Tax Foundation's

Tax Review

Toward better government
Founded 1937

MAY, 1976
Vol. XXXVII, No. 5

Impact of Federal Estate and Gift Taxes

By Dan Throop Smith

Estate and gift taxation should be appraised primarily in terms of social policy and general economic policy. The revenue significance of estate and gift taxation, though appreciable, is minor compared to the impact of these taxes on:

1) The distribution of property among families in the country,
2) The distribution of property among individual members within families,
3) The amount of total capital in the country,
4) The form of ownership and type of investment of capital.

Tax specialists and economists frequently look on the tax system as an end in itself. Proposals for revision in estate and gift taxation which concentrate on technical refinements or, as some may say, seek to make it more intellectually satisfying are likely to be perverse or even destructive in terms of social or economic policies.

Each of the foregoing four points deserves extensive analysis. In many respects, what one may regard as desirable from one standpoint will be condemned as undesirable from another. Decisions on the merits of individual issues, as well as the balance among them, will be based on personal value judgments as well as objective considerations. There is nothing unusual about such subjective factors and conflicts of purpose in the formulation of tax policy; they typically arise in all aspects of public policy.

The purpose here is merely to suggest the social and economic perspective appropriate for consideration of such familiar issues as transfers between spouses, integration of estate and gift taxes, presumptive realization of gain at death, charitable contributions, tax treatment of multiple and multigeneration trusts and the relative merits of estate and inheritance taxation.

Distribution of Property Among Families

Taxes on estates and gifts are the principal measures by which society limits transmissions of property to succeeding generations. Limitations on transfers of property, especially between generations, in fact, is not only the principal purpose of estate and gift taxation, it is also the principal result. Though revenue of $5.8 billion from Federal estate and gift taxation estimated for 1977 is significant, it is considerably less than the receipts from taxes and alcohol and tobacco and less than 4 percent of individual income tax revenues. The social and economic effects of the tax are disproportionately large compared to the revenue.

Attitudes on what is reasonable in rates and exemptions will be determined largely by individual views on how much property may fairly be

This Issue in Brief

Estate and gift taxes are paid out of capital; they deplete and absorb the total supply of capital more fully than any other tax. But the revenue they produce is minor compared to their impact on families, on the amount of available capital and on the form of ownership and type of investment capital.

They should be appraised in terms not only of social policy but also of general economic policy, says Professor Smith.

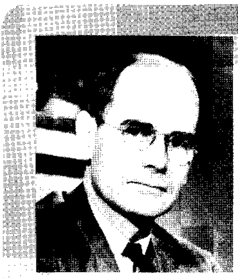
transferred between members of the same family. No objective standards are available. Opinions based on equity may, of course, have to be modified on the basis of the social and economic impacts of estate and gift taxation.

The effects of inherited wealth on the personal motivation and activities of legatees are far from uniform. And the social significance of inherited wealth ranges from availability of funds for private philanthropy and the continuity of whatever is represented by distinguished families to the antics of the jet set. The danger of destructive excesses in rates of taxation is particularly great now as a manifestation of egalitarian sentiments.

Distribution of Property Among Individual Members Within Families

No typical pattern of lifetime transfers of property to spouses and from older to younger generations could be expected to exist even in the absence of estate and gift taxation. When there is sufficient property to permit substantial lifetime gifts, attitudes concerning the desirability of giving children and grandchildren experience in managing property and in having independent incomes of greater or lesser amounts are coupled with a reluctance to "let go" of property before death. Discussions with attorneys and other professional estate planners, as well as with students in tax courses who choose to write reports on estate plans in their own families, reveal a great range of feeling and unpredictable reactions to the non-tax aspects of lifetime property transfers.

Trusts were used in connection with bequests long before the adoption of estate and income taxes. They may be established because of a lack of confidence in the judgment of immediate heirs or a desire to preserve property and start or maintain a "family dynasty" even on a modest scale. The thought that one may perpetuate oneself by providing "old money" income to as yet unknown descendants (to the limits permitted under the rule against perpetuities) is a real influence for some individuals. Others may want to have limited funds held by a trustee for discretionary distribution to the most needy or worthy heirs or kept out of the hands of wastrels.



Dan Throop Smith is Professor Emeritus, Harvard University; Senior Research Fellow, Hoover Institution, Stanford University; former Deputy (Tax Policy) to the Secretary of the Treasury; Past President of the National Tax Association and The Tax Institute of America; and Director, Cambridge Research Institute. This article is from his statement submitted for the record to the House Ways and Means Committee.

Differing national customs regarding the distribution of property among heirs further indicate the importance and significance of non-tax considerations. Primogeniture in England, with the incidental result of large landed estates and the availability of younger male heirs for government, church and military careers, is in contrast to equal division of estates in many continental European countries, with the incidental result of division of agricultural land into small segments and, perhaps, a disposition to limit family size. Laws on inheritance may even be designed for ulterior purposes; one state in India is reported to be attempting to limit inheritances to the first two children in a family as part of its population policy.

Though non-tax influences on transfers of property within families are numerous and indeterminate, the nature of the influence of estate and gift taxation on the distribution of property among members of a family is clear and unequivocal. The extent of the influence, however, has not and probably cannot be isolated from the many other factors. Without elaboration, the principal actions encouraged by tax considerations may be described briefly.

a) The use of trusts to skip as many generations as possible for the purpose of avoiding successive estate taxes which would be paid if property were included in the estates of intermediate heirs. Even on relatively modest estates, the reduction in taxes may increase substantially the total amounts available to third and fourth generations.

b) Gifts before death to minimize total transfer taxes by utilizing the separate exemptions of the gift and estate taxes and the separate progression of tax rates in each tax. In calculations on the relative merits of gifts and bequests, a remaining life expectancy must be taken into account since the amount paid in a gift tax is immediately removed from the donor's capital and is no longer available as a source of income and capital appreciation.

Estimates must also be made of the relative advantages of lower rates of tax on gifts and the fact that property transferred by gift carries forward the tax basis of the donor in calculating gain on sale by the donee. This is in contrast to valuation at date of death as the basis for calculating gain on sale for property transferred at death.

Even deathbed gifts can save taxes, in spite of the fact that the property will be included in the estate of the decedent as a transfer made in contemplation of death. The tax saving occurs because the gift tax, even if the tax has not been paid, becomes a liability of the estate and reduces the taxable estate by that amount as well as being allowed as an offset to the estate tax on the reduced estate. The fact that deathbed gifts are not more common reflects an unwillingness to let go of property even for substantial tax savings.

The adoption of the marital deduction by which up to one-half of an estate can be transferred to a surviving spouse free of estate tax has removed a former major tax advantage of dividing property by gift during life. But if both husband and wife have separate property, it may be better to forego the advantage of a tax-free first transfer to a surviving spouse if the property thus bequeathed is likely to be subject to tax at a higher rate in the near future on the death of the survivor.

The Amount of Total Capital in the Country

Estate and gift taxes absorb and deplete the total supply of the capital more fully than any other tax. Estate and gift taxes are paid out of capital. It is unlikely that either a decedent or an heir (or a donor or a donee) will consciously increase savings to restore any given pre-tax amount of property. What is taken by taxes simply reduces the property by that amount.

An heir or donee will save or not save depending on his relative interest in consumption or accumulation, but it is rare that consumption will be reduced to "restore" a pre-tax capital sum. In this respect estate and gift taxes differ qualitatively from income or excise taxes which ordinarily reduce both consumption and savings. In an era when the need for capital is great, taxes which are paid out of capital are reasonable from the standpoint of public policy only if they serve some overriding social purpose, such as a limitation on transfers of property between generations.

The Form of Ownership and Type of Investment of Capital

Estate and gift taxes influence the form of ownership and type of investment of capital in various ways.

a) To the extent that property is left in trusts to avoid estate taxes on intervening generations, more of the nation's capital is put under trustee management, subject to all the legal and customary constraints under which trustees operate. In general, trust investments will be in forms that are regarded, correctly or incorrectly, as more conservative. The capital available for entrepreneurial use and new ventures is reduced.

b) Payment of gift and estate taxes forces liquidation of investments in family farms and closely-controlled businesses. The sale of property may be made prior to death in anticipation of the cash needs of an estate. Sales, whether of farms or businesses, are likely to be made to larger units with a consequent end of a family farm or an independent business. Those of us who consider family farms and independent business concerns as being of great importance socially and politically, quite apart from their economic efficiency or inefficiency, regard as destructive estate taxes which force the sale of such properties.

The commonly proposed revisions in estate and gift taxation should be appraised in terms of the foregoing broad impacts of the taxes as well as on the basis of their asserted objectives. Comments on a few of the familiar suggested changes, and one unfamiliar suggestion, follow.

1. *Tax-free transfers to spouses during life and at death.* Taxation of transfers of property between spouses is likely to be particularly burdensome, especially as inflation erodes the value of property accumulated and held to provide income after retirement. Transfers between spouses during life or at death should be non-taxable. This relief would have little effect on the final taxation of transfers to succeeding generations. In situations where both spouses had adequate separate property, each one might be expected to leave property to succeeding generations to avoid the higher brackets of estate taxes which would apply if the properties were combined in the single taxable estate of the surviving spouse.

2. *Integration of gift and estate taxes.* An integration of gift and estate taxes with a single set of exemptions and rates would be undesirable on social and economic grounds in that it would inevitably discourage lifetime gifts. If the tax is to be the same regardless of the time of gift, it is obviously better to pay at the latest possible time, that is, at death. Property held by older people is likely to be less venturesome. With transfers postponed until death, members of succeeding generations will have less oppor-

tunity to learn to manage property wisely and be less able to embark on or finance new enterprises.

3. *Taxation of unrealized capital gains at death.* According to one concept of income advanced in tax theory, an appreciation in the value of property is deemed to constitute income similar to wages, rents, interest, dividends and business profits. This concept has no counterpart in trust or corporate law, in national income accounting and, as recent developments have demonstrated, is imprudent in personal financial management. The distinction between capital and income has been intentionally blurred for tax purposes in some forms of financial transactions, with consequent complications in income taxation to prevent subterfuge. But a presumptive realization of gain at death would constitute double taxation (capital levy) on some of the property held at death. Such double taxation would be a strained application of a concept which is itself an abstraction found only in one body of tax theory.

4. *Deduction for charitable bequests.* Estate taxation reduces the amounts available at death for all purposes, including charitable bequests. Any analysis of the effects of the allowance of deductions for charitable bequests in computing taxable estates must take account of this basic fact. Charitable bequests are sometimes said to be relatively more favorably treated under the estate tax than are ordinary bequests to heirs. But since the estate tax reduces the amounts available for heirs of the decedent, it is likely that a rational plan for disposal of property will also reduce the amount left to charities. The *relative* advantage of non-taxable charitable bequests thus must be set against the *absolute* burden imposed on an entire estate so long as any of it goes to ordinary heirs. It is thus more accurate to say that charitable bequests are less unfavorably treated than other bequests.

   The larger the estate, the greater the relative advantage of charitable bequests under the progressive estate tax, but the greater the reduction in the total amount available for all purposes. Attacks on deductions for charitable donations and bequests ignore, unintentionally or intentionally, the fundamental fact that progressive taxation leaves decreasingly smaller proportions or larger estates or incomes available for all private uses. Deductibility for charitable bequests thus merely reduces, but cannot offset, the inherently repressive effect of progressive taxation.

5. *Trusts: multiple trusts and multiple-generation trusts.* As already noted, trusts were developed and widely used long before the adoption of income, estate and gift taxation. Modification of the tax law concerning trusts should recognize that trusts are not fundamentally designed to minimize taxes and they should not be generally penalized. Certain uses or aspects of trusts, however, seem to be primarily designed to circumvent the tax laws. Modifications of the tax law should be directed at but confined to these.

6. *Substitution of inheritance taxation for estate taxation.* The most fundamental change proposed in estate taxation is to substitute for it an inheritance tax under which the tax is based on the amount received by each legatee, with a separate exemption and progressive rate schedule applied to each. The effect would be a smaller total tax as the number of beneficiaries increased.

   On the assumption that exemptions and rates would be set to secure the same total revenue, an inheritance tax by definition would be more effective than an estate tax in limiting the amounts of inherited property in the hands of an individual family. From the standpoint of fairness, should the amount of property left by a decedent or the amount received by an heir be the basis of the tax? Whose psychological burden of the tax is more significant, that of the decedent in anticipation or that of the beneficiary in realization?

   Apart from equity, the question arises as to the significance of an aggregation of property among siblings and cousins. What are the social and economic—and one must add political—effects of rivalry and support in closely related families? Are the social effects of a given amount of inherited property likely to be more or less desirable when the property is divided among a larger number of related persons? Decisions on the relative advantages of estate or inheritance taxation should take account of one's intuitive answers to these questions. (As an incidental but not trivial point, one may wonder whether a shift to inheritance taxation would encourage larger families and thus have adverse effects, at least symbolically, on population policies.)