

Estate Tax Reform



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The Need for Reform

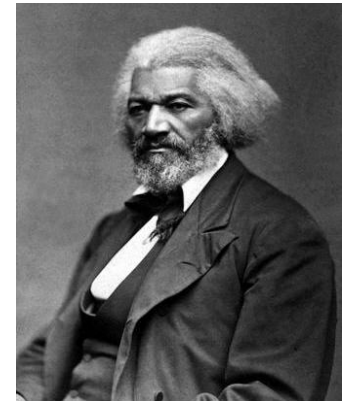
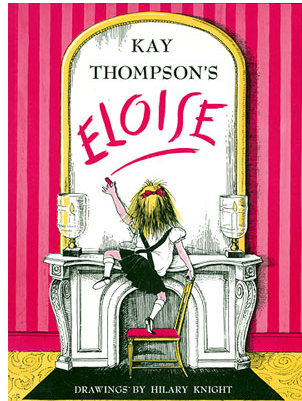
	Tax Rate		Exclusions			Basis Provisions
	Estate & GST	Gift	Annual Gifts	Lifetime Estate & GST	Lifetime Gifts	
2009	45%	41-45%	\$13,000	\$3.5 million	\$1 million	Gifts: Carryover Bequests: Stepped Up
2010	0%	35%		–		Carryover for both. Exemption for up to \$4.3M capital gains.
2011 onward	41-55%			\$1 million		Gifts: Carryover Bequests: Stepped Up

Three Main Points

- Inheritances magnify economic disparities and perhaps the biggest barrier to intergenerational mobility.
- Critical for fairness tax system overall.
 - If no estate tax, all inherited income taxed at lower rates than income from personal work or saving.
 - Mainly burdens high-income heirs receiving extremely large inheritances.
- Could improve by simplifying or targeting more directly on inherited income.

A Hypothetical

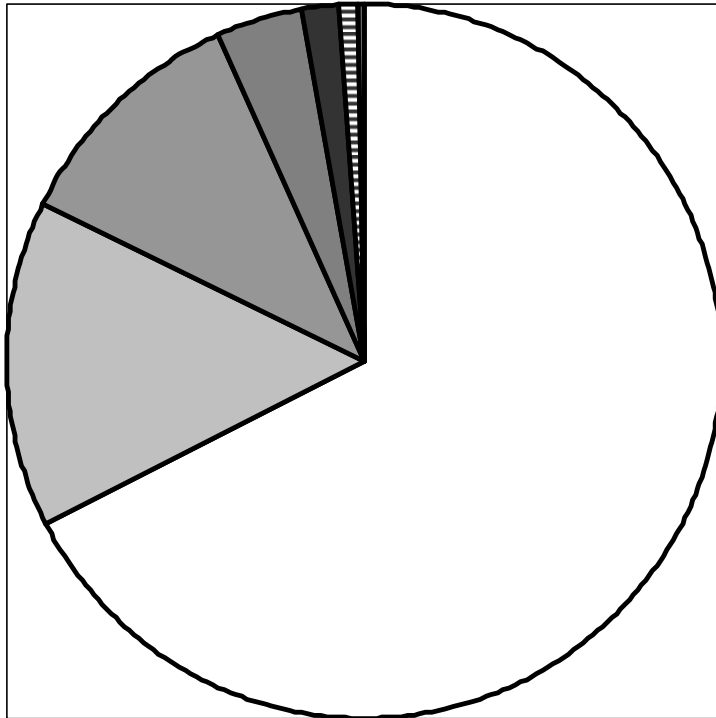
- At age 35, two people are both earning \$1 million / year
- One also inherits \$10 million



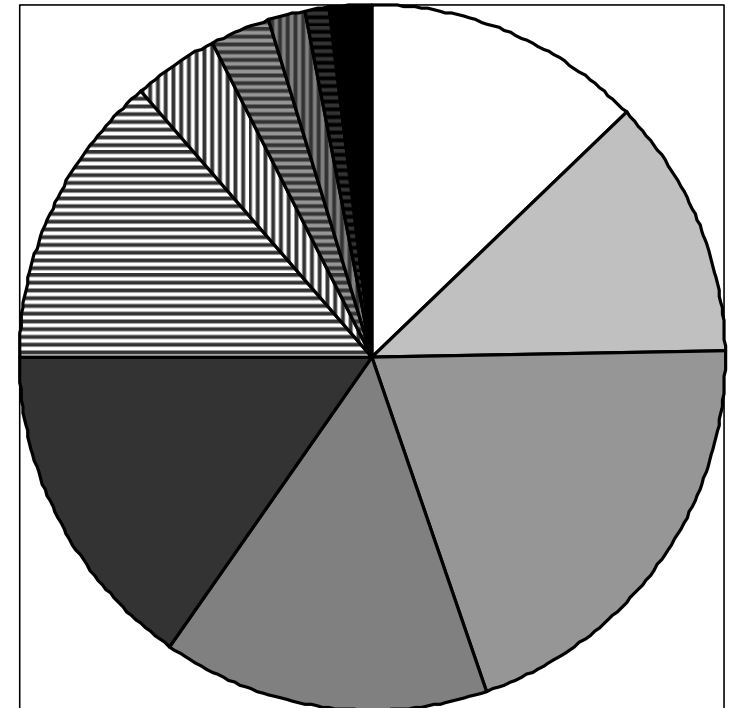
- Should they be taxed the same?

Estimated Share of 2009 Bequests Received

Number of Heirs by Bequest Size

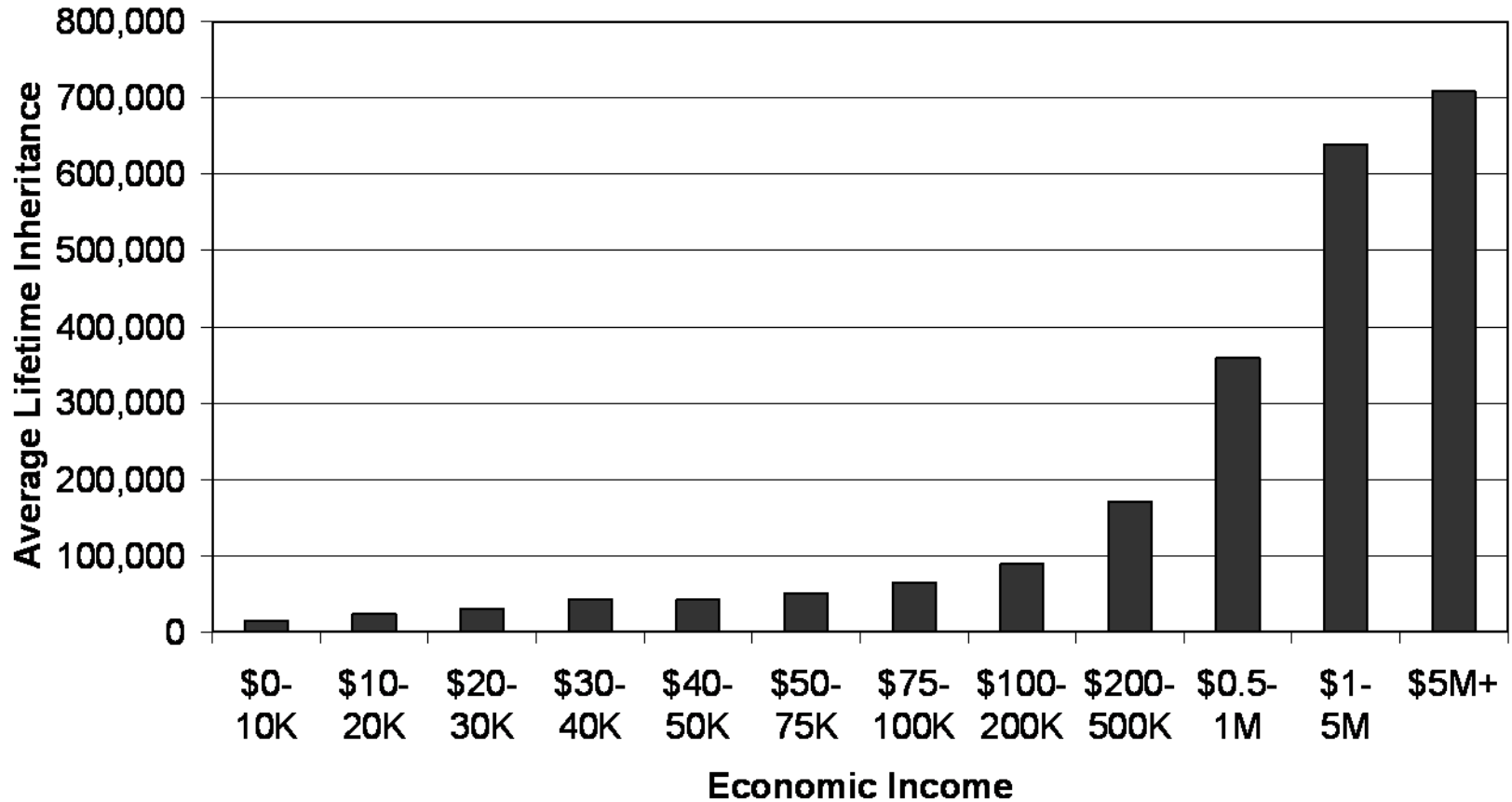


Value of Bequests Received by Bequest Size



- \$0-50K
- \$50-100K
- \$100-250K
- \$250-500K
- \$0.5-1M
- ▨ \$1-2.5M
- ▨ \$2.5-5M
- ▨ \$5-10M
- ▨ \$10-20M
- ▨ \$20-50M
- \$50M+

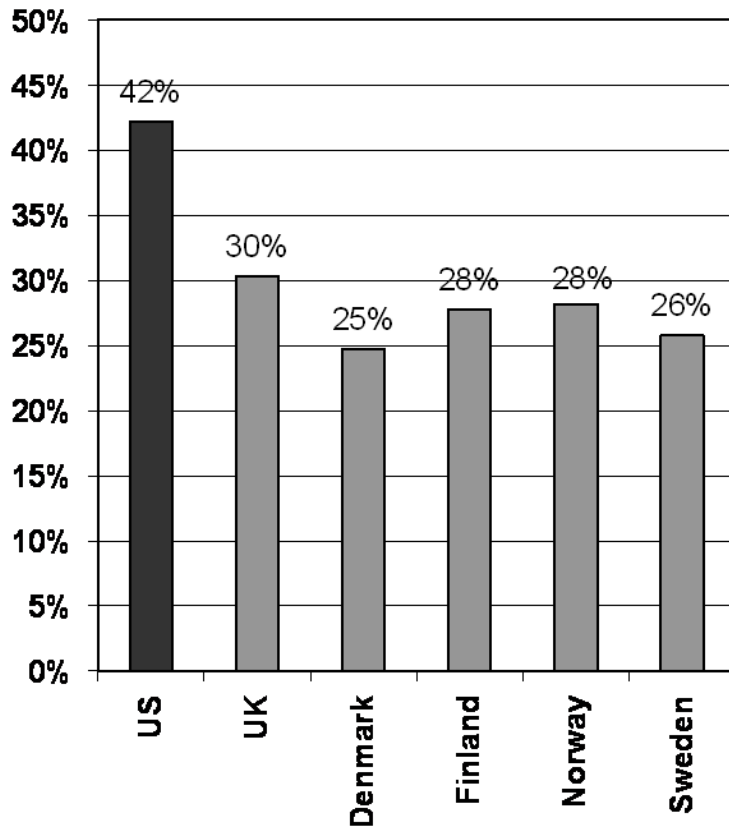
Rough Distribution of Average Lifetime Inheritance by Economic Income



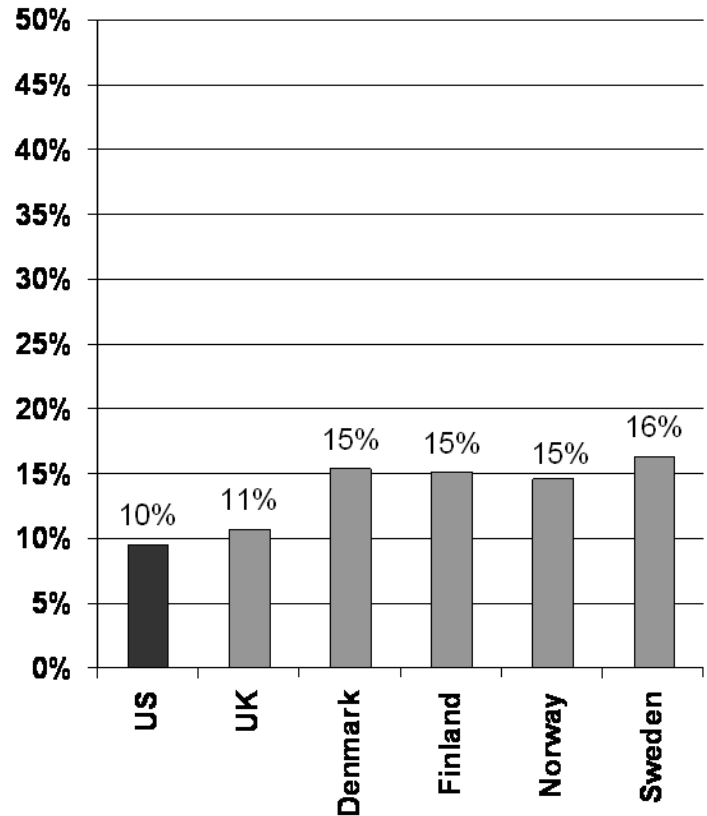
Source: Batchelder & Khitatrakun, 2008.

US Intergenerational Mobility Comparatively Low

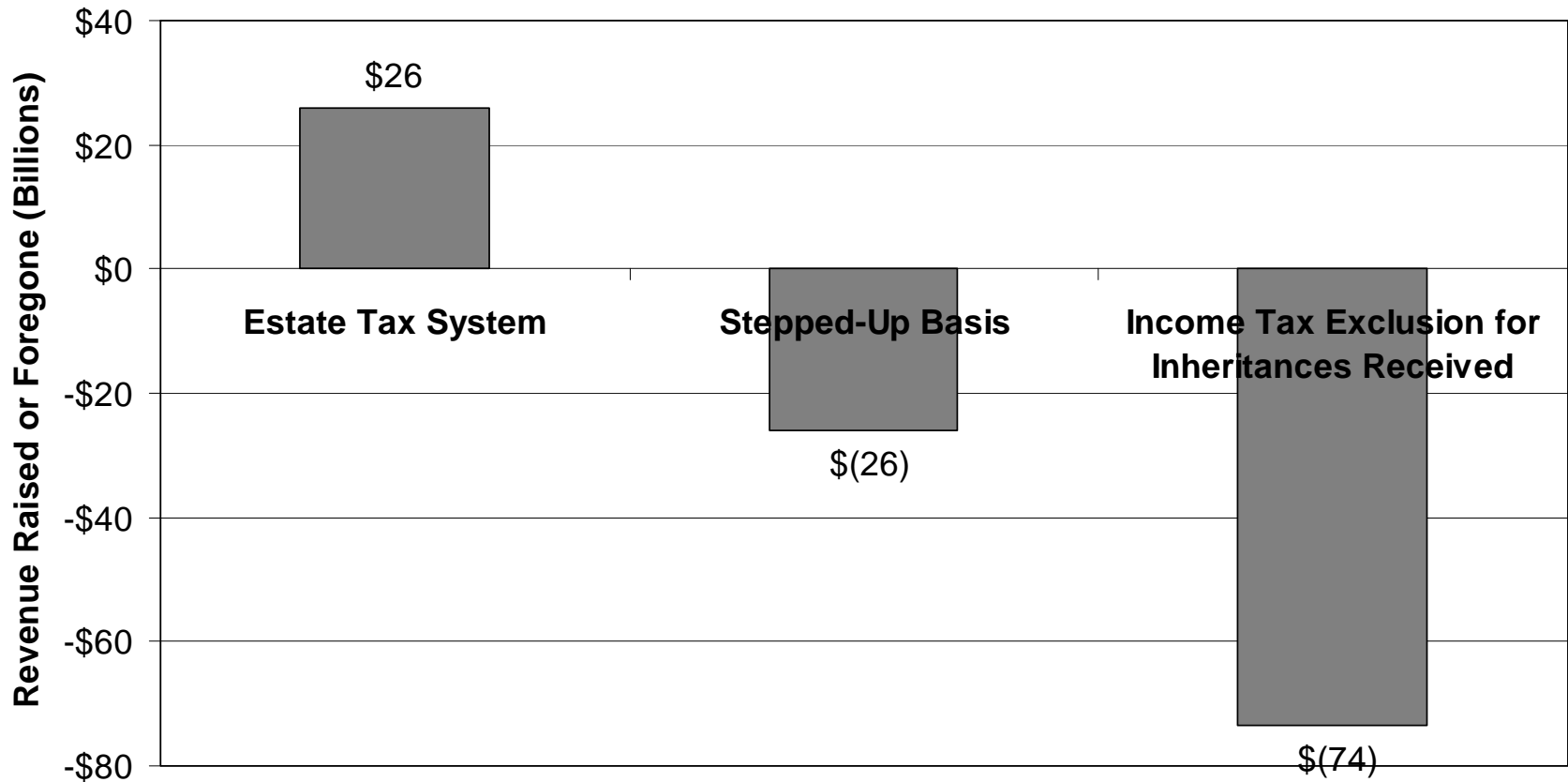
Probability of Boy Born in Bottom Quintile Staying There



Probability of Boy Born in Top Quintile Falling to Bottom

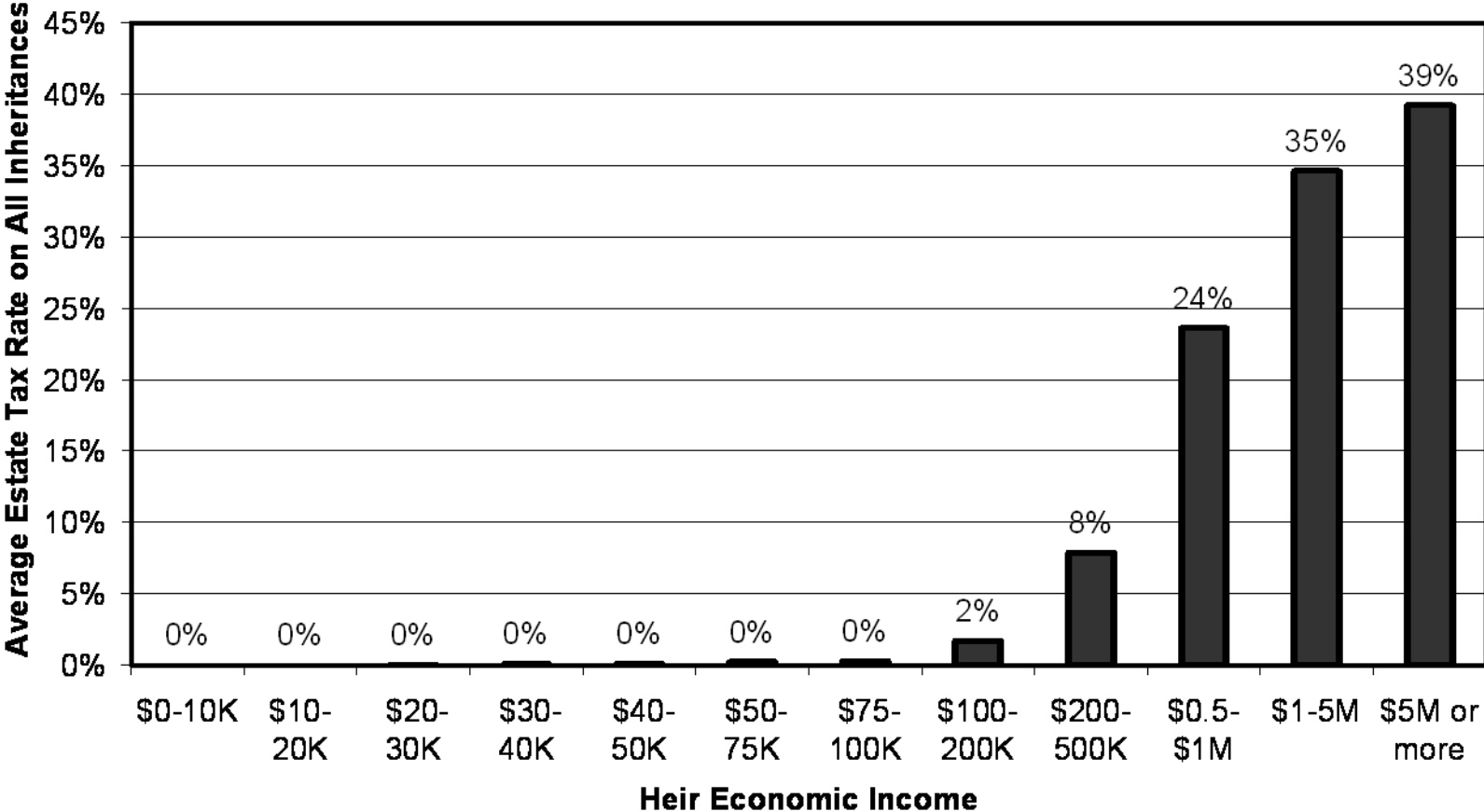


Tax Provisions Affecting Inheritances: Estimated Revenue Effects



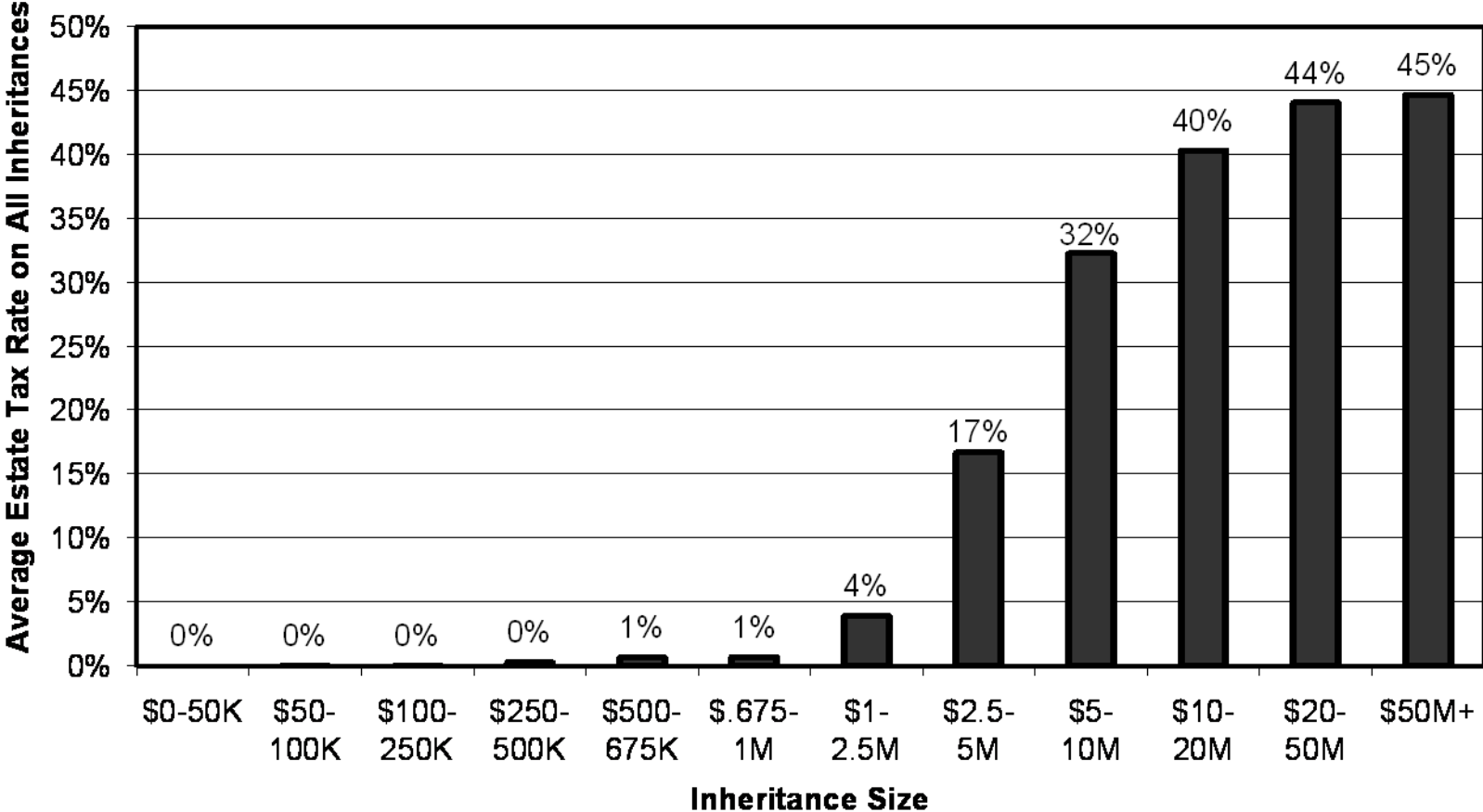
Source: Office of Management and Budget, 2008; Joint Committee on Taxation, 2008 Batchelder & Khatrakun, 2008.

Average 2009 Estate Tax Rate on All Inheritances by Heir Economic Income



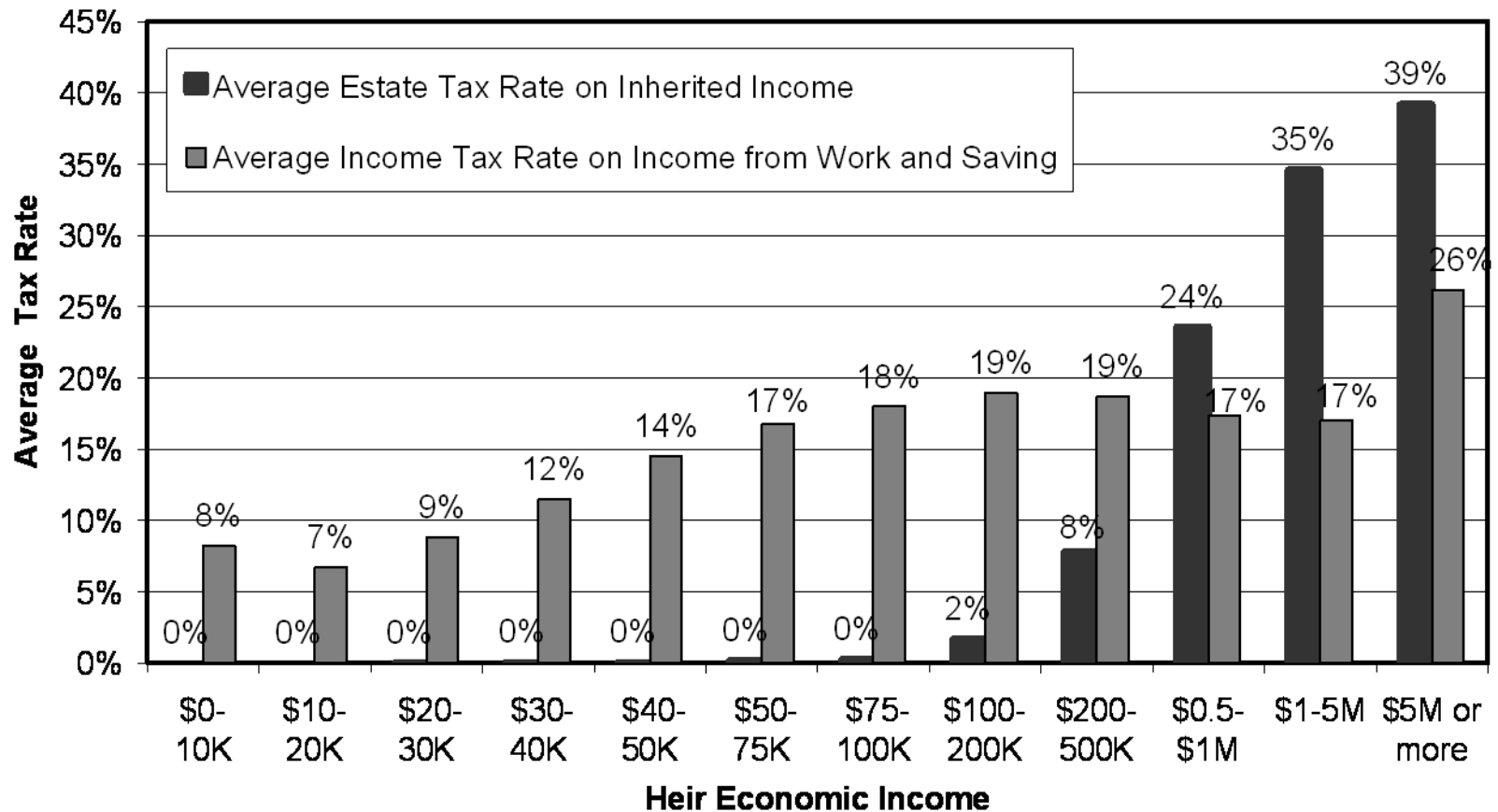
Source: Batchelder & Khitatrakun, 2008.

Average 2009 Estate Tax Rate on All Inheritances by Inheritance Size



Source: Batchelder & Khitatrakun, 2008.

Average 2009 Estate Tax Rate on Inherited Income and Income & Payroll Tax Rate on Earned Income



Source: Batchelder & Khatrakun, 2008.

Shortcomings of Current System

- Complex
- Effects not transparent
- Imprecise at individual level

Options for Reform

- #1 Reform existing estate tax system
 - Smooth rates over time
 - Simplification package

Rate Smoothing: Estimated Estate Tax Revenue in 2009

Estate Tax Law	Exemption (Billions)	Rate	Revenue (Billions)
2008	\$2.0	45%	\$26.2
2009	\$3.5	45%	\$17.5
2011	\$1.0	41-55%*	\$50.2

* Phase-out of lower brackets disregarded.

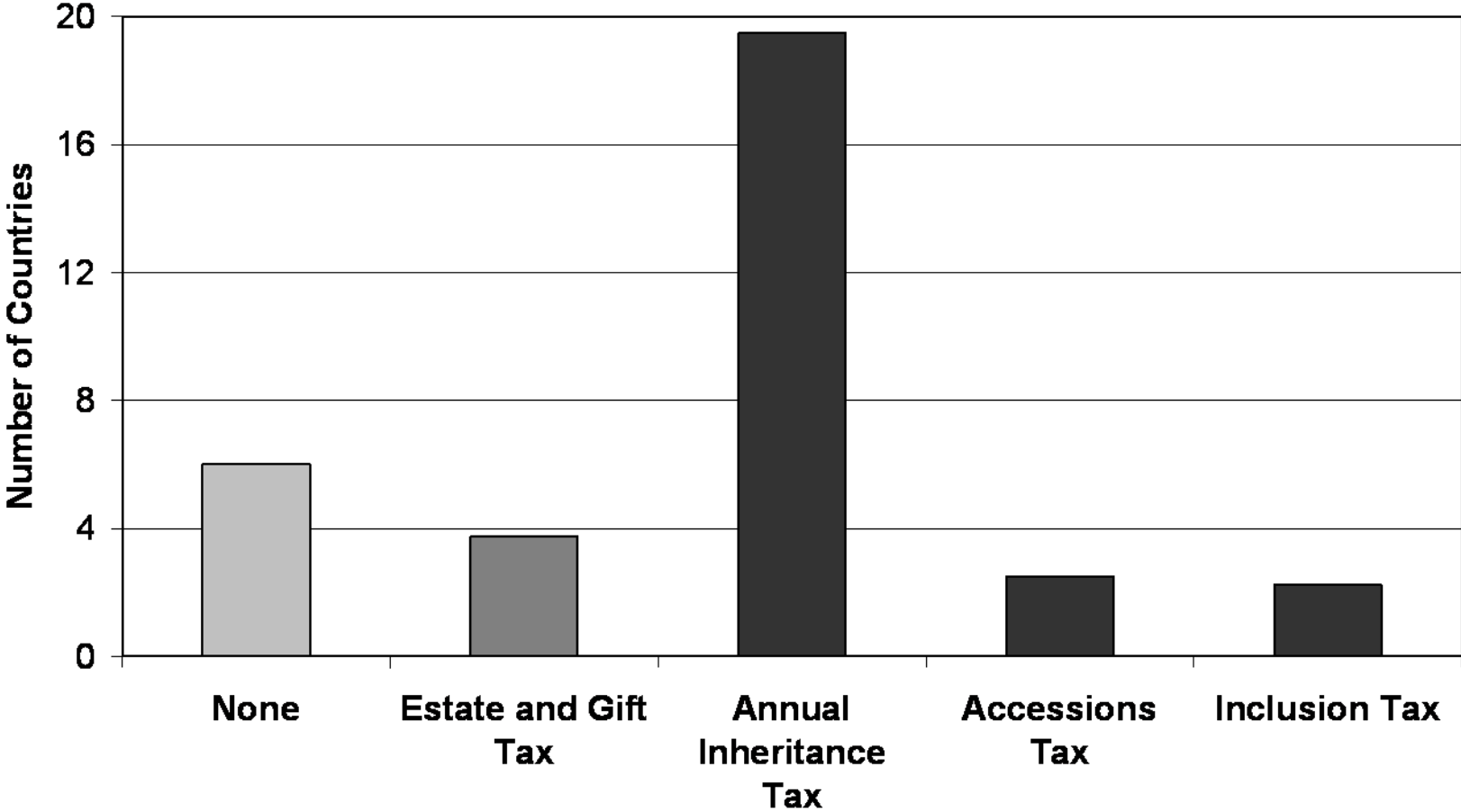
Simplification Measures

1. Spousal carryover for lifetime exemption
2. Harmonize tax treatment of gifts and bequests
3. Replace stepped-up basis with carryover or realization
4. Improve relief for family businesses and illiquid assets

Options for Reform

- #1 Reform existing estate tax system
 - Smooth rates over time
 - Simplification package
- **#2 Replace with inheritance tax**

Form of Wealth Transfer Tax in OECD Countries



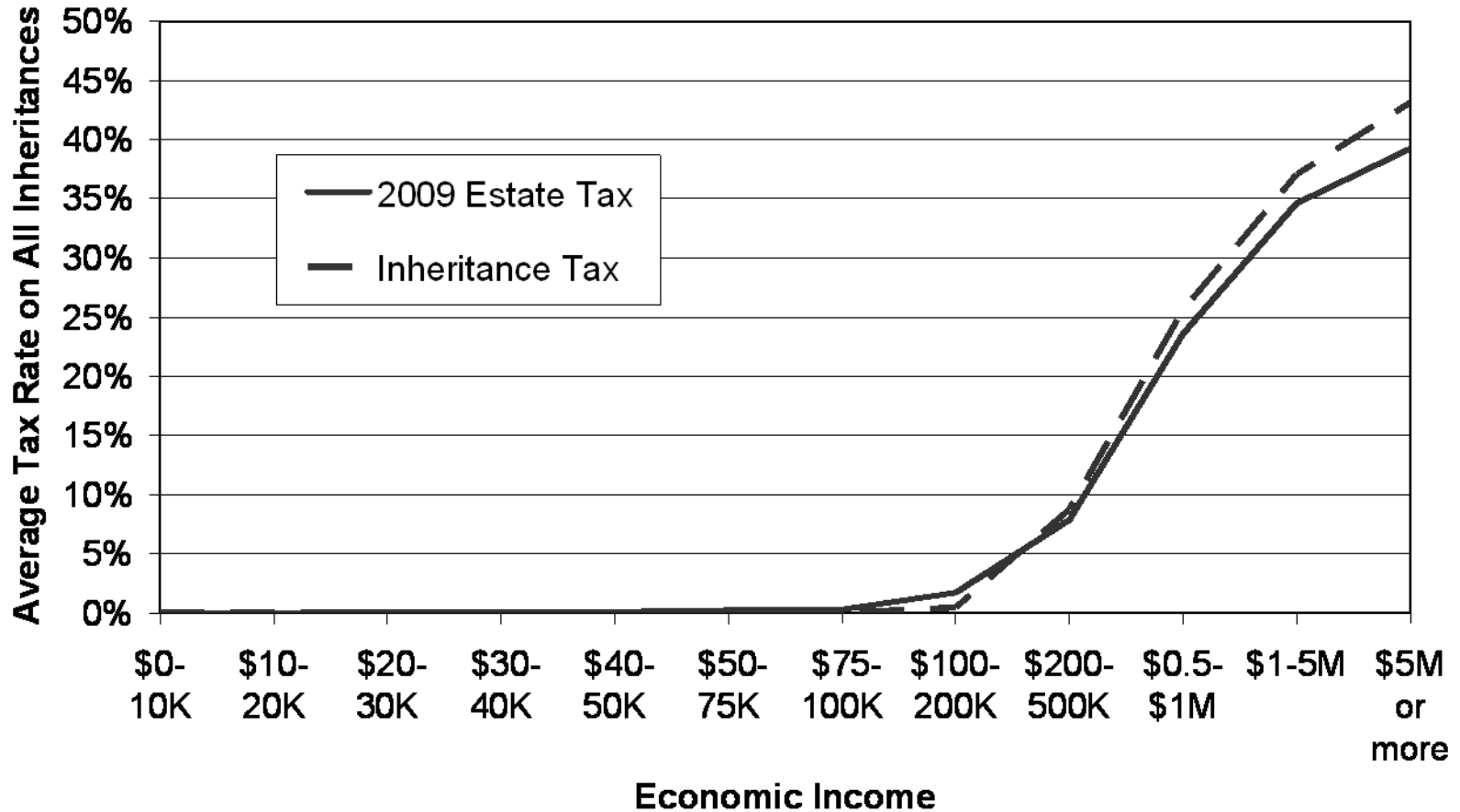
Revenue Effects of Estate Tax and Inheritance Tax under Different Revenue Baselines

Estate Tax			Bush Income Tax Cuts	Revenue-Neutral Inheritance Tax		Revenue (billions)
Law	Exemption (millions)	Rate		Exemption (millions)	Surtax	
2009	\$3.5	45%	Yes	\$1.9	15%	\$17.5
2009	\$3.5	45%	Yes	\$1.6	10%	\$17.5
2008	\$2.0	45%	Yes	\$1.1	15%	\$26.2
2008	\$2.0	45%	Yes	\$1.0	10%	\$26.2
2011	\$1.0	41-55%*	No	\$0.5	15%	\$50.2
2011	\$1.0	41-55%*	No	\$0.4	10%	\$50.2
2011	\$1.0	41-55%*	Some**	\$0.5	15%	\$50.2

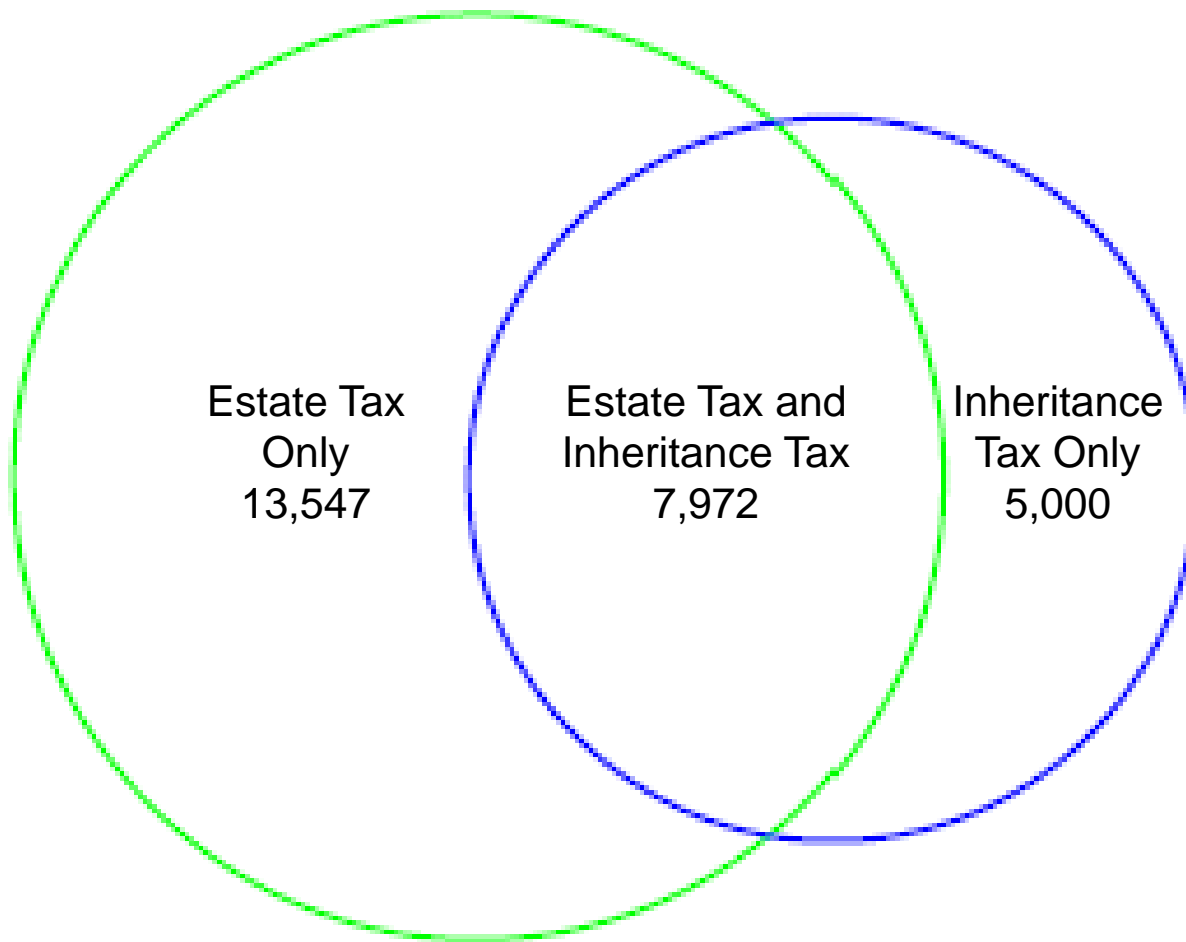
* Phase-out of lower brackets disregarded. ** Tax cuts to top two income tax brackets eliminated.

Source: Batchelder & Khitatrakun, 2008.

Average 2009 Estate and Inheritance Tax Rate on Inherited Income by Heir Economic Income

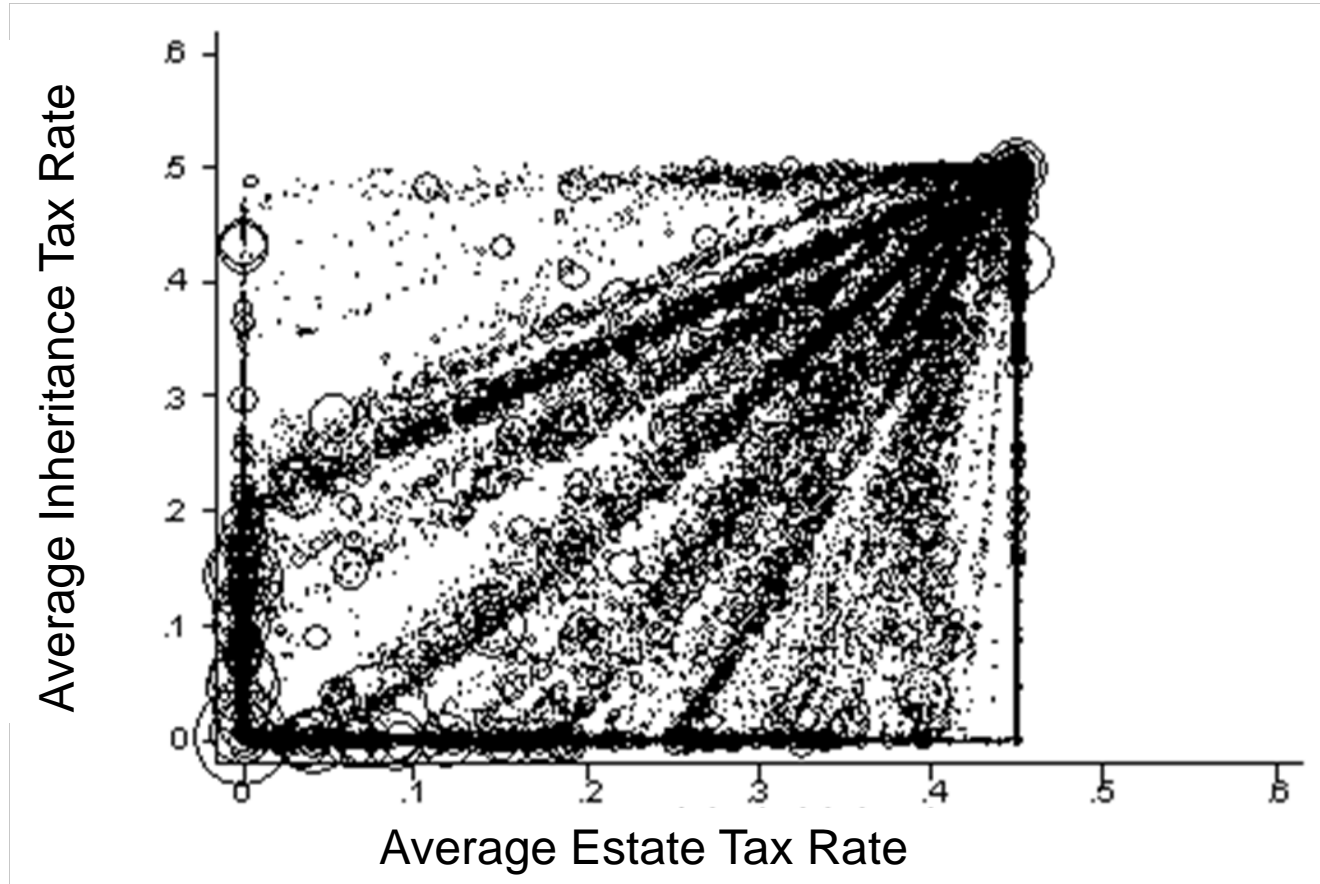


Number of Heirs Burdened by 2009 Estate Tax and Revenue-Neutral Inheritance Tax



Average 2009 Estate and Inheritance Tax Rate on Individual Heirs

(Weighted by Inheritance Size)



Advantages of Inheritance Tax

- More fairly allocates tax burdens at individual level
- Improves incentives
- Simpler
- More transparent

Methodology

- Based on Tax Policy Center Estate Tax Microsimulation Model.
 - Constructed from IRS Statistics of Income public use data augmented by imputed assets based on information from Surveys of Consumer Finances (SCF).
- Adapted to model the amount that individual heirs inherit and each heir's other income.
 - Based on data from the SCF and tabulations from restricted IRS data that matches estate tax returns to the beneficiaries' income tax returns.

Burden on Donors v. Heirs

- Reported estates the same or less in response to estate tax increase. Evasion likely a factor.
 - Suggests heirs generally bear tax burden.
 - But inheritances may not be endogenous and may be externalities so motives matter...
- Accidental and egoistic transfers
 - All on heir
- Compensatory transfers
 - Split, depends on relative elasticities
- Altruistic transfers
 - Heir and donor both lose revenue collected
 - Heir loses reduction in transfers
 - Donor loses part of reduction in transfers

Efficiency and Inheritances

- What is most efficient way to treat wealth transfers?
 - Compensatory: Treat like all other income.
 - Egoistic: 100%+ tax.
 - Accidental: 100%+ after correct market failures to extent possible.
 - Altruistic:
 - 100%+ subsidy for altruistic and redistributive externalities.
 - Increase in underlying tax to finance subsidy → Net subsidy declines to zero as economic income rises.
 - Partial inclusion in heir's tax base for altruistic and revenue externalities.

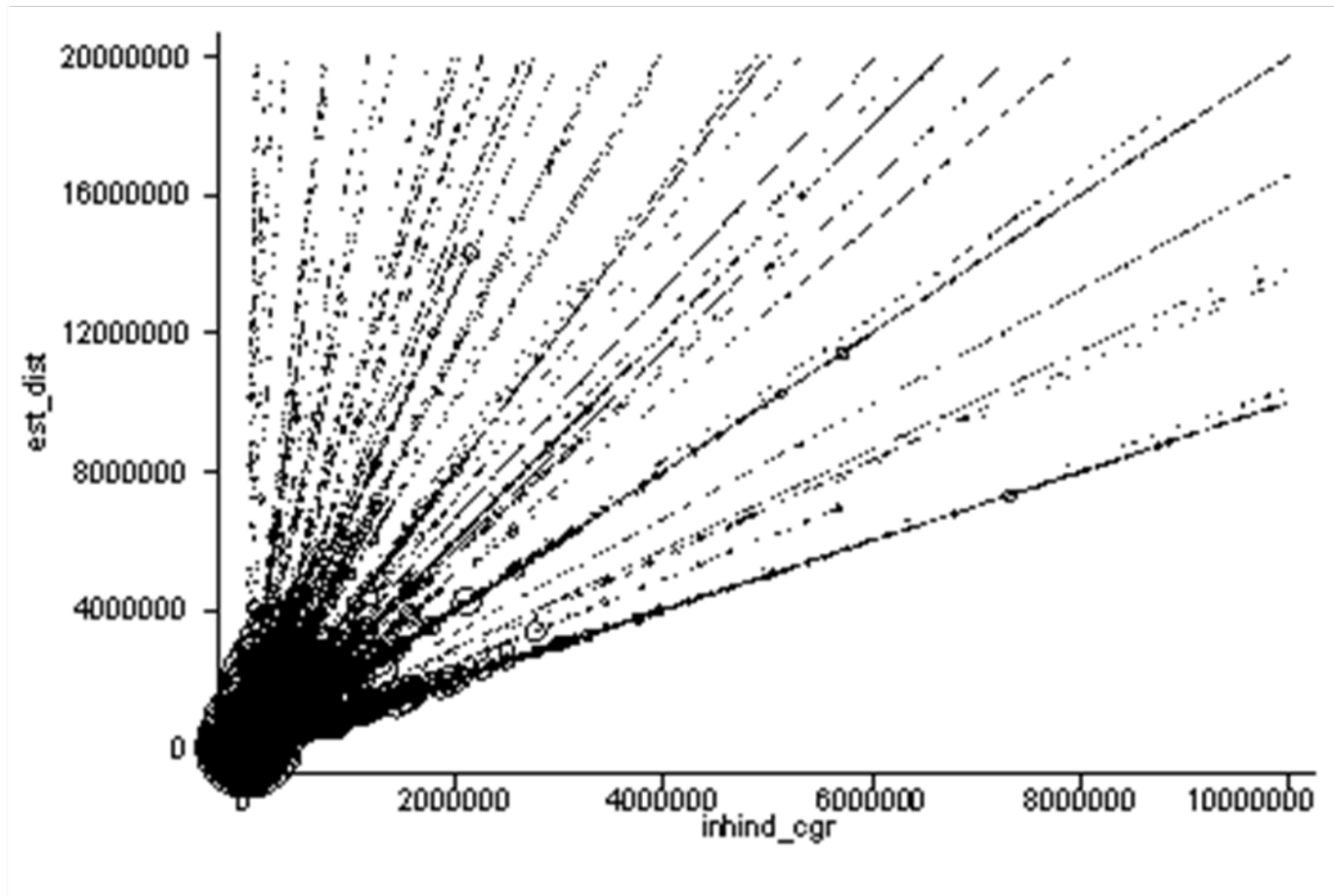
How Prevalent are Different Wealth Accumulation Motives?

Study	Accidental	Egoistic & Pre-Tax Warm Glow	Exchange	Altruistic & After-Tax Warm Glow
Kotlikoff & Summers (1981)	19%	81%		
Hurd (1987)	Most Bequests		Minority of Bequests	
Modigliani (1988)	>80%			<20%
Hurd (1989)	Most		Small	
Bernheim (1991)	<70-84%			>16-30%
Altonji et al (1992)	Most			Model Rejected
Wilhelm (1996)	Most			Little Evidence
Laitner & Juster (1996)	77-82%			18-23%
Laitner & Ohlsson (2001)	Most			Some Evidence
Dynan et al (2002)	Most			<8%
Hendricks (2002)	>47%	<53%		
Page (2003)	Not All		Some	
Li Gan (2004)	Very Large Share			Small
Kopczuk & Lupton (2007)	47%	53%, Mostly Egoistic		

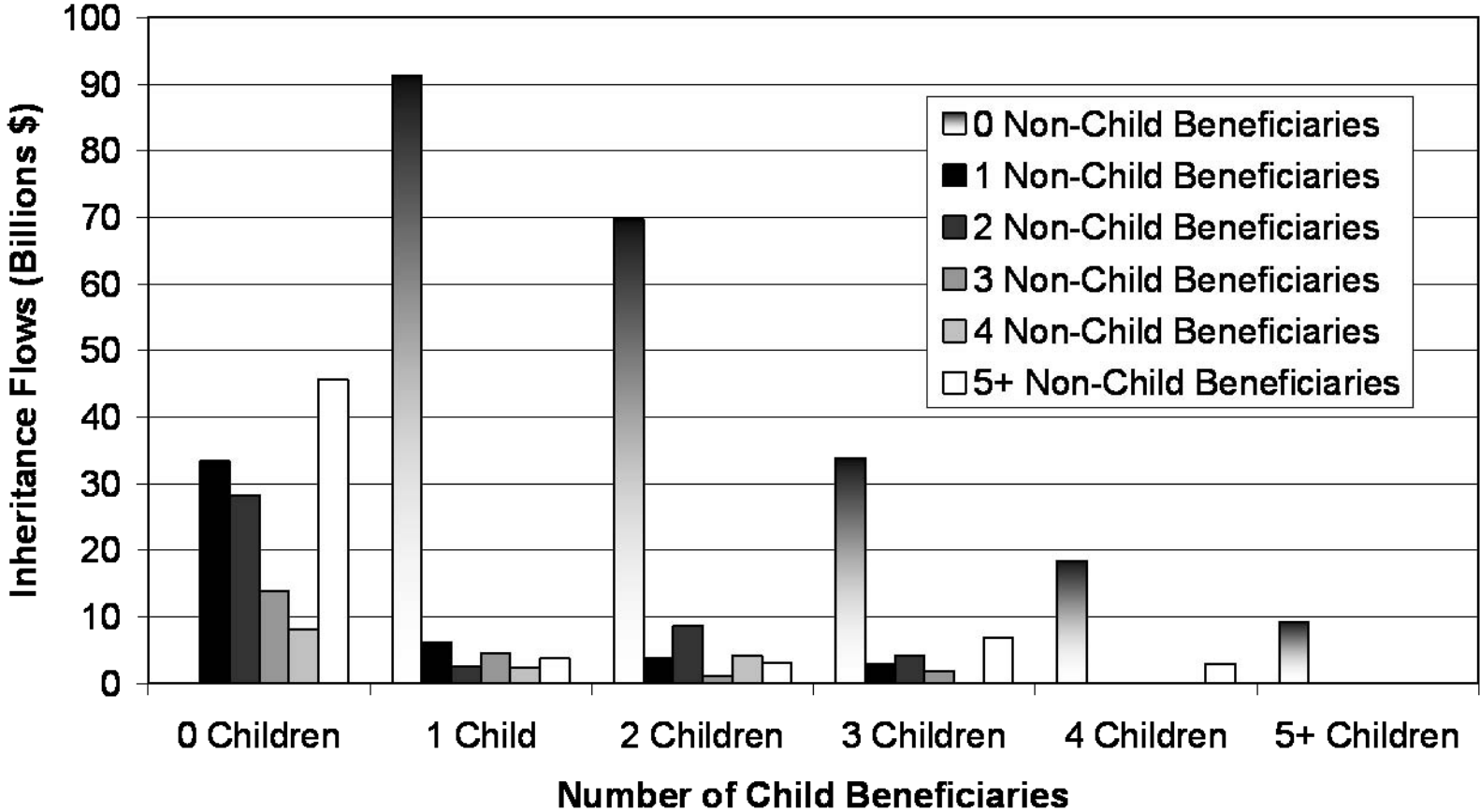
Approaches to Taxing Wealth Transfers

Type of Tax	Payer	Amount Taxed	Tax Rate Schedule	Time Period
No Wealth Transfer Tax	N/A	N/A	N/A	N/A
Estate and Gift Tax	Donor	Amount Transferred	Separate Based on Amount Transferred	Long-Term
Annual Inheritance Tax	Heir	Amount Inherited	Separate Based on Amount Inherited	Annual
Accessions Tax				Long-Term
Inclusion Tax			Income Tax After Including Non-Inherited Income	Flexible
Comprehensive Inheritance Tax			Income Tax & Separate Based on Amount Inherited	Long-Term

Inheritance Size v. Taxable Estate Size



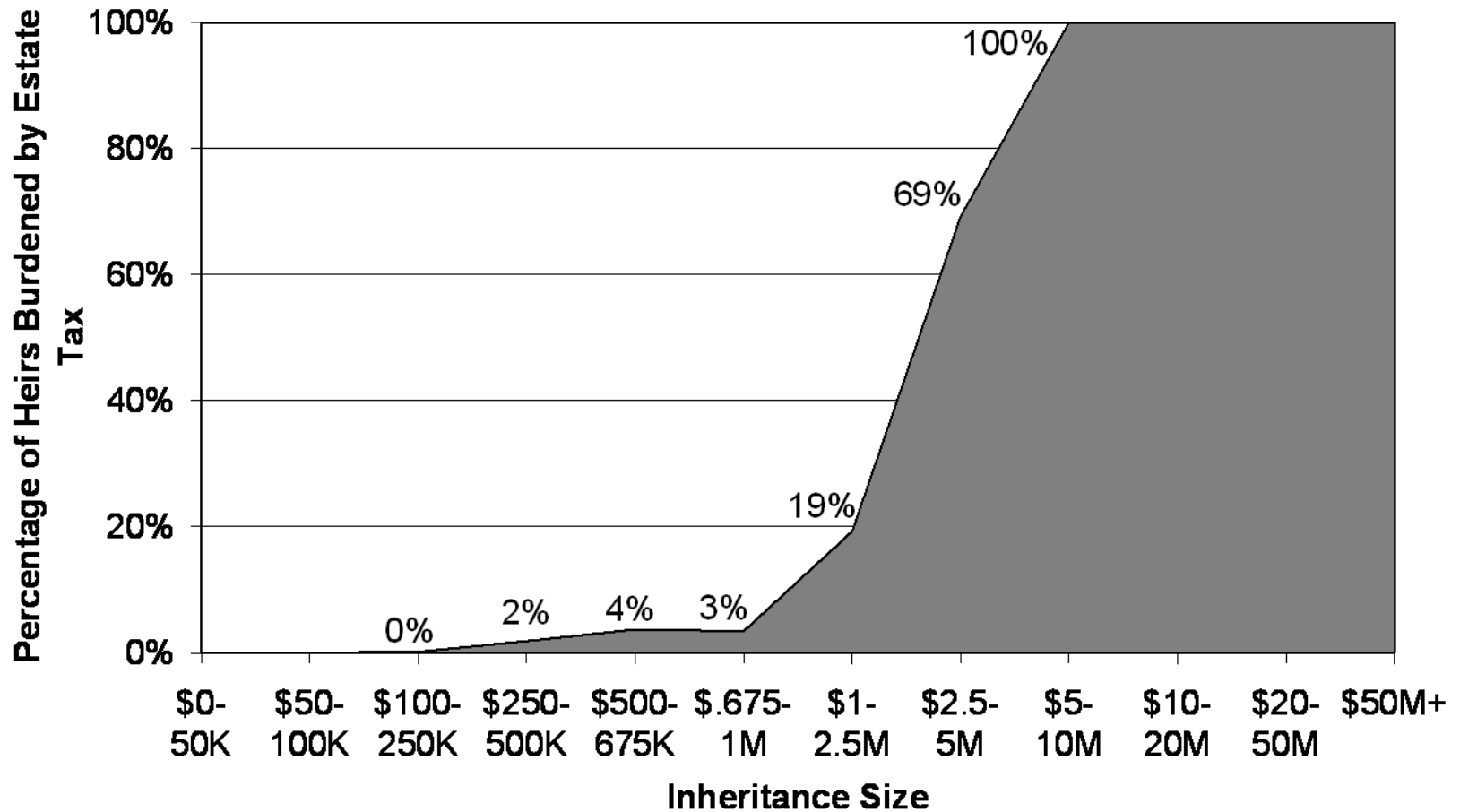
Inheritance Flows by Number of Estate's Child and Non-Child Beneficiaries



Wealth Transfer Taxes Cross-Nationally

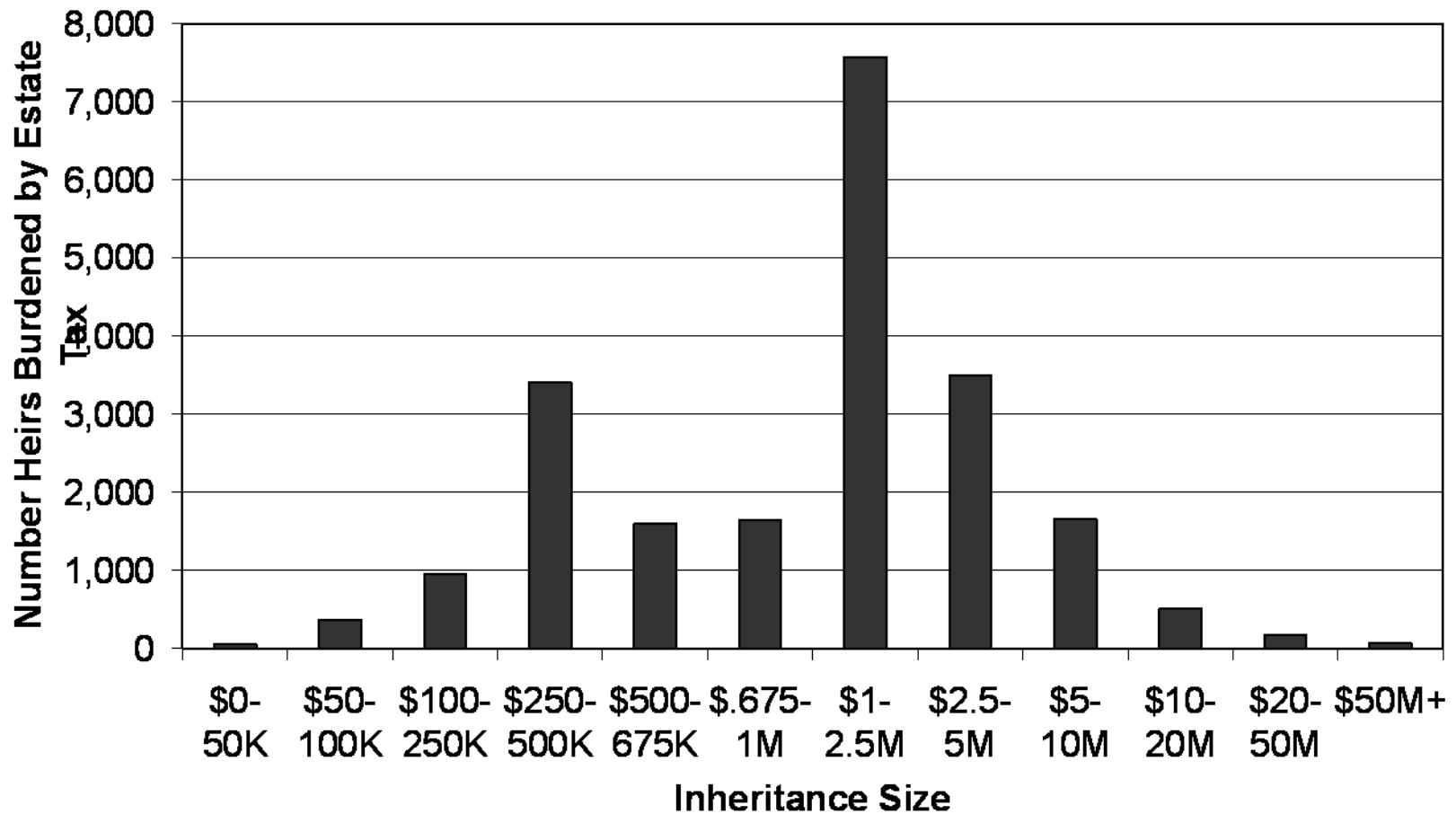
Country	Donor Pays from After-Tax Income	Other Tax on Donor or Donee	Inclusion Tax		Accessions Tax		Estate and Gift Tax		Rate Varies by Relationship	Aggregation Period & Unit	Treatment of Accrued Gains	
			Gifts	Bequests	Gifts	Bequests	Gifts	Bequests			Gifts	Bequests
Australia	Y	N	N	N	N	N	N	N	N		Realization	Carryover
Austria	Y	Y	N	N	Y	Y	N	N	Y	Over 10 years by Donor		
Belgium	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
Bulgaria	Y	Y	N	N	Y	Y	N	N	Y			
Canada	Y	N	N	N	N	N	N	N	N		Realization	Realization
Czech Rep.	Y	Y	N	N	Y	Y	N	N	Y	Annually by Relationship		
Denmark*	Y	Y	Y	N	Y	Y	N	Y	Y	Annually by Donor if Gift, Relationship if Bequest		
Estonia	Y	N	N	N	N	N	N	N	N			Realization
Finland	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
France	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		Step-Up
Germany	Y	Y	N	N	Y	Y	N	N	Y	Over 10 years by Donor		Carryover
Greece	Y	Y	N	N	Y	Y	N	N	Y			
Hungary	Y	Y	N	N	Y	Y	N	N				
Iceland	Y	Y	Y	N	N	Y	N	N	N	Annually by Donor		
Italy	Y	N	N	N	N	N	N	N	N			
Ireland	Y	Y	N	N	Y	Y	N	N	Y	Over Life by Relationship	Realization	Step-Up
Japan*	Y	Y	N	N	Y	Y	N	N	N	Annually from All for Gifts, Relationship for Bequests	Carryover	Carryover
Korea	Y	Y	N	N	Y	Y	N	N	N	Annually by Donor		
Lithuania	Y	Y	Y	N	N	Y	N	N	N	Annually from All		
Luxembourg	Y	Y	N	N	Y	Y	N	N	Y			
Mexico	Y	N	N	N	N	N	N	N	N			
Netherlands	Y	Y	N	N	Y	Y	N	N	Y		Carryover	Carryover
New Zealand	Y	N	N	N	N	N	N	N	N			
Norway	Y	Y	N	N	Y	Y	N	N	Y	Over Life by Donor		
Poland	Y	Y	N	N	Y	Y	N	N	Y	Over 5 Years by Donor		
Portugal*	Y	Y	N	N	Y	Y	Y	Y	Y	Over Life from All		
Russia*	Y	Y	Y	N	N	N	N	N	N			
Serbia	Y	Y	N	N	Y	Y	N	N	Y			
Slovak Rep.	Y	N	N	N	N	N	N	N	N			
Slovenia	Y	Y	N	N	Y	Y	N	N	Y			
Spain*	Y	Y	N	N	Y	Y	N	N	Y	Annually by Donor		
Sweden	Y	N	N	N	N	N	N	N	N		Carryover	Carryover
Switzerland*	Y	Y	N	N	Y	Y	Y	Y	Y	Annually		
Turkey	Y	Y	N	N	Y	Y	N	N	Y			
U.K.	Y	Y	N	N	N	N	N	Y	N	Annually from All	Realization	Step-Up
U.S.	Y	Y	N	N	N	N	Y	Y	N	Over Life from All	Carryover	Step-Up

Percentage of Heirs Burdened by 2009 Estate Tax by Inheritance Size



Source: Batchelder & Khitatrakun, 2008.

Number of Heirs Burdened by 2009 Estate Tax by Inheritance Size



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