Ancestor Worthship

Everything you Ever Wanted to Know about Estate Taxes

By William G. Gale and Joel B. Slemrod

NATIONAL PORTRAIT GALLERY, SMITHSONIAN INSTITUTION/ART RESOURCE, NY

In pondering the Stamp Act passed by the British Parliament in 1765, Benjamin Franklin famously asserted that "in this world, nothing is certain but death and taxes." Two centuries later, recent advances in corporate tax shelters and cryogenic prolongation of life notwithstanding, Franklin's assertion remains uncontroversial. However, the decision to impose taxes that depend on death is a policy choice, not a certainty.

The idea of making death a lucrative event for tax collectors infuriates some people. Steve Forbes campaigned in favor of "no taxation without respiration." Bruce Bartlett, a senior fellow at the National Center for Policy Analysis, points out that the abolition of inheritance rights was a key plank in the Communist Manifesto. In economic terms, the estate tax is alleged to reduce aggregate capital accumulation, wages, jobs and economic growth; to destroy small businesses, farms and the environment; to treat frugal households unfairly compared to spendthrifts, and to support an army of attorneys that generates huge compliance costs and ingenious avoidance strategies.

Others might feel entitled to ask what all of the fuss is about. The tax is levied on the estates of fewer than 2 percent of Americans upon their death and it raises less than 2 percent of federal revenues. Under current law, a married couple with wealth of less than $1.35 million need pay no tax upon death. And that figure is slated to rise to $2 million by 2006.

In addition, the wealthy can make significant tax-free gifts to their descendants, and unlimited tax-free gifts to non-profit organizations. Special provisions generously address the needs of small businesses and farms. As a result, half of estate and gift tax payments are made by decedents with estates in excess of $5 million, who account for only one out of every 1,000 deaths in the United States. Thus, supporters argue, the estate tax is a highly progressive and relatively cost-effective way to raise revenue. And they say the tax has other social benefits too, breaking up large concentrations of wealth and encouraging giving to charitable causes.

BILL GALE is a senior fellow at the Brookings Institution. **JOEL SLEMROD** teaches economics at the University of Michigan Business School.

Besides its association with the rich and the dead – two boundless sources of fascination – the estate tax raises a number of intriguing issues. First, it highlights the pervasive trade-off between equity and efficiency in the design of government policy. There is a prima facie case that the tax is progressive, since it is levied only on the wealthiest households. On the other hand, the tax base is closely tied to accumulated wealth. So there is also a prima facie case that the tax reduces the labor supply, effort and savings that create wealth and are crucial for prosperity.

In addition, the estate tax tests our views on the rights of parents to provide for their offspring. Some bequests are motivated by altruism, some might be considered a form of payment for services that children provide. And some are undoubtedly an afterthought, in that they were intended to provide for the parent's expenditures, but the parent died before consuming the funds. Each alternative provides different implications for the right way, if at all, to tax estates.

To jaded viewers of seemingly endless and predictable policy debates between liberals and conservatives, the estate tax offers a few surprises. It's true that most liberals support the tax and most conservatives oppose it, all for the usual reasons. But some liberals, such as attorney Edward McCaffery, of the University of Southern California, vociferously oppose the tax. McCaffery believes it encourages more of the rich to consume rather than to save. And some conservatives, notably Irwin Stelzer of the Hudson Institute, enthusiastically support near-confiscatory estate taxes. Stelzer argues that allowing large inheritances is basically affirmative action for rich kids – which, as a good conservative, he opposes. Plainly, their analyses cut across the partisan fissures that traditionally demarcate policy debates.

What's more, the estate tax is a hot issue in this electoral season. Last year, in a vote split along partisan lines, Congress voted to phase out the estate tax over the next decade. President Clinton vetoed the bill. In June of this year, though, 65 Democrats in the House joined Republicans to vote the tax out again. Presumptive Republican presidential nominee George W. Bush advocates repeal as well. As of this writing, the bill has not been voted on in the Senate.

To jaded viewers of seemingly endless and predictable policy debates between liberals and conservatives, the estate tax offers a few surprises.

Even if the estate tax issue dies after the election, it won't be out of sight for long. Almost everyone concedes the need to reform the existing laws, especially in light of the fact that the aging of the population and the stock market boom will sharply increase the amount of estate assets subject to taxation in the future.

HOW IT WORKS

History

Taxes on transfers of wealth were levied as far back as the 7th century BC in Egypt. The first American tax on wealth transfers dates to 1797 when, faced with the expense of dealing with French attacks on American shipping, Congress imposed a stamp duty on receipts for legacies and probates for wills. The tax was eliminated in 1802. Similar, short-lived taxes were enacted during the Civil and Spanish-American Wars. The modern estate tax also originated in a time of war preparation, if not war itself, in 1916. However, this incarnation survived World War I because it fit the dominant view of the time that federal revenue from customs and excise taxes should be replaced by more progressive taxes.

Current Law

The laws that govern how and to whom property may pass are the exclusive domain of the states. Each state regulates how property may be transferred to heirs, and the extent to which family members, principally spouses and children, are protected from disinheritance. In contrast, federal law governs the taxation of such transfers, although states may also impose estate or inheritance taxes. The executor of an estate must file a federal estate tax return within nine months of the death of a U.S. resident if the value of the gross estate exceeds $675,000. The unified federal estate and gift taxes apply a single graduated rate schedule to cumulative lifetime taxable transfers made by an individual during life or at death.

The first step in determining estate tax liability is to calculate the value of the gross

estate. Gross asset value is sometimes difficult to determine, and, in particular, closely held businesses are allowed to value assets as they are deployed in the existing business (say, land in farming) rather than their market value (say, as subdevelopment). In addition, it is often possible to discount the valuation of assets by placing them in an alternative ownership form, such as a family limited partnership, rather than holding them directly. In order to prevent avoidance of the tax through gifts made during life, the tax base also includes gifts made by the decedent in excess of an exemption of an annual $10,000 per donee.

In 1997 estates with gross value over $5 million accounted for nearly half of all estate tax revenues, but only one out of every 1,000 deaths.

The next step is to determine the taxable estate – the difference between gross estate and allowable deductions. All transfers to a surviving spouse are fully deductible, as are contributions to charitable organizations. Deductions are also allowed for debts owed by the estate, funeral expenses, and administrative and legal fees associated with the estate. A limited credit against tax liability is given for state-levied inheritance and estate taxes. Most states now levy so-called "soak-up" taxes that fall within the credit limit, so that they transfer revenue from the federal to the state treasuries without adding to the total tax burden on the estate.

The unified credit currently exempts taxes on the first $675,000 of lifetime taxable transfers per individual, a figure that will rise to $1 million by 2006. For estates larger than that, the tax rate begins at 37 percent and rises gradually until it is 55 percent on taxable transfers above $3 million. For estates that are predominantly closely-held businesses, the tax payments can be spread out over 14 years, with the first five years' payments covering only interest at below-market interest rates on the taxes owed.

Who Pays?

In 1999, the federal estate and gift taxes collected $28 billion. This compares to the $879 billion raised by the individual income tax and the $185 billion raised by the corporation income tax. The increase in personal net worth fueled by the boom in the stock market and real estate values suggests that the estate tax, even with the legislated gradual increase in the exemption level, will grow in relative importance as a revenue raiser, although the projections of the Congressional Budget Office do not reflect this.

Estate tax liability is extraordinarily concentrated among high-wealth families. In 1997 estates with gross value over $5 million accounted for nearly half of all estate tax revenues, but accounted for only about 5 percent of all taxable estates and about one out of every 1,000 deaths. The average tax payment for these estates is $3.5 million. Although the marginal tax rate reaches 55 percent, the average tax rate (tax divided by gross estate) in this group is less than 19 percent, reflecting the exemption and graduated rates, as well as the deduction for charitable and spousal bequests. In contrast, the 85 percent of taxable estates with a gross value below $2.5 million account for only 30 percent of estate tax revenues, and have paid an average tax rate of about 13 percent.

To highlight this concentration, one can also classify tax burdens according to household income. The U.S. Treasury Department has calculated that households in the top 5 percent of the income distribution bear 91 percent of estate taxes, compared to 49 percent of income taxes. Households in the top 20 percent of the income distribution bear 99 percent of estate taxes, compared to 77 percent of income taxes. Thus, the estate tax is considerably more progressive than the already-progressive income tax.

Among the top 5 percent of households, estate taxes are the equivalent of about 6 percent of income taxes. Thus, abolishing the estate tax would amount to a permanent 6 percent reduction in income taxes for this group. Lest you worry that the Treasury has cooked its analysis, an independent analysis published in 1997 by Daniel Feenberg, Andrew Mitrusi and James Poterba for the National Bureau of Economic Research reached about the same conclusion.

THE ISSUES

Controversy concerning the estate tax touches on a wide variety of topics. Here, we try to keep score of the various issues. In the next section, we link the various arguments made to specific proposals for change.

1. The appropriateness of imposing taxes at death. Opponents of transfer taxes often view death as an illogical time, at best, to impose taxes, and a morally repugnant time, at worst. Compounding the grief of a family with a tax seems a bit heartless, to be sure, and it is this queasiness that the opponents play on by labeling the estate and gift taxes the "death tax." Evocative as it is, this label is seriously misleading. First, death is neither sufficient nor necessary to trigger the estate and gift taxes. It isn't sufficient because fewer than 2 percent of decedents pay any tax. It isn't necessary because gifts between living people can trigger a tax liability.

Second, estate tax liabilities can be effectively pre-paid via life insurance purchases tied to the expected tax liability or, in the case of qualified family businesses, can be delayed and paid over a 14-year period after the death of the owner. Thus, although death may trigger the tax liability, the payment can be remitted at any of a number of milestones.

Third, at least some component of estate tax payments – for example, payments on unrealized capital gains – can be thought of as a "final settlement" with respect to the income tax. Such taxes would be triggered by death even if the estate tax were abolished and replaced with taxation of previously unrealized capital gains income at death.

Leaving the morality issue aside, death is very likely to be a convenient "tax handle." The public nature of probate can reveal information about a family's wealth that is difficult to obtain in the course of enforcement of the income tax. This aspect of taxation at death likely explains why inheritance and estate taxes date back for millennia. Many economists, in fact, have argued that taxes payable at death are preferable to taxes paid during life, because the former have smaller disincentive effects on lifetime labor supply and savings than do equivalent-revenue taxes imposed during life. For all of these reasons, turning a tragic but inevitable life event into a taxable event may be off-putting, but it is perfectly sensible from an administrative perspective.

Finally, it is worth noting that much of the hostility focused on so-called death taxes is simply disingenuous. Note that no opponent of estate taxes objects to the fact that income

taxes are due on 401(k) and IRA balances at death. Nor do any of the opponents suggest that, in exchange for eliminating estate taxes, they would support increased taxes on the wealthy during life – though the latter, of course, would be the logical solution to the particular problems created by taxation at the time of death.

2. Progressivity. Progressivity has been the traditional justification for the highly graduated estate tax and remains the principal defense now. However, one might reasonably ask why the desired degree of progressivity couldn't be achieved solely through the income tax. The answer usually given is that the capacity of the income tax to impose progressive burdens is limited by several factors, notably the preferential treatment of capital gains. Capital gains are taxed at a lower rate than other capital income. And they are taxed only when the underlying assets are sold, as opposed to when the gains accrue. Most important, gains are excused from income taxation at death.

Certainly the standard liberal defense of the estate tax on progressivity grounds is in part a knee-jerk resistance to a tax change that primarily benefits the most well-to-do. On the other hand, the standard conservative attack on the estate tax is partly a knee-jerk response to any tax that is progressive – witness the criticism over the last few years on the graduated income tax and capital gains taxes, support for the flat tax, and so on. Neither liberals nor conservatives, though, are arguing for a low-exemption, flat-rate estate tax that would be paid by almost everyone upon death.

Instead, the policy debate concerns a tax that applies only to the rich. It would help if opponents of the estate tax clarified whether they are advocating a large reduction in the progressivity of the tax burden, or just a change from one progressive tax instrument to another. Likewise, it would help if supporters of the estate tax clarified whether they would support an equally progressive alternative tax, or whether there is something about taxation of wealth transfers per se that is essential.

3. Backstopping the income tax. Supporters of the estate tax often note that it serves as a backstop for the income tax, imposing taxes on income that escaped taxation during life. As noted above, unrealized capital gains that are inherited receive a "basis step-up" and thus never face income tax. The basis step-up ensures that even though the asset may have appreciated in value over the lifetime of the donor, the recipient is exempt from capital gains taxes on the appreciated value of the inheritance. It is worth noting, too, that this basis step-up also occurs for transfers from one spouse to another, even though such transfers are deductible from the gross estate. As a result, the estate tax contains a very large marriage bonus.

To the extent that the estate tax is meant to capture tax on previously accrued but unrealized capital gains, the tax should apply only to unrealized capital gains and should be capped at the highest capital gains tax rate. Needless to say, that is not what the estate tax looks like, now or in the past.

4. Concentration of wealth. From its beginning the estate tax was viewed as a counterweight to an undue concentration of wealth. These days some opponents claim that the estate tax fails to achieve this goal. True enough, it isn't obvious that the concentration of wealth is less in the era of high estate taxes than it was before. But the real question is whether the concentration of wealth is less than it would be in the absence of the tax.

It is probably unrealistic to expect a tax that raises revenue equal to just 0.3 percent of GDP and just 0.1 percent of household net worth in a typical year would make a serious dent in overall wealth inequality. Small programs typically have small effects. This reduces the scale of both costs and benefits, but doesn't settle the argument about whether the benefits exceed the costs. In fact, the opponents' claim could be construed as an argument for increasing, rather than decreasing the tax.

5. Effects on savings, labor supply and economic growth. Combined with the income tax, the disincentive to work and save created by the estate tax for the affluent can be exceptionally high. The top federal income tax rate of 39.6 percent combined with the top estate tax rate of 55 percent implies that the tax penalty of a dollar earned with the intent to bequeath is taxed at an effective rate of almost 73 percent.

In the 18th and 19th centuries there was a lively discussion among such luminaries as Adam Smith, David Ricardo and J.B. McCulloch as to whether an estate tax was a serious hindrance to saving, and therefore to capital accumulation. The debate focused on whether a tax liability due so far in the future, and attached to an event many people prefer not to think about, could really be a disincentive to activities undertaken in the prime of life. Ricardo (who was very rich) thought the tax was a disincentive; McCulloch and others disagreed.

SHELBURNE FARMS COLLECTIONS, SHELBURNE, VERMONT

Today, this issue remains controversial, but now revolves around the question of what motivates people to give bequests, which turns out to be critical in sorting through the impact of an estate tax on savings rates. Consider the implications of bequests that are unintentional or accidental – bequests that arise from people's unwillingness or inability to convert their wealth to a guaranteed lifetime earnings stream that they can not outlive. In that case, an estate tax would not be a disincentive to save, and would further not burden the bequeathor (although the donee would be less well off, to be sure). And what if bequests are really payments for services rendered by children to parents in their later years? Then an estate tax merely raises the price of purchasing such services. The bottom line: since people are likely motivated by a combination of factors in their bequests, the impact of estate taxes on saving by the estate owner is difficult to sort out.

As it is difficult even to determine whether a tax would have a positive or negative impact on the donor's saving, we must rely on statistical evidence for insight. But direct evidence of the impact of estate taxes on these decisions is sparse. Indirect evidence from analyses of the effects of income taxes on labor supply and savings is of course relevant, and in both cases the bulk of the evidence suggests that the effect is small. Estate taxes are levied at higher rates than income taxes, which might suggest a larger effect. But they are also levied at more distant points in the future, suggesting smaller effects.

Over the history of the U.S. estate tax, it does seem to be true that in years when estate tax rates are relatively high, reported estates as a fraction of national wealth are lower than otherwise. This pattern is consistent with either a depressing effect on wealth accumulation or an stimulative effect on estate tax avoidance – or both. However, closer examination of estate tax returns reveals that this association is statistically fragile, so we are still without any hard evidence that capital accumulation has been undermined.

The discussion above focuses on saving by the donor. But evidence shows that large inheritances reduce the work effort of recipients (consistent with Andrew Carnegie's famous conjecture) and raise their consumption, too. Thus, to the extent that the estate tax reduces net-of-tax inheritances, it can raise saving by the recipients.

Ultimately, the progressivity of the tax depends on its impact on savings and labor supply. Because the impact appears to be relatively small and uncertain, we feel it is appropriate to maintain the view that the estate tax is progressive until new evidence is provided.

6. Family-owned businesses and farms. Even if the estate tax does not affect the level of savings, it could well affect the ability of family businesses and farms to survive their owners' deaths. These issues have received a lot of attention, in part because of the inordinate political importance of Iowa in the presidential election process, more generally because of the political visibility of farmers and small businesses. Estate tax opponents claim that a large proportion of American businesses never make it to second generation owners and assert that the estate tax is the reason why.

This is surely a case of the tail wagging the dog. There are many reasons why businesses do not pass from one generation of a family to another. Because only a very small portion of small businesses and farms ever even pay estate taxes, it is unlikely that the estate tax has a very important impact on the proportion of businesses that make it to the second generation or beyond. In 1997, farm assets were reported on fewer than 6 percent of all taxable estates, and farm assets totaled a microscopic 0.3 percent of taxable estate value. For small businesses, the figures are larger, but still not very significant. Fewer than 10 percent of taxable returns in 1997 listed closely held stock, which accounted for only 7 percent of taxable estate value. Limited partnerships and "other non-corporate business assets" accounted for an additional 2.7 percent of taxable assets.

Thus, using a very expansive definition, farms and small businesses account for at most 10 percent of all assets in taxable estates. And farm and small business assets constitute a majority in only 3 percent of taxable estates. People who own neither farms nor small businesses pay the vast majority of estate taxes. This implies that scaling back or eliminating the estate tax is a very blunt instrument for dealing with this issue.

Moreover, family farms and businesses already receive special treatment under the estate tax. Taxpayers can calculate the taxable value of family farms and businesses on the basis of their worth to family proprietors (rather than their market value). Use of the mandated formula can reduce a gross estate by up to $775,000. In addition, the estate tax due on family farms and businesses can be paid in installments over a 14-year period with only interest payments due in the first five years. Legislation enacted in 1997 permits a special deduction of up to $675,000 worth of family-owned farms and businesses when they constitute at least 50 percent of an estate and in which heirs materially participate.

On top of all that, recall that small businesses already receive numerous tax subsidies, under the income tax as well as the estate tax. In addition, an estimated two-thirds of the value of family-owned businesses consists of unrealized capital gains that have never been taxed under the income tax. Exempting it from estate tax as well would provide an even larger subsidy to small businesses. No convincing case has ever been made for the current level of subsidies, much less for expanding them.

Opponents claim that a large proportion of businesses never make it to second-generation owners and assert that the estate tax is the reason why. This is surely a case of the tail wagging the dog.

7. Fairness. While progressivity issues focus on the treatment of those with higher income or wealth, another component of fairness focuses on how "equals" – different households with the same income or wealth – are treated relative to each other. There are many difficult issues along these lines that arise with the estate tax.

For example, estate tax opponents claim that the tax inequitably burdens families that are altruistic compared with those that are selfish, and punishes those that are unwilling or unable to engage in sophisticated tax planning to avoid the tax. To be sure, the estate tax is a tax on just one way to dispose of one's wealth. Comparing two families of the same

(considerable) means, the tax would not burden the one that chooses to spend every penny on themselves, or even the family that gives it away to charity, but burdens only those families that pass their good fortune along to their own.

Put this way, it seems to violate principles of equity to single out families that are generous to their own children or grandchildren. Edward McCaffery stresses this "horizontal" inequity of the estate tax. Many economists would also argue in favor of intergenerational giving because the bequest provides satisfaction to the giver, as well as to the receiver.

Perspective, however, is crucial to this argument. From the point of view of the giver, the tax seems to single out the altruistic for taxation, leaving the squanderers untouched. But from the perspective of the next generation, inheritance provides an advantage to some rather than others. Supporters of the tax claim that advantages so derived are unearned and unfair. They claim that inheritances provide large benefits to people who may not have demonstrated any other skill than that of inheriting affluent parents. They argue that this seriously distorts notions of equality of opportunity and is detrimental to widely shared notions of fair play.

A second line of debate concerns parental versus societal rights regarding the institution of inheritance. Opponents of the tax note that parents can pass resources to their children in a variety of ways: by investing in their education, providing social contacts and networks, bringing them into a family business, giving gifts of up to $10,000 per year, etc. They question why transfers at death should be treated differently from these other transfers. They also note that inheritances play only a small role in generating overall inequality.

Supporters of the estate tax look at the same set of transfers already being made and say "enough is enough." Irwin Stelzer, for example, notes that high estate taxes do not stop parents from passing on huge amounts of human capital, family reputation and connections, a common set of values, etc. He questions whether, given all of these transfers, the net social gains to having large amounts of financial resources passed on through probate exceed the costs, and he concludes that high estate taxes do not seriously impinge on parents' ability to provide for their offspring. In fact, the taxes create good incentives for younger people to work hard, and they help impress societal notions of fair play in the recipient generation.

Stelzer also notes that putting limits on the use of personal property is a natural role for society to play. Others have argued that inheritance is a civic right – not a natural right, so government has the duty, to regulate such activity.

These fairness issues hinge to a significant extent on value judgments, fairness being always and everywhere "in the eye of the beholder." As a result, it is quite difficult to resolve these issues analytically, and even more difficult to do so in a political arena.

8. Administrative and avoidance costs. It is often alleged that the estate tax is inefficient because avoidance and compliance costs are so high, and the tax is so easy to avoid. A Brookings Institution study from the 1970s referred to the tax as "voluntary" because of the large number of ways it could be avoided. Although tax reforms over the last two decades have tightened up a number of the most egregious features, aggressive sheltering (bordering on the abusive) remains a serious issue for the estate tax.

One issue is how high the costs really are. The widely cited claim that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised is a back-of-the-envelope calculation, at best. It is based on valuing the time of those American Bar Association members who report probate and estate law as their area of concentration. Even this methodology, inexact to be sure, yielded costs that came to just 15 percent of revenues; the 100 percent number from the same study has no quantitative basis.

ARCHIVES OF THE PIERPONT MORGAN LIBRARY/ART RESOURCE, NY

So the oft-cited number is a hunch and no more – and is also more than a decade out of date. More recent estimates based on consultations with tax professionals about their average charges for estate tax planning produce a total cost of collection equal to only 7 percent of revenues. Thus, the available range of estimates of compliance costs relative to revenues is huge. We are inclined to believe that the truth lies much closer to the 7 percent figure. Moreover, an unknown fraction of this may be for estate planning, inter alia about intergenerational succession of the business, that is unrelated to taxation and thus would likely be incurred regardless of whether there was an estate tax.

In addition, if there are high compliance costs, it is not clear whether the tax should be cut back or be bolstered by broadening the base – eliminating loopholes – and reducing tax rates.

9. The non-profit sector. Supporters note that the deduction in the estate tax for charitable contributions generates a significant increase in contributions to the non-profit sector, especially among the wealthiest households. In 1997, of the 329 taxable estates with gross assets in excess of $20 million, 182 made charitable contributions and those that did contributed an average of over $41 million. The presence of an estate tax may also encourage increased charitable contributions during life.

Opponents counter with two claims: first, that the effect of the estate tax deduction for charitable giving is not that large, especially relative to the overall funds raised by the private sector; second, that eliminating the estate tax would raise wealth among the wealthiest families, which would in itself increase charitable contributions. Note, however, that the second claim contradicts the argument that estate tax does not affect the concentration of wealth. The first claim is an example of the selective use of assertions about the behavioral impacts of taxation. Opponents of the estate tax argue that it significantly alters decisions about saving, but play down its impact on philanthropy.

10. Revenues. Finally, opponents argue that the estate tax raises very little cash, so

abolishing it would make little difference to federal revenue. This assertion does not appear to be factually correct: in light of their huge unrealized capital gains in the stock market, elimination of the estate tax would cost over $50 billion annually a few years down the road. But even if it were right, it begs the relevant question; should taxes should be cut in this way, some other way or not at all?

Eliminating the estate tax could cost $50 billion annually a few years down the road.

A more sophisticated version of the "little revenue" argument is that stated revenues may vastly overstate the net revenue effect of the estate tax because the tax avoidance schemes that reduce estate taxes also reduce income taxes. Thus, for example, Stanford economist Douglas Bernheim argued several years ago that the estate tax effectively raises no revenue. If this were the case, then the estate tax would be difficult to justify, as it would create distortions to behavior while not raising any net revenue. This assertion is, however, based on speculative calculations and has not been corroborated by subsequent investigation.

WHERE DO WE GO FROM HERE?

The most radical reform would be to abolish the tax. This, of course, removes the existing problems, but introduces a host of additional issues. It would eliminate what is by far the most progressive tax instrument in the federal tax arsenal – and at a moment when the distributions of income and wealth are unusually skewed. It could hurt non-profits. It would reduce federal revenues. It might not even raise savings, labor supply or growth, as its advocates hope, and it would create a gaping loophole with regard to capital gains in the income tax. Moreover, the case for abolition appears to be backed largely by loose rhetoric about the immorality of taxing at death and the supposed impact on a tiny component of those who would benefit.

Elimination or scaling back of the estate tax could be coupled with the extension of the capital gains tax to the gains accrued but unrealized at death. But this proposal would raise much less revenue than the estate tax, would raise it from a different set of people, and would still have many of the complexities of the estate tax. Moreover, it would impose a significant burden on small businesses and farms, one set of groups that reform is intended to relieve of tax burdens.

The bill passed in the House earlier this year tied elimination of the estate tax to another significant change in the taxation of capital gains, under which heirs would assume the decedent's basis for capital gains purposes – "carryover basis" – for transfers from estates valued in excess of $1.3 million. Linking the two changes is designed to address the concern that the appreciated value of some assets might escape both income and estate taxation with no estate tax and step-up basis. However, this would raise less revenue than taxing gains at death and would be substantially more complicated because records would have to be kept for an even longer period of time. A similar item was passed in the late 1970s but was repealed before it ever came into effect, partly because of anticipated implementation problems.

These implementation problems have not grown easier to solve in the past 20 years. Thus, it seems likely that what the House really passed was an abolition of the estate tax.

Other than tossing out the tax, the appropriate direction for more modest changes in the estate and gift taxes depend in large part on what the system is intended to accomplish. If the goal is to help family-owned business and farms, then the appropriate exemptions could be implemented. But if that is done, it may make more sense simply to raise the exempt amount for all purposes, because doing so only for selected forms of assets creates both horizontal equity problems and inefficient sheltering incentives.

If the goal is to chip away at an undue concentration of wealth, then the effective exemption could be raised substantially – since only the extremely wealthy are the target here – and the high tax rates maintained. This could greatly reduce the number of people that have to pay estate taxes and simplify the tax. But it would also reduce revenues.

If the goal is to improve equality of opportunity, then estate tax revenues could be earmarked for special education and training programs, or for the kind of means-tested asset accumulation subsidies supported by President Clinton, Vice President Al Gore and Governor George W. Bush.

Base-broadening – that is, loophole-closing – and rate reduction carried the day in the last comprehensive income tax reform in 1986, and could improve the equity, efficiency and simplicity of the estate tax as well. Treating different assets in a more similar fashion would reduce sheltering opportunities and thus make the tax simpler and fairer. For example, legislation could address unwarranted valuation discounts and abusive trust arrangements. Reducing rates would also reduce the incentive to shelter.

Finally, it might make sense to replace taxes on estates and gifts given with taxes on gifts and inheritances received – as is the practice in several U.S. states and many foreign countries. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden. Some argue that by encouraging the splitting of estates, a progressive inheritance tax is a more effective instrument for restraining the concentration of wealth. In addition, a unified tax system would tax all the sources or all the uses of income. Currently, the income tax burdens sources and the estate tax falls on a particular use of resources. In contrast, the income tax combined with a tax on inheritances and gifts received would cover all major sources of income over the lifetime.

The historical record shows that transfer taxes of one sort or another can play an important role in the tax system. And, although many of the arguments put forth against the current estate and gift tax system are specious, there is also a significant undercurrent of truth. Likewise, supporters of such taxes need to distinguish between the benefits of such taxes in principle, and the design problems that arise in practice.

A transfer tax system that couples effective marginal tax rates of up to 73 percent with substantial opportunities to shelter funds is asking for trouble. An income tax with similar features in the 1970s was swept out in favor of a broader-base, lower-rate system in the 1980s. In light of these considerations, a package of lower rates and a higher exemption level, combined with a thorough cleaning of the tax base and perhaps judicious earmarking of estate tax revenues, might well ensure the survival of an effective transfer tax system. M