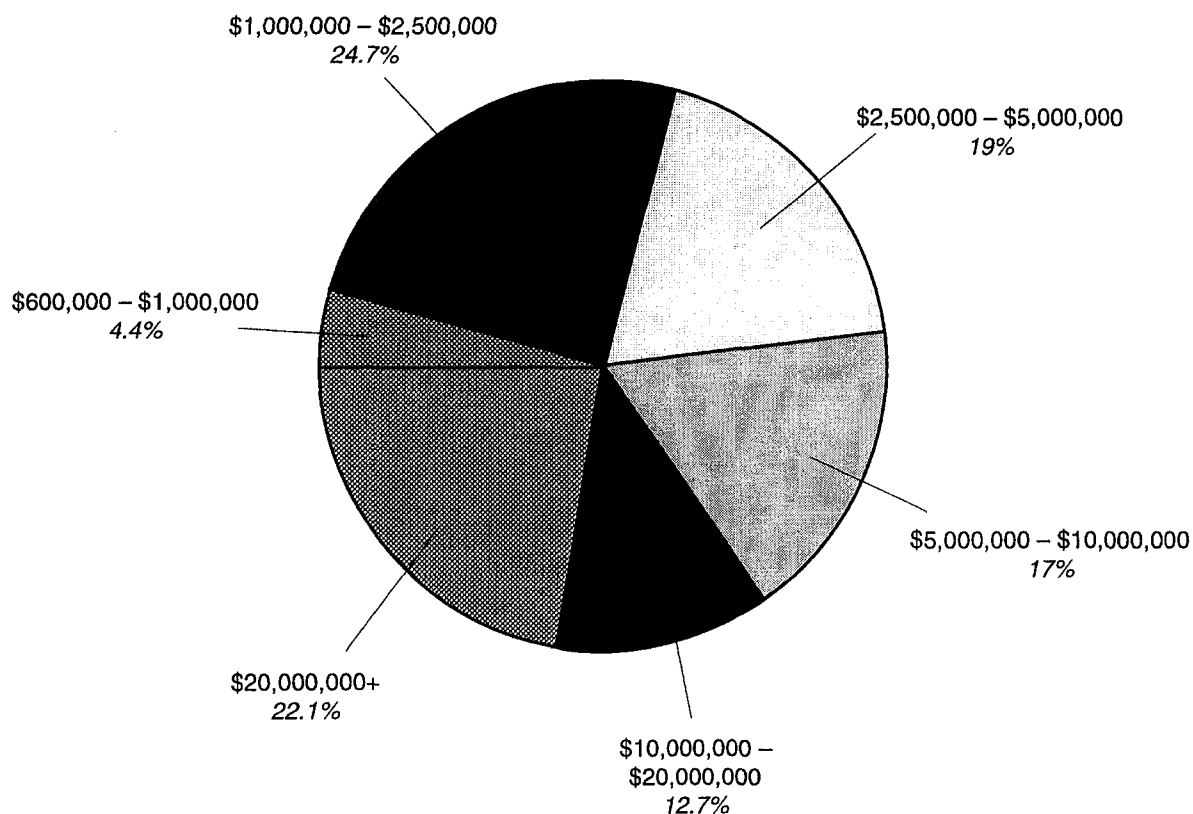
fore, face an effective marginal and average tax rate of 55 percent. As can be seen by comparing the effective marginal and average tax rate columns, the combination of the unified credit, graduated rate schedule, and phase out rule cause the effective transfer tax rates to differ markedly from the statutory tax rates.

### III. Tax Burden by Estate Size

While less than one half of all estate tax returns filed for 1989 decedents were for estates whose gross value exceeded \$1 million, estate tax paid by this group accounted for nearly 96 percent of the total transfer tax receipts. In other words, more than half of all returns were for \$1 million or less, and these estates paid less than five percent of all estate taxes.

According to IRS figures, approximately 50,376 individuals with gross estates valued at \$600,000 or more died in 1989, the last year for which such data is available from the IRS. Figure 6 shows the distribution of federal estate tax returns for 1989 decedents by estate size. More than one half of these returns, 51.8 percent, were filed for gross estates valued at between \$600,000 and \$1 million. Another 36.7 percent were filed for estates valued at between \$1 and \$2.5 million. Only 0.5 percent, or 250 returns, were filed for estates valued at \$20 million or more.

Figure 7  
Contribution to Total Estate Taxes Paid by Estate Size  
(1989 Estates)



Source: Internal Revenue Service.

A total of \$9.03 billion in estate taxes was collected from the estates of 1989 decedents. Figure 7 illustrates the proportion of this figure paid by estate size. While more returns were filed for estates valued at between \$600,000 and \$1 million than all other estate tax returns combined, this category was the smallest contributor to total estate taxes. Estates in this category paid \$396.6 million in estate taxes, about 4.4 percent of total collections. The average tax paid by these estates was \$41,441.

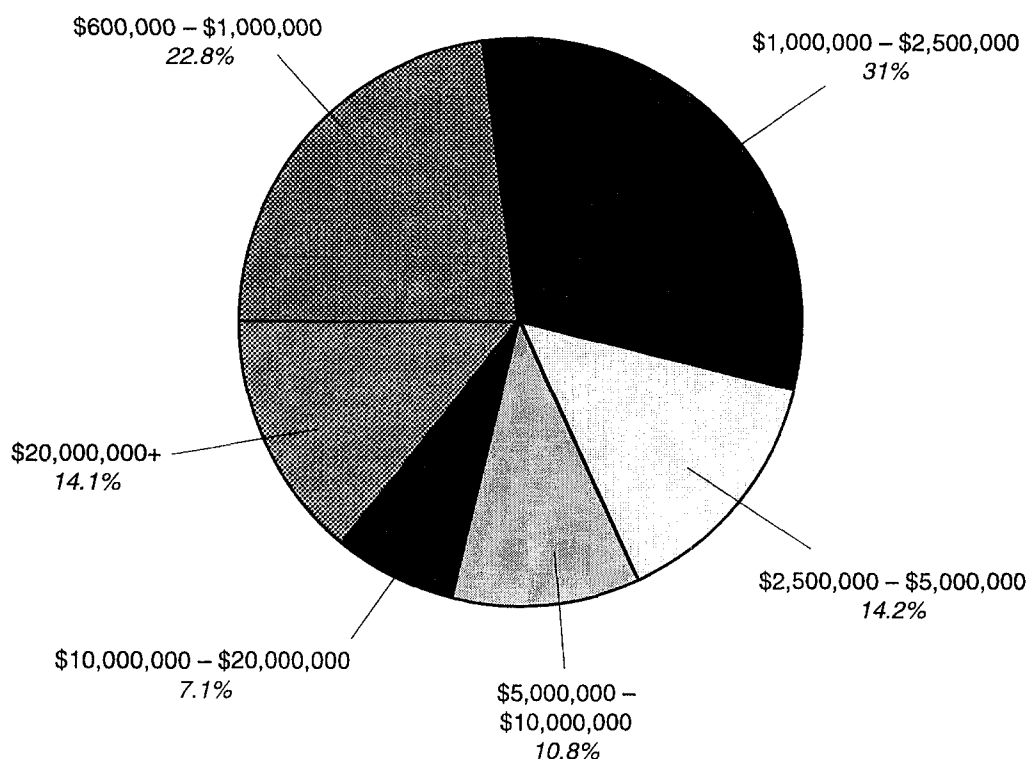
The largest source of estate tax revenue were estates valued at between \$1 million and \$2.5 million. These estates paid over \$2.2 billion in estate taxes. The average estate tax burden of these estates was \$224,741. Estates of over \$2.5 million and less than \$5 million paid over \$1.7 billion in estate taxes with an average burden of \$790,734. Finally, estates of over \$20 million paid almost \$2 billion in estate taxes with an average tax burden of \$9.9 million.

#### IV. Composition of Estates

The value of the assets reported on the 50,376 estate tax returns filed for 1989 decedents totaled almost \$87.7 billion. Figure 8 illustrates the distribution of this wealth by estate size. The lion's share of this wealth, 31 percent or slightly over \$27.2 billion, was held by estates valued at



Figure 8  
Distribution of Total Estate Wealth by Estate Size  
(1989 Estates)



Source: Internal Revenue Service.

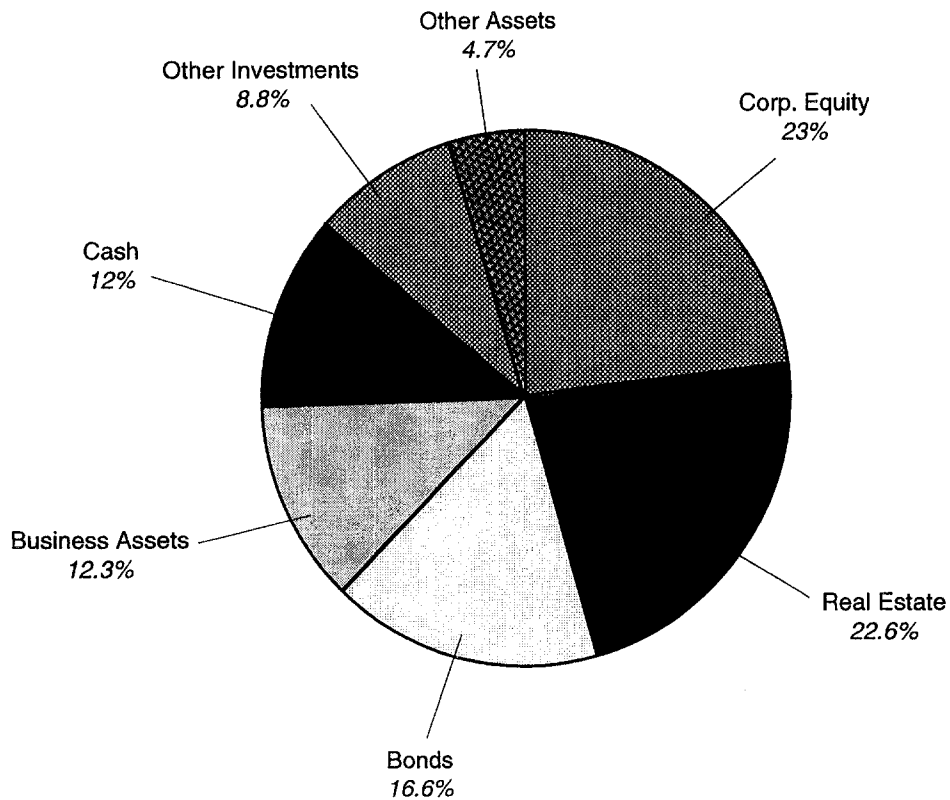
between \$1 million and \$2.5 million. The next largest share, 22.7 percent or \$19.9 billion, was held by estates valued at between \$600,000 and \$1 million. Estates between \$2.5 million and \$5 million and those over \$20 million held 14.1 percent and 14.2 percent of this wealth, or \$12.5 million and \$12.3 million, respectively.

Figure 9 illustrates that the estates of 1989 decedents were composed primarily of equity in corporations (23%), real estate (22.6%), bonds (16.6%), business assets (12.3%), cash (12%), and other investments such as life insurance and annuities (8.8%). Together these six categories of assets accounted for over 95 percent of estate wealth. The remaining 4.7 percent was held in other assets. Figure 10 illustrates that the composition of estates varied markedly by size of estate.

### *Corporate Equity*

Corporate equity was the largest overall component of estate wealth, ranging anywhere from 18.6 percent to almost 30 percent of total wealth. Larger estates tended to hold more of their wealth in the form of corporate equity. Corporate equity was the largest component of wealth for estates valued between \$2.5 million and \$5 million, \$5 million and \$10 million, and \$10 million and \$20 million. It was the second largest component of wealth for estates valued at between \$1 million and \$2.5 million, making up 22 percent of total wealth. It was also the second largest component of wealth for estates valued at \$20 million and over, making up 23.4 percent of total wealth. Corporate

Figure 9  
Composition of Estates  
(1989 Estates)



Source: Internal Revenue Service.

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equity was the third largest component of wealth for estates valued from \$600,000 to \$1 million, making up 18.6 percent of total wealth.

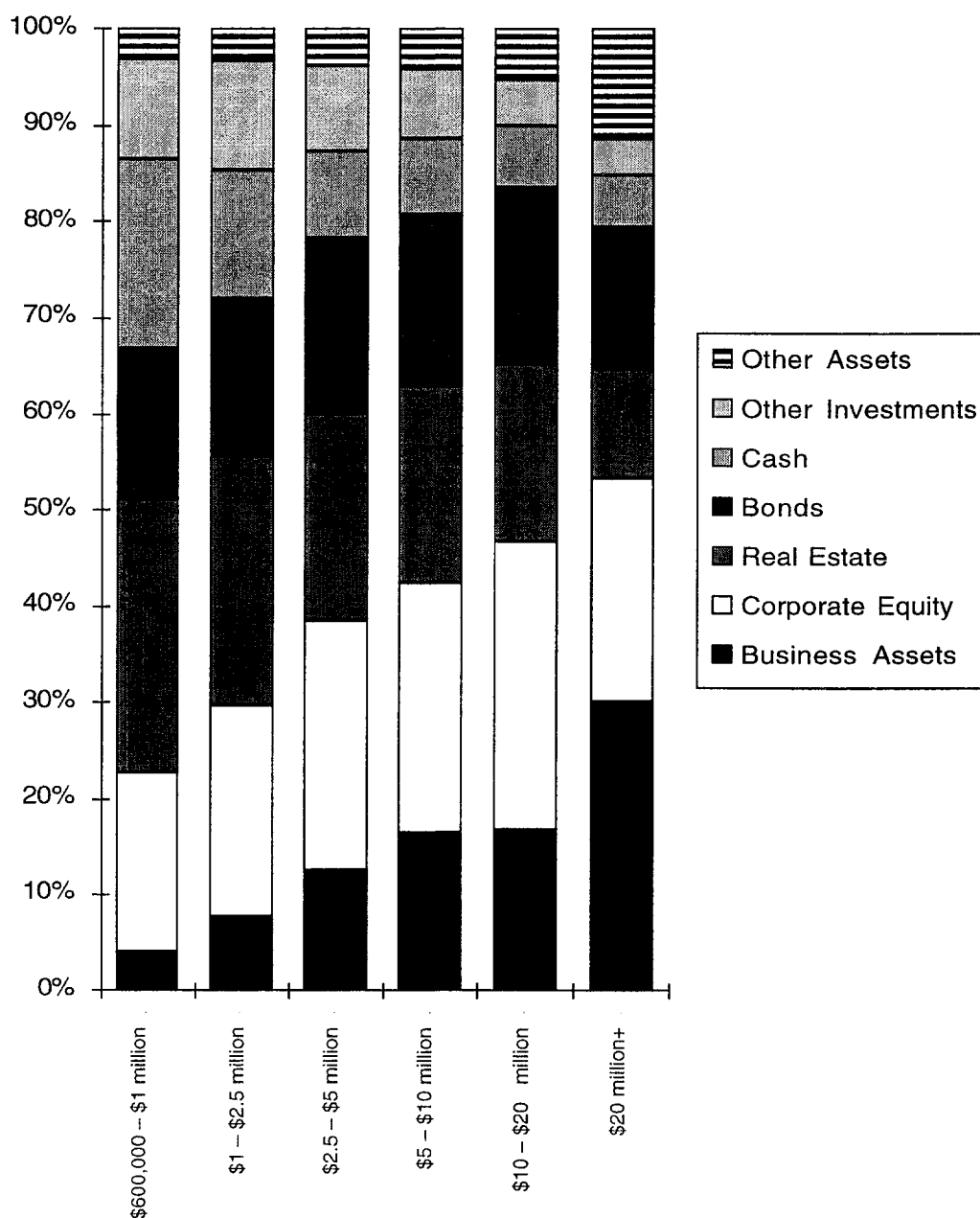
### *Real Estate*

Smaller estates tended to hold a larger fraction of their wealth as real estate. Real estate holdings were the largest component of wealth for the two smallest estate size categories. For estates valued at between \$600,000 and \$1 million, real estate holding accounted for 28.3 percent of total wealth. Estates valued at between \$1 million and \$2.5 million held 25.7 percent of their wealth as real estate. The next three categories of estates all held around 20 percent of their wealth as real estate. For estates valued at \$20 million and over, however, real estate holdings dropped to 11.3 percent of total wealth.

### *Bonds*

Government, corporate, and foreign bonds were the third largest component of the estates of

Figure 10  
Composition of Estates by Estate Size  
(1989 Estates)



Source: Internal Revenue Service.

1989 decedents, comprising 16.6 percent of total estate wealth. Moreover, unlike the other assets held by the estates, there was little variation among the groups of estates with respect to their holdings of bonds. All held moderate levels of bonds, ranging from 14.6 percent to 18.2 percent of total estate wealth.

### *Business Assets*

The most variation among the different estate size categories was with respect to their holdings

of business assets. Business assets consist of closely held stock, farm assets, limited partnerships, and other noncorporate businesses. Larger estates tended to hold a much higher fraction of their wealth in the form of business assets than did smaller estates. For estates valued at less than \$2.5 million, business assets were the smallest component of wealth, representing 4.11 percent and 7.72 percent of total wealth for the respective categories. For estates valued between \$5 million and \$20 million, business assets were a moderate source of wealth, representing 12.5, 16.4, and 16.7 percent of total wealth for their respective categories. For estates valued at \$20 million and over, however, business assets represented almost one third, or 30.1 percent, of the total wealth.

### *Cash*

As was the case with real estate, smaller estates tended to hold a larger fraction of their wealth in the form of cash (which includes savings and checking deposits) than did larger estates. Cash was the second largest component of wealth for estates valued between \$600,000 and \$1 million, accounting for almost 20 percent of their value. For estates ranging between \$1 million and \$2.5 million in value, it was the third largest component, accounting for 13.4 percent of its wealth. But for estates valued over \$2.5 million, cash represented less than 10 percent of total estate value.

### *Other Investments*

Smaller estates also held a much larger fraction of their wealth in mortgages and notes, life insurance, and annuities than did larger estates. Such investments were the fourth largest component of wealth for estates valued between \$600,000 and \$1 million, making up 10.5 percent of their value. These investments were the fifth largest component of wealth for estates valued between \$1 million to \$2.5 million, making up 11.25 percent of estate value. For the remaining estate size categories, however, they were the smallest major component of estate value.

## **Summary**

The federal government did not rely on transfer taxes as a regular source of revenue until the early part of this century. Instead, such taxes were used as temporary sources of revenue during national emergencies. The federal estate tax was permanently enacted in 1916. It was joined by a federal gift tax in 1932. In order to prevent the avoidance of these levies, taxes on generation-skipping transfers were added in 1976. However, with the exception of the mid-1930s, transfer taxes have never been a significant source of federal revenue.

Most estate tax returns filed for the decedents of a particular year are for estates valued at \$1 million or less. These estates pay less than 5 percent of the total estate taxes for decedents of a given year.

There are very few large estates (over \$20 million) each year. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses. This implies that most of the wealth held in large estates is the life work of successful entrepreneurs and farmers, what might safely be termed first generation wealth. These estates pay the highest tax rates and the most tax per estate. These are also the estates where the transfer tax system has its most deleterious economic effects. Thus the tax appears to fall heaviest on the estates of successful entrepreneurs, some of the nation's most productive citizens.