Key Elements of the U.S. Tax System

Q. How do the estate, gift, and generation-skipping transfer taxes work?

A. The federal estate tax applies to the transfer of property at death. The gift tax applies to transfers made while a person is living. The generation-skipping transfer tax is an additional tax on a transfer of property that skips a generation.

The United States has taxed the estates of decedents since 1916. Gifts have been taxed since 1924 and, in 1976, Congress enacted the generation-skipping transfer (GST) tax and linked all three taxes into a unified estate and gift tax.

The tax applies only to the portion of the estate's value that exceeds an exemption level. The Tax Cuts and Jobs Act (TCJA) doubled the estate tax exemption to $11.2 million for singles and $22.4 million for married couples, but only for 2018 through 2025. The exemption level is indexed for inflation. The 40 percent top tax rate remains in place.

The tax rates and exemption levels have varied dramatically over the past two decades. Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax exemption was set at $675,000 and scheduled to gradually increase to $1 million. EGTRRA cut all three taxes sharply, but only through 2010. The act gradually phased out the estate and GST taxes and repealed both entirely for 2010, leaving only the gift tax (at a reduced rate) in effect that year (table 1).

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate and GST taxes for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent, but allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent (table 1).

Here's how the estate tax works:

- The executor must file a federal estate tax return within nine months of a person's death if that person's gross estate exceeds the exempt amount ($11.2 million in 2018).
- The estate tax applies to a decedent's gross estate, which generally includes all the decedent's assets, both financial (e.g., stocks, bonds, and mutual funds) and real (e.g., homes, land, and other tangible property). It also includes the decedent's share of jointly owned assets and life insurance proceeds from policies owned by the decedent.

Key Elements of the U.S. Tax System

How do the estate, gift, and generation-skipping transfer taxes work?

TABLE 1

Estate, Gift, and GST Tax Rates and Exemptions under Current Law

2007–2018

Year	Estate and GST tax rate	Gift tax rate	Estate and GST tax exemptions	Lifetime gift exemptions	Annual gift exclusion[a]
2007	45%	45%	$2 million	$1 million	$12,000
2008	45%	45%	$2 million	$1 million	$12,000
2009	45%	45%	$3.5 million	$1 million	$13,000
2010	0%[a]	35%	N/A[b]	$1 million	$13,000
2011	35%	35%	$5 million	$5 million	$13,000
2012	35%	35%	$5.12 million	$5.12 million	$13,000
2013	40%	40%	$5.25 million	$5.25 million	$14,000
2014	40%	40%	$5.34 million	$5.34 million	$14,000
2015	40%	40%	$5.43 million	$5.43 million	$14,000
2016	40%	40%	$5.45 million	$5.45 million	$14,000
2017	40%	40%	$5.49 million	$5.49 million	$14,000
2018	40%	40%	$11.2 million	$11.2 million	$15,000

Source: Internal Revenue Code.

(a) The exemption, which was $10,000 in 1998, is indexed for inflation in $1,000 increments.

(b) Executors can elect to apply the EGTRRA rules, which repealed the estate tax for 2010, but otherwise the 2011 parameters apply.

- The estate and gift taxes allow an unlimited deduction for transfers to a surviving spouse, to charity, and to support a minor child. Estates may also deduct debts, funeral expenses, legal and administrative fees, charitable bequests, and estate taxes paid to states. The taxable estate equals the gross estate less these deductions.
- A credit then effectively exempts a large portion of the estate: in 2018, the effective exemption is $11.2 million. Any value of the estate over $11.2 million is generally taxed at the top rate of 40 percent.
- The exemption level is portable between spouses, making the effective exemption for married couples double the exemption for singles. For example, if the first spouse to die bequeathed $5 million to children and grandchildren, the survivor's exemption would increase by the unused $6.2 million
- Although tax rates are graduated, all transfers in excess of the exemption are taxed at the top rate because the exemption exceeds the threshold at which the top rate applies.
- Special provisions reduce the tax, or spread payments over time, for family-owned farms and closely held businesses. Estates that satisfy certain conditions may use a special-use formula to reduce the taxable value of their real estate, often by 40 to 70 percent. Family-owned businesses may often claim valuation discounts on the logic that when a business (including, potentially, one only passively investing in liquid assets) is divided among many heirs, the resultant minority stakes may have a market value less than proportional to the total value of the business. When farms or businesses make up at least 35 percent of a gross estate, the tax may be paid in installments over 14 years at reduced interest rates, with only interest due during the first five years.
- Inheritances are not taxable income to the recipient under the income tax.
- The basis for inherited assets is stepped up to the value at the time of death, meaning that unrealized capital gains on assets held until death are never subject to income tax. (Journalist Michael Kinsley famously called this the "angel of death loophole.")

How do the estate, gift, and generation-skipping transfer taxes work?

Here's how the gift tax works:

- Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth before they died.
- The tax provides a lifetime exemption of $11.2 million per donor in 2018. This exemption is the same that applies to the estate tax and is integrated with it (i.e., gifts reduce the exemption amount available for estate tax purposes). Beyond that exemption, donors pay gift tax at the estate tax rate of 40 percent.
- An additional amount each year is also disregarded for both the gift and estate taxes. This annual exclusion, $15,000 in 2018, is indexed for inflation in $1,000 increments and is granted separately for each recipient. Thus, a married couple with three children could give their children a total of $90,000 each year ($15,000 from each parent to each child) without owing tax or counting toward the lifetime exemption.
- Gifts received are not taxable income to the recipient.

And here's how the generation-skipping trust tax works:

- Congress enacted the GST tax in 1976 to prevent families from avoiding the estate tax for one or more generations by making gifts or bequests directly to grandchildren or great-grandchildren. The GST tax effectively imposes a second layer of tax (using the exemption and the top tax rate under the estate tax) on wealth transfers to recipients who are two or more generations younger than the donor.

Data Sources

Internal Revenue Code, 26 USC Subtitle B: Estate and Gift Taxes.

Further Reading

Gleckman, Howard. 2017. "Only 1,700 Estates Would Owe Estate Tax in 2018 under the TCJA." *TaxVox* (blog). December 6.

Harris, Benjamin. 2013. "Estate Taxes after ATRA." *Tax Notes*. February 25.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

———. 2018. "Overview of the Federal Tax System as in Effect for 2018." JCX-3-18. Washington, DC: Joint Committee on Taxation.

Q. Who pays the estate tax?

A. The top 10 percent of income earners pays more than 90 percent of the tax, with nearly 40 percent paid by the richest 0.1 percent. Few farms or family businesses pay the tax.

The Urban-Brookings Tax Policy Center estimates that some 4,000 individuals dying in 2018 will leave estates large enough to require filing an estate tax return (estates with a gross value under $11.2 million need not file this return in 2018). After allowing for deductions and credits, 1,900 estates will owe tax. Over 90 percent of these taxable estates will come from the top 10 percent of income earners and more than one-third will come from the top 1 percent alone (table 1).

Estate tax liability will total an estimated $14.9 billion in 2018. The top 10 percent of income earners will pay 93 percent of this total. The richest 0.1 percent will pay $5.8 billion, or 39 percent of the total (table 1). According to TPC's 2017 estimates, only about 80 small farms and closely held businesses—estates with farm and business assets totaling no more than $5 million and making up at least half of the gross estate—paid any estate tax in 2017. Small farms and businesses will not be subject to the estate tax in 2018 because of the $11.2 million effective exemption under the Tax Cuts and Jobs Act. The higher exemption amount expires after 2025.

TABLE 1

Estate Tax, Number of Returns and Distribution of Burden

2018 Current Law

	Expanded Cash Income Category					Businesses and Farms	
	All	Top 10%	Top 5%	Top 1%	Top 0.1%	All[a]	Small[b]
Number of returns[c]	4,020	3,530	3,020	1,970	480	450	N/A
Number of taxable returns[c]	1,890	1,720	1,330	690	150	140	N/A
Share of all taxable returns	100%	91%	70%	37%	8%	7%	N/A
Estate tax paid ($ billions)[d]	$14.9	$13.9	$13.1	$10.6	$5.8	$1.5	N/A
Share of all estate tax paid	100%	93%	88%	71%	39%	10%	N/A

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

Note: Estimates are for estate tax returns filed for individuals who die in 2018.

(a) Estate tax returns on which farm and business assets represent at least half of gross estate.

(b) Estate tax returns on which farm and business assets represent at least half of gross estate and these assets are no more than $5 million.

(c) Number of returns is rounded to nearest multiple of 10.

(d) Estate tax paid is rounded to nearest multiple of $10 million.

Key Elements of the U.S. Tax System

Who pays the estate tax?

While most estimates assume the decedent bears the estate tax, this is primarily because of data limitations. There is good reason to believe that heirs most often bear the tax. When the burdens are analyzed this way, individuals inheriting over $1 million bear the estate tax almost exclusively.

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0718-1."

Further Reading

Batchelder, Lily. 2009. "What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax." *Tax Law Review* 63 (1).

Harris, Benjamin. 2013. "Estate Taxes after ATRA." *Tax Notes*. February 25.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

Williams, Roberton. 2013. "Finally, a Permanent Estate Tax, Though Just for the Wealthy Few." *TaxVox* (blog). February 7.

Key Elements of the U.S. Tax System

Q. How many people pay the estate tax?

A. About 4,000 estate tax returns will be filed for people who die in 2018, of which only about 1,900 will be taxable—less than 0.1 percent of the 2.7 million people expected to die in that year.

Because of a series of increases in the estate tax exemption, few estates pay the tax. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the estate tax exemption from $675,000 in 2001 to $1 million in 2002 and to $3.5 million in a series of steps through 2009, sharply reducing the number of estates that paid estate taxes. EGTRRA repealed the estate tax for 2010 but after that, the estate tax was scheduled to revert to pre-EGTRRA rules.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax and generation-skipping transfer tax and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. The American Taxpayer Relief Act of 2012 permanently extended the exemption, but the top rate was increased to 40 percent.

The Tax Cuts and Jobs Act doubled the exemption to $11.2 million in 2018, but the estate tax cut is scheduled to expire after 2025 (along with most other provisions of the new law).

Internal Revenue Service data show that roughly 109,600 estate tax returns were filed for decedents in 2001, the year before the EGTRRA changes began to go into effect. Fewer than half—about 50,500—of those estates had any estate tax liability after credits. Estate tax liability totaled $23.7 billion (table 1).

For decedents in 2009, the year the final increase in the estate tax exemption under EGTRRA went into effect, only about 12,900 estate tax returns were filed, of which only 5,700 were taxable. Estate tax liability totaled $13.6 billion (table 1).

For those who died in 2010, executors could elect to have the EGTRRA rules apply, which meant that no estate tax was imposed. However, instead of recipients of bequests receiving a full step-up in basis, they were limited to $1.3 million (plus an additional $3 million for surviving spouses), with any additional unrealized gains required to be carried over. Recipients, therefore, will pay deferred income tax on these additional unrealized gains when the gains are realized.

For decedents in 2018 (with an exemption of $11.2 million), the Urban-Brookings Tax Policy Center estimates only about 4,000 estate tax returns will be filed, of which 1,900 will be taxable. Estate tax liability will total $14.9 billion after credits (table 1).

Key Elements of the U.S. Tax System

How many people pay the estate tax?

To put the number of estate tax returns filed in perspective, the Population Division of the Bureau of the Census projects that 2.7 million people will die in 2018. Thus, an estate tax return will be filed for only about 0.15 percent of decedents, and only about 0.07 percent will pay any estate tax.

TABLE 1

Estate Tax, Number of Returns, and Tax Liability
2001, 2007–2018

Year	Number of Returns[a]	Number of Taxable Returns[a]	Estate tax liability ($ billions)[b]
2001	109,600	50,500	$23.7
2007	36,700	16,600	$24.6
2008	29,000	15,100	$18.9
2009	12,900	5,700	$13.6
2010	*	*	*
2011	9,400	4,400	$10.9
2012	9,600	4,100	$12.0
2013	11,300	4,700	$16.6
2014	11,000	5,400	$18.3
2015	11,000	5,300	$18.6
2016	11,200	5,300	$19.3
2017	11,300	5,500	$20.0
2018	4,000	1,900	$14.9

Sources: For 2001, 2007, 2009, 2011, and 2013: Internal Revenue Service. Statistics of Income. "Estate Tax Year of Death Tables." For 2008, 2012, and 2014–2018, Urban-Brookings Tax Policy Center Microsimulation Model (versions 0217-1 and 0718-1).

Note: Figures are for estate tax returns filed for decedents dying in each calendar year.

* The estate tax was repealed for 2010 decedents by the *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)*, but reinstated by the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* with an option for executors to elect the EGTRRA rules; IRS SOI did not publish statistics for 2010 decedents.

(a) Number of returns is rounded to nearest multiple of one hundred.

(b) Estate tax paid is rounded to nearest multiple of $10 million.

Key Elements of the U.S. Tax System

How many people pay the estate tax?

Data Sources

Internal Revenue Service. *Statistics of Income*. "Estate Tax Year of Death Tables."

Urban-Brookings Tax Policy Center. "Microsimulation Model, versions 0217-1 and 0718-1."

US Census Bureau, Population Division. *2014 National Population Projections: Summary Tables*. Table 1. "Projections of the Population and Components of Change for the United States: 2015 to 2060."

Further Reading

Gleckman, Howard. 2017. "Only 1,700 Estates Would Owe Estate Tax in 2018 under the TCJA." TaxVox (blog). December 6.

Harris, Benjamin. 2013. "Estate Taxes after ATRA." *Tax Notes*. February 25.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

———. 2018. "Overview of the Federal Tax System as in Effect for 2018." JCX-3-18. Washington, DC: Joint Committee on Taxation.

US Department of Health and Human Services, Centers for Disease Control and Prevention. "Deaths: Final Data for 2014." *National Vital Statistics Report* 65 (4).

Q. What is the difference between carryover basis and a step-up in basis?

A. The difference is whether heirs who sell an inherited asset will pay tax on the capital gains from the time the asset was originally purchased or from the time it was inherited. In some cases, the difference is a lot of tax liability.

A capital gain occurs if a capital asset is sold or exchanged at a price higher than its "basis," the original purchase price plus the cost of improvements less depreciation. When a person inherits an asset, the basis becomes the asset's fair market value at the time of the owner's death. This is called a "step-up in basis" because the basis of the decedent's asset is stepped up to market value. With gifts made during the giver's lifetime, the recipient retains the basis of the person who made the gift ("carryover basis").

The donor's income does not include the unrealized gain (or loss) on assets given by gift or bequest. The recipient does not owe any tax until the asset is sold, at which point any gain is taxable. The taxable gain is the amount received from the sale of the asset less the asset's basis. For most sales, the basis is the amount the taxpayer invested in the asset, adjusted for subsequent improvements, depreciation, and certain other items. For gifts and bequests, however, special basis rules apply.

For gifts, the basis remains the same as when the asset was held by the person who made the gift ("carryover basis"), but with an adjustment for any gift tax paid. For inheritances, the basis is the fair market value of the asset at the time of the donor's death (or six months afterward, if the executor elects the alternative valuation date). This is referred to as "step-up in basis" (or "stepped-up basis") because the previous basis is stepped up to market value.

The effect of carryover basis on gifts is to tax the unrealized gain accrued by the donor when the recipient sells the asset. The effect of step-up in basis on inheritances is to eliminate income tax on any unrealized gain accrued by the decedent.

There have been past efforts to repeal or eliminate step-up in basis.

- The Tax Reform Act of 1976 would have imposed carryover basis on all inherited assets, but the provision was repealed before it could ever take effect.

- The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the estate tax and curtailed step-up in basis, but only for one year—2010. The act limited step-up to $1.3 million (plus an additional $3 million for surviving spouses) with any additional unrealized gains carried over. (Estates could elect to

What is the difference between carryover basis and a step-up in basis?

retain step-up in exchange for paying an estate tax; a few estates with highly appreciated assets chose this option.)

- The Obama administration proposed repealing stepped-up basis subject to several exemptions, including a general exemption for the first $100,000 in accrued gains ($200,000 per couple). The US Department of the Treasury estimated that, together with raising the capital gains rate to 28 percent, this proposal would raise $210 billion over 10 years. Ninety-nine percent of the revenue raised would come from the top 1 percent of households ranked by income.

Further Reading

Executive Office of the President and US Treasury Department. 2015. "The President's Plan to Help Middle-Class and Working Families Get Ahead." Washington, DC: The White House.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

Q. How could we reform the estate tax?

A. Possible reforms run the gamut from repeal to modest fixes that would make the tax more difficult to avoid.

Proposals to reform the estate and gift tax range from comprehensive options, such as permanently repealing the estate tax or replacing the existing tax with a tax on inheritances, to more modest options, such as decreasing exemption amounts, increasing tax rates, and blocking avenues for avoidance.

The federal estate and gift taxes (including the generation-skipping tax, or GST) have changed more than a dozen times since 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut these taxes sharply but only through 2010. EGTRRA gradually phased out the estate tax and GST, eliminating them entirely for 2010 and leaving only the gift tax (at a reduced rate) in that year.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax and GST for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. But the law allowed executors to elect the EGTRRA rules for decedents who died in 2010. The American Taxpayer Relief Act of 2012 (ATRA) permanently extended the 2012 rules, though with a new top rate of 40 percent.

The Tax Cuts and Jobs Act of 2017 (TCJA) doubled the estate tax exemption to $11.2 million in 2018 but kept the 40 percent top rate. The TCJA changes expire after 2025.

REPEAL

Many members of Congress have called for the repeal of the estate and gift taxes. That would be expensive, however. The Office of Management and Budget projects that these taxes will raise $205 billion in fiscal years 2019 through 2028.

Repeal would also be regressive—the benefits would go almost entirely to people at the top of the income distribution—and would invite significant sheltering of income. Further, gifts from an estate to charity currently qualify for full deduction from the estate's taxable value, creating a substantial incentive to leave bequests to charities. Prior estimates indicate that repealing the estate tax would reduce charitable donations by 6 to 12 percent.

INHERITANCE TAX

One option, the substitution of an inheritance tax, would tax wealth transfers somewhat differently. An inheritance tax differs from an estate and gift tax in that the rate depends on the amount of gifts and bequests the taxpayer receives rather than on how much the donor gives or bequeaths. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly, because each of any number of recipients can claim an exemption and take advantage of progressive tax rates, thus reducing the total tax attributable to an estate. Most countries that tax wealth transfers do so with inheritance taxes rather than estate taxes and many states levy inheritance taxes.

LIMIT PREFERENCES

A more modest reform could repeal or modify the many estate tax preference items, such as special trust arrangements and valuation discounts, that allow savvy millionaires to drastically reduce or even eliminate estate tax liability. University of Southern California law professor Edward McCaffery said the tax was so easy to avoid that it was essentially a "voluntary tax" (albeit one that raised about $20 billion per year at the time of his writing). The plethora of loopholes complicates estate planning and results in comparable estates facing very different tax bills. Eliminating estate tax preferences could increase revenues, which could pay for extending the higher estate tax exemption scheduled to return to pre-TCJA levels after 2025 or for reducing the deficit.

RETURN TO PRIOR LAW

Alternatively, policymakers might simply reverse some of the estate tax changes enacted since 2001 (figures 1 and 2).

- 2000 law. Before 2001, the estate tax had an exemption level of $1 million (not indexed for inflation), a top statutory rate of 55 percent, a 5 percent surtax that phased out the benefit of lower rates for large estates, and a credit (rather than a deduction) for state wealth transfer taxes. Making pre-ATRA law permanent starting in 2019 would increase the number of estate tax returns filed for decedents who died between 2019 and 2028 by 1.7 million and increase the estate tax liabilities of these decedents by $585 billion.

- 2009 law. The estate tax law in effect under EGTRRA for 2009 had an exemption of $3.5 million (unindexed) and a top rate of 45 percent. If 2009 law were made permanent starting in 2019, the number of estate tax returns filed for decedents who died between 2019 and 2028 would increase by 246,000, and estate tax liabilities of these decedents would increase by $234 billion.

- 2009 law, exemption indexed by chained consumer price index. If 2009 law, modified to index the exemption to inflation, were made permanent starting in 2019, the number of estate tax returns filed for decedents who died between 2019 and 2028 would increase by 162,000, and estate tax liabilities of these decedents would increase by $171 billion (about three-quarters the increase without indexing the exemption).

- 2017 law. The TCJA doubled the estate tax exemption and adopted a somewhat slower inflation adjustment starting in 2018, but only through 2025. Returning to an estate tax exemption of $5 million (indexed for inflation from 2011) in 2019 through 2025 would increase the number of estate tax returns filed by 55,000 between 2019 and 2028 and would increase estate tax liabilities by about $60 billion.

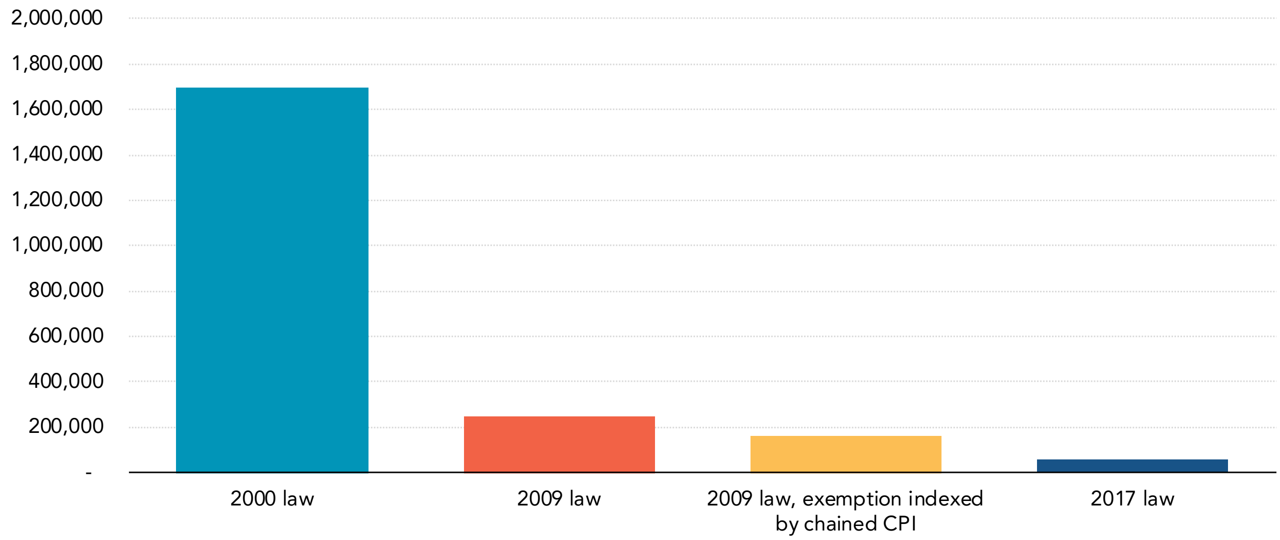
Key Elements of the U.S. Tax System

How could we reform the estate tax?

FIGURE 1

Change in Number of Estate Tax Returns under Alternative Reforms

2019–27

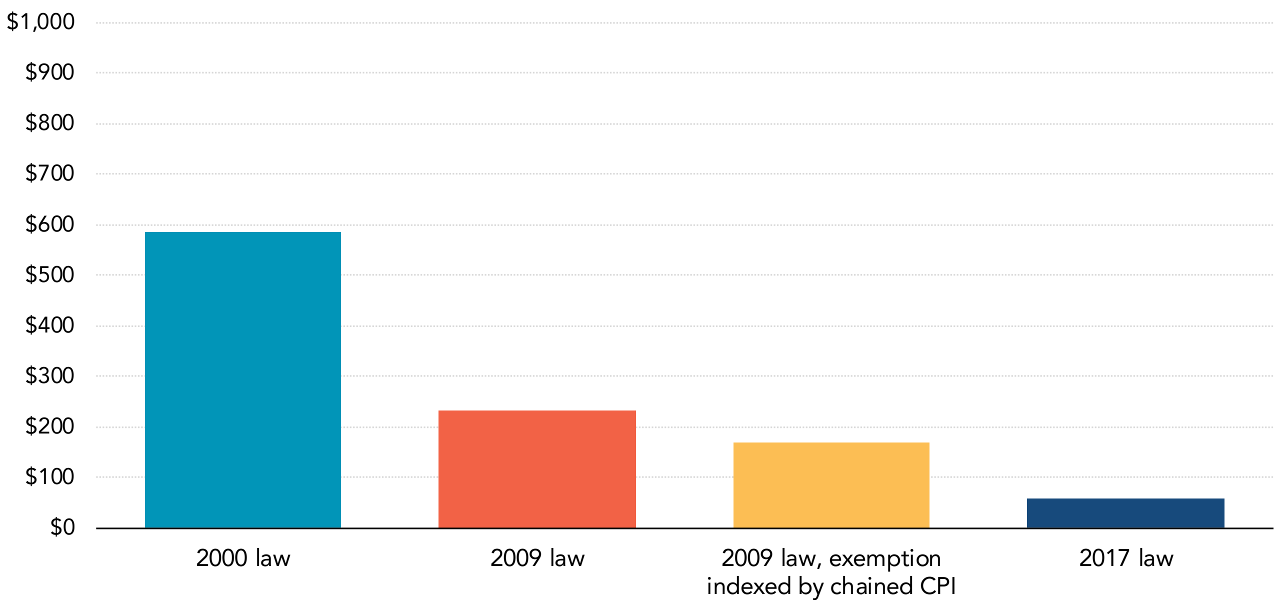


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).
Note: Returns included have gross estate greater than exemption; years refer to decedent's year of death.

FIGURE 2

Change in Estate Tax Liability under Alternative Reforms

2019–27, billions of dollars



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).
Note: Returns included have gross estate greater than exemption; years refer to decedent's year of death.

Key Elements of the U.S. Tax System

How could we reform the estate tax?

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0718-1."

Office of Management and Budget. 2018. An American Budget: Analytical Perspectives. Washington, DC: US Government Publishing Office.

Further Reading

Bakija, Jon M., and William G. Gale. 2003. "Effects of Estate Tax Reform on Charitable Giving." Washington, DC: Urban-Brookings Tax Policy Center.

Batchelder, Lily L. 2009. "What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax." *Tax Law Review* 63 (1): 1–112.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

———. 2018. "Overview of the Federal Tax System as in Effect for 2018." JCX-3-18. Washington, DC: Joint Committee on Taxation.

McCaffery, Edward J. 2000. "A Voluntary Tax? Revisited." USC Olin research paper 01-5. Presented at the National Tax Association's 93rd Annual Conference on Taxation, Santa Fe, NM, November 9–11.

Task Force on Federal Wealth Transfer Taxes. 2004. *Report on Reform of Federal Wealth and Transfer Taxes*. Washington, DC: American Bar Association.

US Department of the Treasury. 2015. "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals." Washington, DC: US Department of the Treasury.

Q. How should wealth be taxed?

A. There are three options: an estate and gift tax (like the current US federal system), an inclusion tax, or an accessions tax.

The transfer of wealth through gifts or bequests can be taxed in three ways: under an estate and gift tax (like the current US federal system), under an inclusion tax, or under an accessions tax.

ESTATE AND GIFT TAX

An estate and gift tax applies to the donor or the donor's estate using separate estate and gift tax rate structures. Apart from transfers to spouses and charities, which are generally exempt from tax, and the small annual exemption from the gift tax, the amount of tax imposed on the transfer does not vary with income or other characteristics of recipients of large gifts and bequests.

INCLUSION TAX

An inclusion tax requires recipients to treat transferred assets as taxable income under the federal income tax. The amount of tax, therefore, varies with the recipients' characteristics (e.g., their filing status), the amount of their other income, the amount of their deductions, and other factors that affect income tax liability.

ACCESSIONS TAX

An accessions tax, like an inclusion tax, taxes recipients on the value of transfers received, but under a rate structure different from the income tax rate structure. The tax imposed on the transfer, therefore, depends only on the amount the recipient receives in the relevant time period.

CONSIDERATIONS

Under all three approaches, the treatment of the donor's unrealized gains affects incentives to transfer and the amount of tax revenue produced. A donor's unrealized gains could be taxed as part of his or her income. Alternatively, such gains could be taxed when realized by the recipient if a carryover basis is required. On the other hand, if the recipient is allowed a step-up in basis, such gains could never be taxed at all.

One consideration for an accessions tax is the period over which transfers are taxed. If transfers are taxed annually with a graduated rate schedule, recipients would pay much less tax on lifetime transfers received evenly over many years than if they received the entire amount in one year. The tax system could address these differences by taking into account the transfers recipients accumulate over their lifetimes, much like the federal estate and gift taxes. With these current taxes, bequests and gifts are added up over the recipient's lifetime to determine whether he or she has exceeded the exempt amount.

How should wealth be taxed?

The taxation of lifetime transfers can also differ under an inclusion tax because of the graduated income tax rate schedule. One way to address these differences would be to average inclusions over several years. Under an estate and gift tax, the number of recipients doesn't affect the amount of tax paid on transfers. Taxing inheritances under an inclusion tax or an accessions tax may encourage broader transfers of wealth, because broader transfers would generally reduce the total amount of tax paid.

Further Reading

Batchelder, Lily L. 2008. "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax." In *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes*, edited by Jason Furman and Jason Bordoff, 1–28. Washington, DC: Brookings Institution Press.

———. 2009. "What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax." *Tax Law Review* 63 (1): 1–112.

Joint Committee on Taxation. 2015. "History, Present Law, and Analysis of the Federal Wealth Transfer System." JCX-52-15. Washington, DC: Joint Committee on Taxation.

Q. What is an inheritance tax?

A. A type of wealth transfer tax in which the recipient, rather than the donor's estate, is taxed.

An inheritance tax applies to the gifts and bequests a taxpayer receives. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly. Recipients can claim an exemption and take advantage of graduated tax rates, thus reducing the effective tax rate. Currently, the United States has no federal inheritance tax, but several states do.

While donors or their estates are legally obliged to remit wealth transfer taxes, evidence suggests that all or most of the economic burden falls on recipients, who receive a smaller after-tax gift or inheritance than they would without the tax. However, an individual recipient's burden varies depending on whether the tax is an inheritance tax or an estate and gift tax.

Inheritance taxes come in three principal forms:

1. An accessions tax applies to the amount an individual receives by gift or bequest over a lifetime.
2. An annual inheritance tax applies to the gifts and bequests a person receives in a given year.
3. An inclusion tax counts gifts and bequests as income and taxes them as such.

Thus, the tax rate depends on the size of the gift or bequest, as well as on the recipient's other income. An inclusion tax could be combined with either of the other two types of inheritance taxes into a single tax that takes advantage of the strengths of each.

Most countries rely on inheritance taxes rather than on estate and gift taxes. More than half of the 34 countries in the Organisation for Economic Co-Operation and Development have an annual inheritance tax (figure 1); a few use accessions and inclusion taxes. Only three (besides the United States) have estate taxes. The past several decades have seen a shift away from estate taxes: Australia, Canada, and New Zealand repealed their estate taxes, and Ireland replaced its estate tax with an inheritance tax.

Some analysts argue that inheritance taxes are simpler to administer than estate taxes because they curtail strategies used to avoid estate taxes, such as moving assets into complicated trusts that falsely suggest a decedent's estate will go to a person or entity exempt from the tax. Others argue that estate taxes are simpler because they require less record keeping.

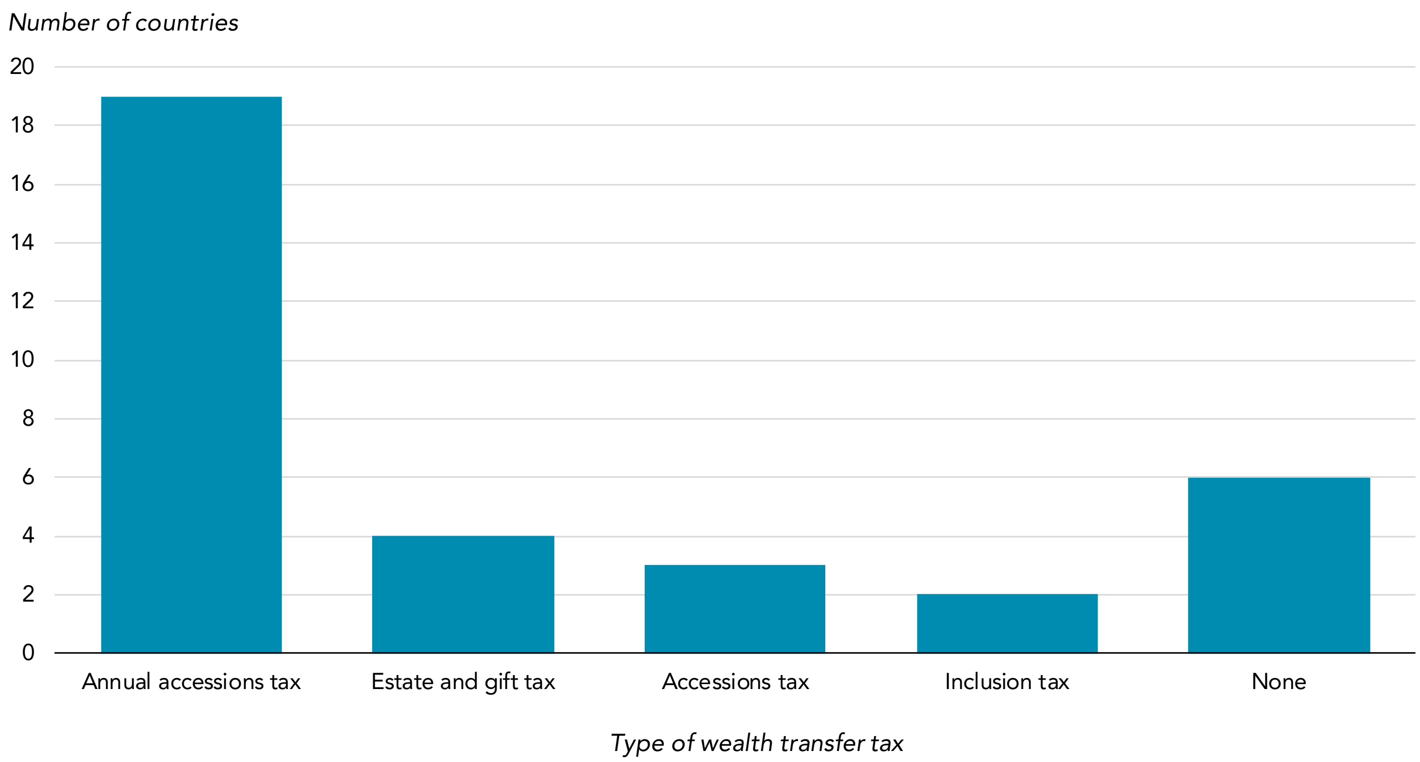
Key Elements of the U.S. Tax System

What is an inheritance tax?

FIGURE 1

Type of Wealth Transfer Tax in 34 Countries

2007



Source: Batchelder (2009).

Further Reading

Ault, Hugh J., and Brian J. Arnold. 2004. *Comparative Income Taxation: A Structural Analysis*, 2nd ed. The Hague, Netherlands: Kluwer Law International.

Batchelder, Lily. 2008. "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax." In *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes*, edited by Jason Furman and Jason Bordoff, 345–83. Washington, DC: Brookings Institution Press.

———. 2009. "What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax." *Tax Law Review* 63 (1): 1–112.

International Bureau of Fiscal Documentation. 2006a. *Asia-Pacific Tax Surveys*. Amsterdam, Netherlands: International Bureau of Fiscal Documentation.

———. 2006b. *European Tax Surveys*. Amsterdam, Netherlands: International Bureau of Fiscal Documentation.

Ministry of Finance and Economy. 2007. *Korean Taxation*. Seoul, Korea: Ministry of Finance and Economy.