

**DESCRIPTION AND ANALYSIS OF ALTERNATIVE WEALTH
TRANSFER TAX SYSTEMS**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on March 12, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



March 10, 2008
JCX-22-08

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I. OVERVIEW

The Committee on Finance has scheduled a public hearing for March 12, 2008, entitled “Alternatives to the Current Federal Estate Tax System.” This document¹ provides a description and analysis of various alternative wealth transfer tax systems, including estate taxes and inheritance taxes.

On November 13, 2007, the staff of the Joint Committee on Taxation published a separate pamphlet that includes a detailed description and economic analysis of the U.S. Federal estate and gift tax system.² The present document is intended to supplement that pamphlet.

Rationales for taxing transfers of wealth

Wealth transfer taxes have been part of the U.S. Federal tax system since 1797. Federal taxes on transfers at death in the United States, for most of its history, were imposed primarily to finance wars or the threat of war or otherwise to raise revenue.³ However, commentators have articulated several other policy rationales for taxing transfers of wealth, whether through an estate tax or an alternative system.

Some, for example, argue that wealth transfer taxes are necessary to prevent transfers of vast estates within families and to break up dynastic concentrations of wealth. In 1906, for example, President Theodore Roosevelt advocated

a progressive tax on all fortunes beyond a certain amount, either given in life or devised or bequeathed upon death to any individual – a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual.⁴

Some view a tax on transfers of wealth as a tool to mitigate the concentration of economic power and concomitant political power.

Another rationale often given for taxing transfers of wealth is to maximize equality of opportunity.⁵ A child born to wealthy parents may have opportunities not available to a child

¹ This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008. This document is also available on the web at www.house.gov/jct.

² Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), Nov. 13, 2007.

³ *Id.* at 4-10.

⁴ Congressional Research Service, *A History of Federal Estate, Gift, and Generation-Skipping Taxes* (No. 95-444 A), Updated Jan. 3, 2008, at 6 (citing Randolph E. Paul, *Taxation in the United States* 88 (1954)).

⁵ See, e.g., Jeremy Bentham, *Principles of the Civil Code*, in *The Theory of Legislation* 88, 122 (C.K. Ogden ed., Harcourt, Brace & Co. 1931) (1802) (“When property by the death of the proprietor

born to poor parents. By reducing the amount that wealthy parents can pass to their heirs, one might argue that taxing transfers of wealth helps level the playing field among members of the next generation.

Others argue that a wealth transfer tax is justifiable because it lends progressivity to an overall tax system. One commentator, for example, asserts that progressivity is a desirable characteristic of the U.S. tax system, and that the estate tax “provid[es] an important element of progressivity in the federal tax system.”⁶ Furthermore, wealth transfer taxes sometimes are thought to serve as an important backstop to an income tax system, potentially capturing and taxing certain accrued income that “leaks” through the income tax system.

Commentators have long debated both (1) the legitimacy of the various articulated policy rationales for taxing transfers of wealth and (2) the optimal structure for achieving any policy goals that are deemed legitimate.

Alternative wealth transfer tax systems

The choice of one form of wealth transfer tax system over another necessarily will involve tradeoffs among efficiency, equity, administrability, and other factors. A determination whether one system is preferable to another could be made on the basis of each system’s relative success in achieving one or a majority of these goals, without sacrificing excessively the achievement of the others. Alternatively, such a determination could be made based on which system provides the best mix of efficiency, equity, and administrability.

The United States, State governments, and foreign jurisdictions tax transfers of wealth in many different ways. Some wealth transfer tax systems, for example, impose a tax on the transferor. Such systems include the U.S. estate and gift tax system, which imposes a gift tax on certain gratuitous lifetime transfers, an estate tax on a decedent’s estate, and a generation-skipping transfer tax on certain transfers that skip generations. Another approach that involves imposition of a tax on a transferor is a “deemed-realization” approach, under which a gratuitous transfer is treated as a realization event and the gain on transferred assets, if any, generally is taxed to the transferor as capital gain.

Other wealth transfer tax systems tax the transferee of a gift or bequest. Such systems include inheritance (or “accessions”) tax systems, under which a tax is imposed against the

ceases to have an owner, the law can interfere in its distribution . . . by regulating the succession in favour of equality . . .”); John Rawls, *A Theory of Justice* 277 (1971) (noting that wealth transfer taxes help “correct the distribution of wealth and [] prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity”); Tax Message Memorandum from Felix Frankfurter to Franklin Roosevelt (undated), in *Roosevelt and Frankfurter: Their Correspondence 1928-1945*, at 434-36 (1967) (discussing Roosevelt statement that an estate tax “would help to preserve a measure of equality of opportunity”). Cf. John Locke, *Two Treatises of Government* 206-07, 210 (Peter Laslett ed., student ed., Cambridge University Press 1994) (1690) (arguing that in certain cases it is a natural law right to pass property to one’s children).

⁶ Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L.J. 259, 270-73 (1983).

recipient of a gratuitous transfer. Some jurisdictions do not impose a separate tax, but instead treat receipts of gifts or bequests as gross income of the recipient (referred to in this document as the “income inclusion approach”).

Among the thirty OECD countries, only the United States and the United Kingdom have estate and gift tax systems that tax the transferor on gratuitous transfers during life and at death.⁷ The majority of OECD countries have inheritance taxes.⁸ Five countries have no inheritance or estate taxes: Australia, Canada, Mexico, New Zealand, the Slovak Republic and Sweden.⁹ In Canada, a capital asset transferred at death is deemed sold immediately before death. Gains on capital assets are deemed recognized at the time of the transfer. In Australia and Mexico, recipients of capital assets transferred at death take a carry-over basis from the transferor. In Australia, for example, there is no gift tax but the donor is treated as transferring a capital asset for market value. New Zealand has no estate tax but imposes a graduated “gift duty” on donors who transfer gifts totaling more than NZD 27,000 (USD 21,444) in a 12-month period.¹⁰

Regardless of whether the tax is imposed against the transferor or the transferee, some commentators assert that the real economic burden of any approach to taxing transfers of wealth falls on the recipients, because the amount received effectively is reduced by the amount of tax paid by the transferor or realized by the transferee.¹¹ Some commentators argue that systems that impose a tax based on the circumstances of the transferee – such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a

⁷ Information in this paragraph and throughout this pamphlet relates to foreign law and is based on the Joint Committee staff’s review of publicly available secondary sources, including in large part the International Bureau of Fiscal Documentation (“IBFD”) County Surveys and Country Analyses.

⁸ Denmark has a hybrid system: The estate tax is calculated on the net value of the estate and is due upon the transfer of property. The executor of the estate is responsible for payment of the estate tax; recipients of the decedent’s property are jointly and severally liable for the tax. Gifts to non-relatives are included in the donee’s income. Gifts to certain close relatives are subject to a gift tax (and not the income tax). The donor and the donee are responsible for reporting gifts to the taxing authorities on an annual basis. IBFD European Taxation, Denmark Country Analysis, B.11.

⁹ Austria has an inheritance and gift tax that was abolished by the Austrian Constitutional Court in decisions dated March 7, 2007, and of June 15, 2007. The abolition will become effective on August 1, 2008. IBFD European Taxation, Austria Country Survey, B.5.

¹⁰ New Zealand Inland Revenue, “Gift duty: A guide to the gift duty and how to pay it,” (June 2005) available at <http://www.ird.govt.nz/resources/file/eb9f324798320ac/ir194.pdf>.

¹¹ See, e.g., Lily L. Batchelder, “*Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax*,” The Hamilton Project, The Brookings Institution, Discussion Paper 2007-07, at 5 (June 2007) (hereafter Batchelder, *Taxing Privilege More Effectively*); *Alternatives to the Current Wealth Transfer Tax System*, in American Bar Association, *Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes* 171 app. A (2004) (hereafter ABA, *Alternatives*); Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. Rev. 551, 556 (2003).

greater number of transferees and potentially to lower-income beneficiaries. Others assert that such systems promote fairness in the tax system. However, the extent to which one form of transfer tax system in practice is more effective than another in achieving these goals is not clear.

Wealth transfer tax systems other than an estate tax also may present benefits or additional challenges in administration or compliance. Inheritance taxes or income inclusion systems, for example, may reduce the need for costly tax planning in the case of certain transfers between spouses. At the same time, to the extent such systems are effective in encouraging distributions to multiple recipients in lower tax brackets, they may be susceptible to abuse such as through the use of multiple nominal recipients as conduits for a transfer intended for a single beneficiary. These and other issues are discussed in greater detail below.

II. DESCRIPTION OF ALTERNATIVE WEALTH TRANSFER TAX SYSTEMS

A. Estate Tax Systems

1. Imposition of tax

The United States and a limited number of other countries such as the United Kingdom tax wealth transfers using some form of an estate tax.¹² Under an estate tax system, a tax generally is imposed on a decedent's estate before bequests are distributed to the decedent's heirs. In theory, estate tax liability depends upon the size of the estate and the rate of tax imposed thereon, rather than the identity of the beneficiaries to whom the estate is distributed. In practice, in the United States, exceptions are made for certain distributions (e.g., to surviving spouses, charities, etc.). Estate tax systems also may include a gift tax on gratuitous lifetime ("inter vivos") transfers and/or some form of additional or enhanced tax on transfers that skip one or more generations. As stated above, under an estate tax system, the tax is imposed on the transferor (i.e., the donor of a gift or the estate of a decedent).

Under the U.S. estate tax system, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor).¹³

2. Tax base

As under most estate tax systems, the U.S. system exempts a certain amount of transfers from tax. With the exception of the year 2010 (when the U.S. estate tax is scheduled to be repealed for one year), a lifetime unified credit is available with respect to taxable transfers both by gift and at death. This unified credit effectively exempts \$2 million in transfers from estate tax for decedents dying in 2008, \$3.5 million for 2009, and \$1 million for decedents dying after 2010,¹⁴ while the gift tax exemption remains at \$1 million throughout this period.¹⁵

In addition to a lifetime exemption, certain other transfers may be excluded from the base of tax under an estate tax system. For example, under the U.S. system, a donor may exclude from his or her gift tax base \$12,000 (for 2008) in transfers per donee per year.¹⁶ A marital

¹² IBFD European Taxation, United Kingdom, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007).

¹³ For a more detailed description of the present U.S. estate tax system, see Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), Nov. 13, 2007.

¹⁴ Sec. 2010.

¹⁵ Sec. 2505.

¹⁶ Sec. 2503(b).

deduction generally is permitted for the value of property transferred between spouses,¹⁷ and a charitable deduction generally is permitted for the value of property transferred to charity.¹⁸ Also under present U.S. law, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$500,000.¹⁹ In addition to the marital deduction for transfers to a surviving spouse and the charitable deduction for transfers to charity, the Federal estate tax permits deductions for funeral expenses, claims against the estate, and administration expenses of the estate. The effect of such deductions generally is to impose the Federal estate tax only on amounts in the estate that pass to the estate's beneficiaries.

The U.S. estate tax system also includes preferential rules for certain business interests. In general, an executor can elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.²⁰

Estate tax systems also may have varying rules for determining the basis of property received as a gift or bequest. Under the U.S. system, property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. Property passing from a decedent's estate, on the other hand, generally takes a stepped-up basis (assuming the property has appreciated in value). "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death.

3. Tax rates

Under the U.S. system, gifts and bequests are taxed under a common rate table, with a top estate and gift tax rate of 45 percent through 2009 and 55 percent after 2010. The highest gift tax rate is 35 percent in 2010 (during the one-year repeal of the estate tax). The generation-skipping transfer tax rate generally equals the highest estate tax rate.

¹⁷ Secs. 2056, 2523.

¹⁸ Secs. 2055, 2522.

¹⁹ Sec. 2031(c).

²⁰ Sec. 2032A.

B. Inheritance Tax Systems

1. Imposition of tax

Whereas estate and gift taxes are imposed on the transferor of a gift or on the estate of a decedent, an inheritance tax (sometimes referred to as an accessions tax) is imposed on the recipient of a gratuitous transfer.²¹ As discussed above, among OECD countries, a significant majority have inheritance tax systems.

Most frequently, an inheritance, or accessions, tax is structured as an annual inheritance tax. An annual inheritance tax is a tax imposed against receipts during a particular year. Most countries that tax transfers of wealth use annual inheritance taxes. As an alternative to an annual inheritance tax, an accessions tax may be structured to apply to cumulative receipts of lifetime gratuitous transfers in excess of a lifetime exemption amount. Relatively few countries currently use such a cumulative accessions tax system.

2. Tax base

An inheritance tax, like an estate tax, often provides an exemption from the tax for up to a specified amount of gratuitous transfers. Under an annual inheritance tax, the exemption generally applies on an annual basis to receipts during a particular year. Under a cumulative accessions tax, on the other hand, receipts are cumulated with prior year receipts; only cumulative receipts in excess of a lifetime exemption amount generally are subject to tax.

Under inheritance tax systems, the amount of exemption typically varies based on the familial relationship of the recipient taxpayer and the transferor, with receipts from closer relatives qualifying for a higher exemption amount. Because an inheritance tax generally is supposed to tax recipients on the value of the bequests they receive,²² in theory the same exemption schedule (and rates) should apply to all inheritances. In practice, however, countries generally discriminate across different classes of recipients. Under the German inheritance tax, for example, the spouse is exempt from tax on the first €307,000 (\$471,429)²³ received by gift or, subject to certain limitations, the first €63,000 (\$864,542) received by bequest. Each child is exempt from tax on the first €205,000 (\$314,798) received by gift. In the event of a transfer by bequest, this basic exemption amount is increased by an amount up to €2,000 (\$79,823) depending on the age of the child. Stepchildren, grandchildren, great-grandchildren, and, in the case of a bequest, parents and grandparents, are exempt from tax on the first €1,200 (\$78,595) received. Siblings, nieces, nephews, stepparents, sons-in-law, daughters-in-law, parents-in-law, divorced spouses, and, in the case of a gift, parents and grandparents, are exempt from tax on the

²¹ The term inheritance tax sometimes is used more broadly to describe any system in which the recipient (rather than the transferor) of gifts or bequests is taxed on the transfer. This would include systems under which the gift or bequest is included in the gross income of the recipient (“income inclusion” systems), discussed separately below.

²² See Batchelder, *Taxing Privilege More Effectively*, *supra*, at 47.

²³ Currency conversions are as of March 7, 2008.

first €10,300 (\$15,811) received. All others are exempt from tax on the first €5,200 (\$7,982) received.²⁴ In France, beginning August 22, 2007, inheritances between spouses and between unmarried individuals who live together and have entered into a partner contract are exempt from inheritance tax.²⁵

An inheritance tax also may exempt or provide special treatment for certain types of property received. The German inheritance tax, for example, provides an exemption for household goods, works of art, and certain other property.²⁶ As another example, in France half the value of shares in a company and assets of a business is exempt from inheritance and gift tax if at least one of the beneficiaries agrees to run the company or business and provided certain conditions regarding the holding of the shares or business are satisfied.²⁷ The Irish gift and inheritance taxes also exempt certain life insurance proceeds.²⁸ Under the Spanish inheritance tax, a deduction is allowed to a spouse or child of a deceased individual for 95 percent of the value of a family business.²⁹

3. Tax rates

Under an inheritance tax, the tax rates may vary with the relationship between the recipient taxpayer and the transferor, with lower tax rates applying to receipts from closer relatives.

In Finland, for example, there are three different inheritance tax schedules: (1) spouse (including, in certain cases, a domestic partner), parent, child, or child's direct heir; (2) siblings and their descendants; and (3) others. For spouses, parents, children, and children's heirs, tax rates begin at 10 percent on the first €13,600 (\$20,877) of taxable transfers, followed by a marginal rate of 13 percent on the next €33,000 (\$50,657), and rise to a 16 percent marginal tax rate on taxable transfers in excess of €46,600 (\$71,533). For siblings and their descendants, the applicable tax rates are twice those above. For all others, the applicable tax rates are three times those above.³⁰

²⁴ IBFD European Taxation, Germany, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007) (hereafter IBFD European Taxation, Germany).

²⁵ IBFD European Taxation, France, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007) (hereafter IBFD European Taxation, France).

²⁶ IBFD European Taxation, Germany, *supra*.

²⁷ IBFD European Taxation, France, *supra*.

²⁸ IBFD European Taxation, Ireland, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007).

²⁹ IBFD European Taxation, Spain, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007).

³⁰ IBFD European Taxation, Finland, Country Survey, B.5: Inheritance and Gift Taxes (updated through October 15, 2007). The same rate schedule is used for bequests and for gifts, except that (1) all

In addition to using different tax brackets for different categories of heirs or donees, the Spanish inheritance and gift tax applies a net worth surcharge to the transferee's tax liability. The surcharge varies by category of the beneficiary in relation to the transferor and by level of the beneficiary's wealth before receipt of the gift or inheritance.³¹

gifts from the same donor received within a three-year period are cumulated for the purpose of determining gift tax liability, and a credit is allowed for any gift tax paid on a prior gift, and (2) all gifts received by a beneficiary within three years before a decedent's death are added to the recipient's taxable inheritance, and credit is allowed for any gift tax paid. *Id.* Finland thus combines features of an annual inheritance tax with features of a cumulative accessions tax.

³¹ *Id.*

C. Income Inclusion Approach

1. Imposition of tax

Under an income inclusion approach, gifts and bequests generally are treated as income of the recipient and thus are subject to income tax. In Mexico, for example, there is no Federal or State tax on inheritances or gifts. However, certain gifts may be included in the recipient's taxable income.³²

Under present U.S. law, gross income generally excludes the value of property acquired through gift, bequest, devise, or inheritance (section 102(a)) and amounts received under a life insurance contract, if received by reason of the death of the insured (section 101(a)). Commentators have noted that Congress could adopt an income inclusion approach by repealing sections 102(a) and 101(a).³³

2. Tax base

An income inclusion system subjects the receipt of gifts and bequests to income tax. Generally, gifts and bequests are cumulated with the recipient's other income and reported on the recipient's annual income tax return. Because charities generally are exempt from tax on their net income,³⁴ they would not be subject to tax on receipts of gifts or bequests.

3. Tax rates

Under an income inclusion system, gifts and bequests generally are taxed under the same rate schedule applicable to the taxpayer's other income. To mitigate the tax burden on recipients of having all or most of an inheritance taxed at the recipient's highest marginal income tax rate, an income inclusion system could be designed such that large gifts or bequests received in one year are treated as if they had been received over a period of years (in other words, the income could be spread out temporally for income tax purposes).³⁵

³² IBFD Latin American Taxation, Mexico, Country Survey, B.5: Inheritance and Gift Taxes (updated through July 1, 2007).

³³ ABA, *Alternatives, supra*, at 176 (citing Joseph C. Dodge, *Taxing Gratuitous Transfers Under a Consumption Tax*, 51 Tax L. Rev. 529, 589-93 (1996); Joseph C. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 93 Harv. L. Rev. 1177 (1978)).

³⁴ Sec. 501(a).

³⁵ This design issue might be significant in practice. In a study that matched the estate tax returns of individuals dying in 1982 with the income tax returns of their heirs, David Joulfaian, "*The Distribution and Division of Bequests: Evidence from the Collation Study*," Office of Tax Analysis, U.S. Department of Treasury, OTA Paper 71, August 1994, found that the average inheritance of a child heir was approximately three times the size of the heir's income.

D. Deemed-Realization Approach

1. Imposition of tax

Some jurisdictions do not impose a separate tax on transfers of wealth, but instead generally treat gifts and bequests as income tax realization events to the donor or decedent. Any gain that resulted from this deemed sale in most cases would be taxed as capital gain. (This approach is thus the mirror image of the income inclusion approach discussed immediately above.) Under a deemed realization approach, a donor or decedent would pay income tax on the difference between the value of any gift or appreciated asset held at death and the tax basis of that asset at the time of the gift or the decedent's death. Under a deemed-realization system, gains on assets bequeathed to an heir would be reported on the decedent's final income tax return (as opposed to a separate estate tax return, as under the U.S. estate tax system).

Perhaps of particular note in light of present law in the United States for persons dying in 2010 is the taxation of decedents in Australia and Canada, both of which follow a deemed-realization approach for taxing gifts and bequests. For U.S. decedents dying in 2010, present law generally provides that the decedent's basis in capital assets is carried over to be the heir's basis in the assets. Both Australia and, to a lesser degree, Canada have carryover basis regimes for certain capital assets transferred at death.

2. Tax base

Under a deemed realization system, the amount realized generally is the fair market value of the asset transferred. The gain subject to tax would be the difference between fair market value and the transferor's adjusted basis.³⁶ Because gain is not recognized on cash, a deemed-realization approach would exclude cash from the tax base.

Australia.—Australia has no inheritance or gift tax.³⁷ However, the transfer of capital assets generally is subject to Australia's capital gains tax ("CGT"). Under the CGT, lifetime gifts are taxed similarly to capital assets sold for profit. Testamentary transfers of capital assets, however, generally are not subject to the CGT and consequently there is no realization of gain on assets transferred at the time of death.³⁸

³⁶ ABA, *Alternatives, supra*, at 177 (citing Joseph C. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 Tax L. Rev. 421 (2001)).

³⁷ Australia repealed its estate and gift taxes in the late 1970s. Jeffrey S. Kinsler, *The Taxation of Gifts and Bequests in Australia: A Prototype for Transfer Tax Reform in the United States?* 6 Pacific Rim Law & Policy Journal 305 (1997); Willard H. Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 Tax Lawyer 113 (1981). See also Keith G. Banting, *The Politics of Wealth Taxes*, 17 Canadian Public Policy 351, 360 (1991);

³⁸ One exception to the rule exempting transfers by a decedent from CGT is when an asset is bequeathed to a tax-exempt organization. In such a case, there is a deemed disposition of the asset by the decedent immediately before death for consideration equal to the asset's market value at the time of

In Australia, assets passing to beneficiaries via the administrators of a deceased person's estate generally will not be subject to taxation.³⁹ Except for assets acquired by the decedent before September 20, 1985, the cost basis of the asset in the hands of the personal representative and the beneficiary is that of the decedent.⁴⁰ That is, heirs carry over the basis of the decedent. The carryover of a decedent's cost basis applies to assets passing under a will, a court order varying a will, the laws of intestacy and a deed of family arrangement (from April 2, 1992). For assets acquired by the decedent prior to September 20, 1985, the asset's basis is deemed to be its market value (that is, is stepped-up) at the date of death.⁴¹

Canada.—Canada has no formal gift or inheritance tax.⁴² The deemed distribution provisions of Canada's Income Tax Act ("ITA"), however, impose a tax on capital gains of the decedent unrealized at the time of his or her death. In Canada, a decedent is deemed to have disposed of all property owned immediately before death.⁴³ Depending on the property involved, this deemed disposition may cause the decedent to recognize income, recaptured depreciation, or capital gains.⁴⁴ A taxpayer who is deemed to dispose of a capital property is deemed to have made the disposition at fair market value, and a capital gain will arise to the extent that the proceeds of disposition (whether actual or deemed) exceed the taxpayer's cost of the asset and any related costs of disposition. The estate of the decedent generally will be deemed to have acquired the property at a cost equal to the deemed proceeds of disposition.

death, and gain is included in the decedent's estate's income. Income Tax Assessment Act of 1997 ("ITAA"), sec. 160Y(3). Jeffrey S. Kinsler, *The Taxation of Gifts and Bequests in Australia: A Prototype for Transfer Tax Reform in the United States?* 6 Pacific Rim Law & Policy Journal 305, 324 (Mar. 1997).

³⁹ ITAA Div. 128, available at Australian Government, Australian Taxation Office, at <http://law.ato.au> (last accessed Nov. 9, 2007).

⁴⁰ The beneficiary obtains a cost basis equal to the decedent's indexed cost base.

⁴¹ IBFD Asia-Pacific Taxation, Australia, Country Analysis, 17: Capital Gains (updated through January 1, 2007).

⁴² See Robert Couzin and Mark Novak, *Business Operations in Canada*, BNA Tax Management Portfolio 955-3rd (noting that with the 1972 introduction of an income tax on capital gains, Canada moved toward a system of taxation on successions by way of an income tax on incremental increases in value and under which there are no longer any estate taxes or succession duties levied by either the federal government or the provinces); David G. Duff, *The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand*, 3 Pittsburgh Tax Rev. 71, 99 (2005) (attributing the repeal of the federal gift and estate tax to "the introduction of the capital gains tax at death, the low revenue yield for the federal government, and the disparate effects of federal and provincial occupancy of the field"); see also Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 Osgoode Hall Law Journal 133 (1978); Meyer Bucovetsky & Richard M. Bird, *Tax Reform in Canada: A Progress Report*, 25 National Tax Journal 15 (1975).

⁴³ ITA sec. 70.

⁴⁴ IBFD Canada Taxation, Canada, Country Survey, B.5.1: Deemed disposition rules (last updated October 15, 2007).

The ITA provides an exemption from the capital gains tax that otherwise would arise on deemed dispositions for property that passes to the spouse of a decedent. This exemption (termed a “rollover”) allows deferral of tax to the extent that certain property of the decedent passes to the decedent’s spouse or a qualified spousal trust.⁴⁵ That is, the rollover creates a carryover basis regime for property that passes to the spouse of a decedent. Generally, the rollover also will defer recognition of recaptured depreciation that might otherwise arise on the disposition of depreciable capital property. The rollover applies automatically (unless the transferor elects otherwise) and applies whether the transfer occurs during the transferor’s lifetime or as a result of death.⁴⁶ A rollover also applies on a transfer to a former spouse in settlement of rights arising out of the marriage.

3. Tax rates

Under a deemed-realization approach, tax rates that apply generally to capital gains would apply to gains on deemed realizations resulting from gifts and bequests.

⁴⁵ IBFD Canada Taxation, Country Analysis, Canada, 20.7: Rollover of Capital Gains. Deferral of tax is also available in the case of qualifying farm and fishing property that passes to the children of the decedent.

⁴⁶ ITA secs. 70(6) and 73(1).

E. Hybrid Approaches

Some commentators advocate adoption of a hybrid inheritance tax system that would combine aspects of both an accessions tax and an income inclusion approach. As described previously, Finland, for example, uses a combination of an annual inheritance tax and a cumulative accessions tax.⁴⁷

One commentator advocates replacing the U.S. estate tax system with a hybrid system that combines attributes of an income inclusion approach and a cumulative accessions tax.⁴⁸ Under this hybrid approach, each taxpayer would be entitled to a lifetime exemption from taxation for up to \$2.3 million in gifts and inheritances received. Amounts received in excess of \$2.3 million must be included in the recipient's taxable income along with the recipient's other income. In addition, gifts and inheritances in excess of \$2.3 million would be subject to an additional 15-percent surtax. The transferor's basis in amounts gifted or bequeathed would be carried over to the recipient so that if the donor did not pay capital gains tax on appreciation in a transferred asset, the recipient will recognize a capital gain on any subsequent sale of the asset.⁴⁹ This proposal resembles an income inclusion approach in that the recipient is required to include certain gifts and bequests in income. But the proposal also incorporates characteristics of a cumulative accessions tax by providing for a lifetime exemption and also a surtax on receipts in excess of the exemption amount.

⁴⁷ See *supra* note 30.

⁴⁸ Batchelder, *Taxing Privilege More Effectively, supra*.

⁴⁹ *Id.* An heir would be required to include the fair market value of an appreciated asset as an inheritance at the time of receipt and also would be taxed on the accrued gain when she subsequently sold the asset. However, to mitigate potential double taxation, she would be permitted to deduct from her capital gain on the subsequent sale an amount equal to the share of her inheritance that the accrued gain represented at the time of receipt, multiplied by her inheritance tax rate at that time.

III. ISSUES AND ANALYSIS

A. Distributional and Equity Issues

Commentators have articulated various rationales for taxing transfers of wealth, including breaking up dynastic concentrations of wealth, maximizing equality of opportunity, and contributing to progressivity in the Federal tax system.⁵⁰ The articulated rationales themselves are controversial. Moreover, the extent to which the various alternative means of taxing transfers of wealth further these policy goals has been a subject of vigorous debate.

Incentives related to the concentration of wealth

Overview

Taxes on wealth transfers may have multiple avenues by which they affect the concentration of wealth. The obvious direct effect is that the tax may affect the distribution of wealth by reducing net transfers of wealth. An indirect effect may occur if taxes on the transfer of wealth affect the accumulation of wealth. There is some evidence the U.S. estate tax may reduce the reported net worth of high wealth individuals.⁵¹ A third avenue by which taxes on the transfer of wealth may affect the concentration of wealth is by creating incentives to distribute accumulated wealth more widely or less widely. Some argue, for example, that because the current U.S. estate tax system is focused solely on the circumstances of the transferor, it does little to break up concentrations of wealth or to promote equality of opportunity.⁵² Such commentators argue that systems that impose a tax based on the circumstances of the transferee – such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries.⁵³

⁵⁰ See Part I above.

⁵¹ Wojciech Kpczuk and Joel Slemrod, “The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior,” in William G. Gale, James R. Hines Jr., and Joel Slemrod, editors, *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution Press), 2001. Kpczuk and Slemrod write, “We found that over time summary measures of the state tax rate structure are generally negatively related to the reported aggregate net worth of the top estates ... This finding is consistent with estate taxation reducing either wealth accumulation r inducing avoidance, or both” (pp338-9).

⁵² Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. Rev. 551, 553 (Winter 2003) (“[A]ny transferee-oriented tax should possess greater appeal than a transferor-oriented tax with respect to achieving such goals as curbing undue accumulations of wealth or improving equality of opportunity.”).

⁵³ *Id.* at 560-61.

Example

To highlight this argument assume that the sole motivation of the transferor is to maximize the total after-tax transfer received by all transferees. Consider the three different types of wealth transfer tax systems described above: an estate tax with an exemption amount and graduated tax rates applied to the taxable estate in excess of the exemption amount; an inheritance tax in which there is an exempt amount for each transferee with graduated tax rates applied to the taxable inheritance in excess of the exempt amount; and an income tax inclusion system under which the income tax has an exempt amount and graduated tax rates on income in excess of the exempt amount. Further assume the transferor has two possible beneficiaries.

Estate tax.—Under the current estate tax system, the number of beneficiaries who will receive bequests from an individual decedent does not affect the overall tax burden on the estate. Whether the transferor makes bequests of equal size or unequal size to the two beneficiaries, the total after-tax wealth in the hands of the two beneficiaries is unaffected. All after-tax wealth could be concentrated in the hands of one beneficiary at no extra cost in terms of diminished after-tax wealth.

Inheritance tax.—Under the inheritance tax, if the transferor's sole goal is to maximize the total after-tax transfer, the transferor should always make bequests of nearly equal size to the two possible beneficiaries. The transferor should divide his or her wealth such that the bequests in the hands of each beneficiary are subject to the same marginal tax rate on the inheritance. In such a circumstance shifting one dollar of bequest from one beneficiary to the other has no effect on total after-tax wealth. If the bequests were sufficiently unequal that the inheritance of one beneficiary is in a higher marginal tax bracket, for example 25 percent, while the inheritance of the other beneficiary is in a lower marginal tax bracket, for example 15 percent, then total after-tax wealth could be increased by reducing the bequest to the former and increasing the bequest to the latter. Reducing the bequest to the former by \$100 would reduce the tax cost the bequest by \$25, while increasing the bequest to the latter by \$100 would increase the tax cost by only \$15. An increase in total after-tax wealth of \$10 would occur. To maximize after-tax wealth such transfers should be made from the higher-bracket beneficiary to the lower-bracket beneficiary until the two beneficiaries are in the same tax bracket. To maximize after-tax wealth, the maximum differential in bequests should be no greater than the width of the tax bracket into which both gifts fall.⁵⁴

Income tax inclusion.—Under the income inclusion approach, the transferor has an incentive similar to that under the inheritance tax, except the transferor must take into account the initial income position of the two potential beneficiaries. The transferor should plan bequests such that the two beneficiaries' taxable income inclusive of the bequests is in the same marginal tax rate bracket. In general this will lead to less equal bequests than under the incentive structure of the inheritance tax. If the two potential beneficiaries are in different taxable income positions prior to receipt of the inheritance, the total tax cost of the inheritance is minimized by initially

⁵⁴ Of course, in practice the bracket might be quite "wide." If both beneficiaries are in the highest tax bracket there is no limit on the differential in bequests that maximizes after-tax wealth.

bequeathing sufficient funds to the beneficiary in the lower marginal tax rate bracket to raise that individual's income plus inheritance to the marginal tax rate bracket of the higher income beneficiary. From that point on, the bequests should be divided roughly equally such that both beneficiaries remain in the same marginal income tax bracket.

Summary of example and discussion.—The preceding example highlights that an inheritance tax has incentives for equal division of transferred wealth; income inclusion has incentives for an unequal division of transferred wealth, but only to the extent that transferees are in different income positions prior to receipt of the transfer; and an estate tax is indifferent to the division of the transferred wealth. Hence, looked at another way, both the inheritance tax and income inclusion relatively penalize concentrating transferred wealth in one person's hands and the estate tax does not. However, transfer taxes in practice around the world have features that differ from the stylized transfer taxes of this example that create different incentives.

Under the present U.S. gift tax, for example, the annual per-donor, per-donee gift tax exclusion (currently \$12,000) provides an incentive to make lifetime gifts to a greater number of recipients than might occur in the absence of such an exclusion. Under the assumption that the transferor wishes to maximize the after-tax wealth of the beneficiaries, the transferor should make annual gifts at the full value of the annual exclusion to all potential beneficiaries. This, in fact, is common estate tax planning advice in the United States. Such a plan of gift giving promotes equal division of transferred wealth.

In addition, as an empirical matter it is not obvious that transferors in the United States are motivated to concentrate their transferred wealth into one set of hands. The typical decedent in the United States has multiple objects of affection and despite the ability to concentrate their wealth, they most frequently choose not to do so. Studies have found that more than two-thirds of testate decedents with multichild families divide their estates exactly equally or very close to equally.⁵⁵ Table 1, below, reports for a sample of 8,500 1982 estate tax returns the number of heirs who received bequests by the heir's relationship to the decedent.⁵⁶ On average there were approximately five beneficiaries receiving bequests from each decedent. Bequests to trusts, which may make distributions to multiple beneficiaries, comprised 10 percent of all bequests. More recent data suggests similar patterns. In 1999, returns of 104,000 decedents made bequests to a surviving spouse on 42 percent of the returns (43,700), 195,200 bequests to heirs other than

⁵⁵ Mark O. Wilhelm, "Bequest Behavior and the Effect of Heirs' Earnings: Testing the Altruistic Model of Bequests," *American Economic Review*, vol. 86, September 1996, pp. 874-92. Wilhelm finds that 68.6 percent of all decedents with multichild families divide their estates exactly equally among their children and 76.6 percent divide their estates so that each child receives within two percent of the average bequest made to all children. Wilhelm's study uses a sample of 1982 decedents matched with the income tax returns of heirs. These data and other results are also discussed in David Joulfaian, "The Distribution and Division of Bequests: Evidence from the Collation Study," Office of Tax Analysis, U.S. Department of Treasury, OTA Paper 71, August 1994.

⁵⁶ Joulfaian, "The Distribution and Division of Bequests," 1994, Table 3A.

the spouse (1.9 such bequests per return), and 139,400 bequests to trusts (1.3 such bequests per return).⁵⁷

Table 1.—Recipient and Number of Bequests Per Estate Tax Return, 1982

Bequests to	Number of Bequests	Bequests per Return
Spouse	4,698	0.6
Son	4,674	0.5
Daughter	4,807	0.6
Grandchild	5,547	0.7
Sibling	1,794	0.2
Niece/Nephew	5,428	0.6
Aunt/Uncle	38	0.0
Parent	99	0.0
Other Relatives/Not Related	11,847	1.4
Trust	4,404	0.5
Not Ascertainable	894	0.1
TOTAL	44,230	5.2

Source: Joulfaian, U.S. Department of the Treasury, OTA Paper 71, August 1994.

Countries and States that have adopted inheritance taxes generally do not apply the same exemption amount and tax rate schedule to all beneficiaries. Under most existing inheritance tax structures, a larger exemption and lower tax rate schedule is assigned to transfers to a surviving spouse, often followed by a smaller exemption and higher tax rate schedule for transfers to lineal descendants, followed by a yet smaller exemption and higher tax rate schedule for transfers to other relatives, followed by an even smaller exemption and higher tax rate schedule for other transfers. Consequently, in practice, the exemption levels and rate schedules favor retention of wealth within the nuclear family as opposed to a broad division of transferred wealth. In the United States, the unlimited marital exemption creates within the estate tax a preferential system like that of many inheritance taxes, favoring transfers to a surviving spouse. If, as noted above, most bequests to children in the United States are roughly equal in amount, in many cases there may be no real difference between the U.S. estate tax and an inheritance tax in terms of the ultimate division of transferred wealth.

In contrast to inheritance taxes, inclusion of transfers in a country's income tax base does not readily permit a policy that favors some beneficiaries over other beneficiaries.

⁵⁷ Joint Committee on Taxation staff estimations from 1999 estate tax returns.

Taxes on wealth transfers and the progressivity of the Federal tax system

Most analysts think it is appropriate to discuss the tax system as a whole and ask how each component of the Federal system contributes to the overall efficiency effects, equity, and administrability of the system. In assessing the effect of taxes on wealth transfer to the progressivity of the Federal tax system a conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of \$1 million to her son and incurs a gift tax liability of \$500,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by \$500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son \$1.5 million, so that the gift tax has reduced the son's economic well-being by \$500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and donee generations may not be important to assessing the fairness of transfer taxes if both the donor and donee have approximately the same income.⁵⁸

Proponents of inheritance taxes or income inclusion argue that tax systems that focus on the circumstances of transferees may be more effective in promoting fairness in the tax system. If the burden of any wealth transfer tax falls on the transferee in the form of a reduced inheritance or gift, such commentators argue that systems that compute tax based on the transferee's circumstances are preferable.⁵⁹ Some also question whether it is appropriate to exclude gifts and bequests from gross income (as under present U.S. law) while income earned through labor is subject to tax, and propose that the present estate tax system be replaced by a hybrid system under which gifts and bequest would be included in income, taxed at ordinary income tax rates, and subject to an additional surtax.⁶⁰

At least one commentator has argued that the present U.S. estate tax should be retained and strengthened because it "has had a significant progressive effect" on the Federal tax system.⁶¹ Some suggest that by serving as a "backstop" for income that escapes income taxation, transfer taxes may help promote overall fairness of the U.S. tax system. Others agree that the estate tax is highly progressive, but argue that inheritance tax systems are equally progressive,

⁵⁸ Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992. These studies, however, examine data relating to a broad range of incomes in the United States and do not directly assess the correlation of income among family members with transferors subject to the estate tax.

⁵⁹ See, e.g., Batchelder, *Taxing Privilege More Effectively*, *supra*, at 6.

⁶⁰ *Id.* at 7, 16-28.

⁶¹ Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 *Yale L.J.* 259, 271-72 (Dec. 1983).

while distributing the tax burden among heirs more precisely on the basis of the amount of their inheritances and of their other income.⁶² Others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the contribution of transfer taxes to the overall fairness of the U.S. tax system.⁶³

⁶² Batchelder, *Taxing Privilege More Effectively*, *supra*, at 29.

⁶³ Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), November 13, 2007, discusses the uncertainties regarding the economic incidence of the estate tax.

B. Administrative and Compliance Issues

Different types of wealth transfer tax systems raise different administrative and compliance issues, including filing or tax planning burdens, opportunities for aggressive planning, and opportunities for abuse. If, for example, migrating from an estate tax to an inheritance tax would in fact lead to wider dispersal of gifts and bequests, such a migration also might be expected to increase compliance costs, because a greater number of taxpayers would need to file returns or reports with the IRS. Even where no tax is due in a particular year because receipts fall below an annual or lifetime exemption amount, such taxpayers still would need to track and likely report on such receipts to keep track of the amount of exemption used. On the other hand, it is possible that the need for tax planning in advance of death would be reduced under an inheritance tax system.⁶⁴

Although a full discussion of administrative and compliance issues is beyond the scope of this document, the following subsections briefly highlight some key administrative concerns that may arise under various wealth transfer tax systems.

Valuation discounts

A significant issue under the current U.S. estate and gift tax system is the use of valuation discounts in planning gratuitous transfers, particularly transfers of closely held business interests.⁶⁵ Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value.⁶⁶ In some cases, these reductions in value for estate and gift tax purposes may not accurately reflect actual fair market value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.

The need for actuarial tables in order to value beneficial interests in a trust may be mitigated under an inheritance tax system, because the tax generally is imposed when a

⁶⁴ See, e.g., *id.* at 41-46 (arguing that certain “indirect” compliance costs associated with planning for spousal transfers, deciding between gifts and bequests, techniques for minimizing valuations would be reduced under Batchelder’s hybrid inheritance tax proposal).

⁶⁵ See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), at 396-404, Jan. 27, 2005.

⁶⁶ Under the U.S. system, property is taxed at its fair market value, which generally is the price at which the property would change hands between a willing buyer and a willing seller. See, e.g., sec. 2031; Treas. Reg. sec. 20.2031-1(b). Numerous court cases have addressed the appropriateness of various types of discounts in the contexts of gifts and bequests.

beneficiary takes possession of property transferred and not, for example, when property is first transferred to trust.⁶⁷ Therefore, there would be no need for actuarial assumptions to be applied at the time of the transfer, as sometimes is necessary under the current U.S. estate tax system.

Adoption of an inheritance tax system would not, however, address the difficult questions that arise in applying valuation discounts in the case of fractional gifts, because the use of minority or marketability discounts still would be appropriate in certain cases in valuing fractional shares of property received. Moreover, if certain commentators are correct that migration from an estate tax to an inheritance tax would lead to a greater dispersal of gifts and bequests, an inheritance tax may increase compliance costs in the specific case of gifts of fractional shares of assets, because assets would be split into more, but smaller, fractional shares, potentially increasing complexity when determining appropriate valuation discounts.

Furthermore, the ability of taxpayers to undervalue assets through aggressive discount planning arguably could be mitigated in the current U.S. estate tax system through modifications to present law.⁶⁸

Spousal transfers

Under the current U.S. estate tax system, each taxpayer (including spouses) has his or her own unified credit. For decedents dying during 2008, the credit effectively exempts \$2 million in cumulative transfers from tax. Under certain circumstances, current law may encourage taxpayers to engage attorneys to assist with tax planning to ensure that both spouses' credits are fully used when passing assets to heirs. For example, first assume that Husband and Wife each has \$2 million in assets titled in his or her individual name and each passes those assets directly to Son at death. Assuming neither Husband nor Wife previously had used any of his or her credit to shield lifetime taxable gifts from gift tax, each would pass \$2 million in assets to Son free of estate tax, fully utilizing each of their unified credits. Now assume that Husband dies first and passes his \$2 million in assets to Wife. Because present law provides for an unlimited estate tax marital deduction, there is no estate tax on the transfer from Husband to Wife. However, when Wife subsequently dies and passes her \$4 million estate to Son, she has available only her own \$2 million exemption. Absent tax planning, the additional \$2 million will be subject to estate tax.

Under wealth transfer tax systems that focus on the circumstances of a transferee rather than the transferor (such as an inheritance tax or income inclusion approach), it likely would be irrelevant whether, in the example above, Son received \$2 million from each parent or \$4 million from one parent (assuming a marital deduction still would apply such that transfers between Husband and Wife would not be subject to tax). Such systems therefore may reduce or eliminate the need for costly tax planning to maximize the use of exemptions, thereby potentially reducing

⁶⁷ See ABA, *Alternatives*, *supra*, at 183.

⁶⁸ See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), at 396-404, Jan. 27, 2005 (proposing rules that would limit the use of minority and marketability discounts under the present U.S. estate and gift tax system).

compliance costs and burdens.⁶⁹ Others argue that the need for such planning could be reduced or eliminated under the current U.S. estate tax system. For example, some argue that the present U.S. system could be modified generally to allow a surviving spouse to use any estate tax exemption that was not used by the first spouse to die.⁷⁰

Transfers in trust

Trusts are used extensively under the present U.S. Federal estate and gift tax system to effect transfers of split or temporal interests in property. The use of trusts raises a number of difficult issues, such as when a gift is deemed to have been completed, particularly where all the beneficiaries of the trust may not be known at the time assets are transferred to the trust. The transfer of temporal interests also raises complicated valuation issues.

Under the present U.S. estate and gift tax system, if a transfer to a trust is treated as a completed gift under the gift tax rules, actuarial tables and assumptions are used to value present and future interests as of the time of the transfer.⁷¹ These assumptions may or may not result in accurate valuation of a future interest that ultimately is distributed to a beneficiary if, for example, the assets in the trust earn returns greater than those assumed under applicable actuarial tables. The use of actuarial tables that may or may not reflect actual returns (among other factors) has created opportunities for aggressive tax planning, such as through the use of grantor retained annuity trusts.

In contrast, the use of actuarial tables to value a gift of a temporal interest may be unnecessary under an inheritance tax, which generally values gifts in the hands of the recipient at the time of receipt (and not, for example, when such amounts first are transferred to a trust for such person's benefit). Similarly, an income inclusion approach may in certain circumstances eliminate the need for actuarial tables to value future interests, because the income tax treats a trust as a separate taxpayer, and transfers to a trust generally would be treated as income of the trust, subject to income tax.⁷² However, because annual inheritance taxes and income inclusion approaches generally do not cumulate receipts over time, it may be possible (depending on when a taxpayer is treated as receiving income under such systems) to avoid tax in whole or in part under such a system through the use of a trust that makes distributions to beneficiaries over an extended period of time to take advantage of multiple annual exemptions or lower marginal tax rates.

One commentator has proposed designing an inheritance tax system under which transfers to trusts would be treated differently depending on the trust's beneficiaries. If the trust has only one beneficiary, the tax would be imposed at the time of the transfer to the trust. If the

⁶⁹ See Batchelder, *Taxing Privilege More Effectively*, *supra*, at 19.

⁷⁰ See, e.g., American Bar Association, *Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes* (2004), at 99-101; H.R. 5970 (109th Cong.).

⁷¹ See sec. 2702.

⁷² ABA, *Alternatives*, *supra*, at 183.

trust has only tax-exempt beneficiaries, no tax would apply. If the trust has multiple potential beneficiaries, however, the tax would not be imposed until distributions are made to beneficiaries, but a withholding tax would apply during the interim period.⁷³ Determining the appropriate level of withholding under such an approach could raise difficult structural issues.

Use of nominal recipients

As discussed above, commentators argue that one of the benefits of an inheritance tax or an income inclusion approach is that it provides an incentive to transfer wealth to a greater number of recipients in lower tax brackets. However, this perceived strength also could give rise to abuse, such as where a transferor uses multiple nominal recipients to transmit wealth to a single intended beneficiary.⁷⁴ The ABA Task Force on Federal Wealth Transfer Taxes notes that such concerns could be addressed through anti-abuse rules, such as rules that would attribute transfers to certain family members to other family members (such as a transfer to a spouse or a minor child of a family member).⁷⁵

⁷³ Batchelder, *Taxing Privilege More Effectively*, *supra*, at 23-25.

⁷⁴ ABA, *Alternatives*, *supra*, at 180-181.

⁷⁵ *Id.* at 181.