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Does the Death Tax Deserve the Death Penalty - An Overview of the Major Arguments for Repeal of Federal Wealth-Transfer Taxes

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DOES THE DEATH TAX DESERVE THE DEATH PENALTY? AN OVERVIEW OF THE MAJOR ARGUMENTS FOR REPEAL OF FEDERAL WEALTH-TRANSFER TAXES

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With the election of George W. Bush as president, the federal wealth-transfer tax system went onto death row. President Bush campaigned on a platform calling for repeal of the federal estate, gift, and generation-skipping transfer taxes, and, within his first month in office, introduced a bill that would accomplish that result. Because he enjoys narrow but probably adequate majorities in both houses of Congress, it would seem at this point that repeal is more likely than not. Whether or not these taxes are repealed this year, however, the debate over them will not immediately end. If repeal efforts fall barely short, they will likely be undertaken again in the next legislative session. If the repeal efforts succeed, it will only be with a lengthy phase-out; as such, discussion of possible deferral or reversal of any repeal could continue for some time.

In the spirit of that on-going debate, I offer this essay considering the major arguments that have been made by advocates of repeal. Although I will focus mostly on those arguments in opposition to the existing system, I will begin with a brief description of the federal wealth transfer taxes, followed by an even more brief affirmative defense of these taxes. These preliminary sections are simply to set forth background facts, and a basic, *prima facie* case, so that the comments on the arguments for repeal will not reside in a complete vacuum.

A. Description of Federal Wealth Transfer Taxes

1. The Federal Estate Tax[2]

The centerpiece of the transfer tax system is of course the federal estate tax, which has in various forms applied to decedents' estates since 1916. In its current form, the federal estate tax imposes a transfer tax on the passage of assets from an estate to the decedent's heirs and beneficiaries in cases where the value of the taxable estate so transferred exceeds $675,000. The $675,000 exemption–which is technically achieved through the use of a "unified credit" equal to the tax on a taxable estate of precisely that size–is scheduled under current law to increase in unequal increments over the next several years, until it reaches $1,000,000, effective for estates of decedents dying 2006 or later years.[3] Although the statutory rate structure runs from 18 percent to 55 percent, the actual marginal rate faced by estates subject to the tax begins at 37 percent for estates just over the $675,000 exemption

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[2]This description borrows heavily from a similar description provided in my recent paper Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, *in* RETHINKING ESTATE AND GIFT TAXATION 113 (William G. Gale et al. eds., 2001).

[3]I.R.C. § 2010 (1994).

level, reaches its highest marginal rate of 60 percent on estates between $10,000,000 and $17,184,000, and reverts thereafter to the statutory maximum rate of 55 percent.[4]

Congress has tried to give the estate tax a fairly broad reach, so that assets may be included in an estate even if the decedent enjoys less than full ownership of those assets at the time of death. For example, if a testator gives away a remainder interest in property, but retains a life estate, the value of the entire property will generally be included in the testator's estate.[5] Similar rules apply to property over which a testator has retained a power of appointment;[6] life insurance owned by the decedent (which ordinarily does not pass through the decedent's probate estate, but is rather paid directly to beneficiaries);[7] certain transfers within three years of death;[8] certain annuities;[9] and so on.

But the reach of the tax is circumscribed by a number of deductions, of which two are particularly important: the unlimited marital deduction, which allows any part of the estate left to a surviving spouse to be deducted in full;[10] and the unlimited charitable deduction, which allows deduction in full of any testamentary gifts to charitable organizations or governmental units.[11] These two deductions are hugely important; on estate tax returns filed in 1997, they reduced the total taxable estates by nearly 40 percent.[12] Thus, the federal estate tax is intended to apply to a broad sense of the decedent's wealth transferred at or because of death, but only to the extent that that wealth is transferred to someone other than a surviving spouse or a charitable entity.

[4]I.R.C. § 2001(c)(1) (1994). The rates below 37 percent are irrelevant because they are fully offset by the unified credit. Actual tax liabilities begin at the point that the credit is exhausted, and the rate schedule by that point is at 37 percent. The 60 percent bracket is intended to phase out the benefit of the rate brackets below the 55 percent bracket. Until 1997, the 60 percent bracket was also intended to phase out the benefits of the unified credit, but a technical defect in the Taxpayer Relief Act of 1997 omitted that effect. If this is corrected by a subsequent technical corrections bill, the 60 percent rate would fall back to the 55 percent rate on an estate of $24,100,000 by the time the $1,000,000 exemption is effective in 2006.

[5]I.R.C. § 2036 (1994). There is, however, a credit for any gift tax paid on the original transfer of the remainder interest during the testator's life.

[6]I.R.C. § 2041 (1994).

[7]I.R.C. § 2042 (1994).

[8]I.R.C. § 2035 (1994).

[9]I.R.C. § 2039 (1994). Only annuities having a death benefit or refund feature, or those covering multiple lives, are includable under these provisions. A single-life annuity does not ordinarily pass anything to anyone at the death of the annuitant, and would not be included in a decedent's estate.

[10]I.R.C. § 2056 (1994). The marital deduction, like a number of other rules in the estate and gift tax area, only applies in this way if the spouse is a U.S. citizen.

[11]I.R.C. § 2055 (1994).

[12]Author's calculations are based on Barry Johnson & Jacob Mikow, *Federal Estate Tax Returns, 1995-1997*, 19 STAT. OF INCOME BULL. 69, 102, 105 (1999). Total charitable deductions of about $14.3 billion, and marital deductions of about $49.3 billion together eroded 39.2 percent of the $162.3 billion reported as the aggregate gross estate total in 1997.

2. Other Federal Wealth Transfer Taxes

Roughly speaking, the federal wealth transfer tax system is intended to impose an excise tax on the passage of wealth from one generation to the next. If the estate tax stood alone, testators would be tempted to defeat the tax by making some significant proportion of their wealth transfers in advance of their death; additionally, they would be tempted to seek ways of passing wealth to grandchildren (and perhaps even more remote generations) as a way of lengthening the period of time between tax assessments. Although the first federal estate tax, added to the Code by the Revenue Act of 1916, did indeed stand alone, the wisdom of also taxing transfers during life became clear relatively early in the history of American transfer taxes. Accordingly, a gift tax was added in 1924. In the Tax Reform Act of 1976, the gift tax was "integrated" with the estate tax, so that lifetime transfers were subject to the same rate structure as transfers at death would be, and were allowed the shelter of the unified credit.[13] Thus, it is now possible to make up to $675,000 of tax-free transfers during life, but doing so exhausts pro tanto the unified credit that would otherwise be available at death.[14] Like the estate tax, the gift tax allows unlimited deductions for transfers to a spouse[15] and for transfers to charities or governments.[16] The gift tax also allows an "annual exclusion" of $10,000 per donee, so that relatively small gifts in the ordinary course of events would not occasion the imposition of either a tax or a reporting obligation.[17]

Congress was much slower to deal with the avoidance opportunity presented by transfers that skipped one or more generations, but, also in the Tax Reform Act of 1976, decided that an additional tax should be imposed on certain transfers to grandchildren and others not in the generation immediately following the transferor's.[18] The aptly named "generation-skipping transfer tax" ("GST tax") accomplishes this end. This tax can be quite complex, but essentially it treats the termination of life interests of any intermediate generation as a taxable event, effectively imputing the value of the interest passing to the next generation as a part of the estate of the member of the intermediate generation. The GST tax also taxes certain "direct skips" that do not pass through the intermediate generation.[19] Like the gift tax, the GST tax has its own exclusion, which considerably simplifies compliance for the bulk of estates: up to $1,000,000 of generation skipping transfers can be made by an individual before the tax applies.[20]

Neither the gift tax, nor the GST tax are primarily intended to raise revenue. Rather, they exist to protect the integrity of the estate tax, and thus to preserve its

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[13]The current gift tax is imposed by I.R.C. § 2501; the availability of the unified credit is described in I.R.C. § 2505.

[14]See I.R.C. §§ 2505, 2010(b) (1994).

[15]I.R.C. § 2523 (1994).

[16]I.R.C. § 2522 (1994).

[17]I.R.C. § 2503(b) (1994).

[18]Codified at I.R.C. § 2601 (1994) *et seq.*

[19]I.R.C. § 2611(c) (1994).

[20]I.R.C. § 2631 (1994).

revenue-generating capacity. Although many of the standard devices used to reduce transfer taxes involve making taxable gifts during life, and the use of the $1,000,000 GST exemption is common among the very wealthy, the existence of these two ancillary taxes, nonetheless, appears substantially to control the abuses at which they were directed. As a result, the transfer tax system overall is a reasonably potent source of revenue. It is expected that it will generate about $32.3 billion of federal revenue in the fiscal year that ends on September 30, 2001.[21]

A further consideration of some importance is that the existence of a generous, dollar-for-dollar credit for state death taxes paid makes the federal estate tax indirectly responsible for about $6 billion per year in wealth-transfer taxes at the state level.[22] Many states have set their estate or inheritance tax rates at levels that are precisely intended to take advantage of this essentially free source of revenue sharing. Some will cease doing so automatically if the federal inheritance tax is repealed.[23] Those that do not will be put in the position of appearing to increase the tax burdens on their citizens, while merely maintaining historical rates of taxation.

B. The Prima Facie Case for Wealth Transfer Taxes

The strongest defense of the existing wealth-transfer tax system is that it restrains a tendency in a society dominated by private markets (such as ours surely is) toward inequalities in wealth-holding. Free markets reward winners generously, but penalize losers mercilessly. Some of the qualities that make winners win are inheritable in a purely physical sense: good health, intelligence, and, for all we know, less measurable qualities of personality. Wealthy families also make larger investments in the human capital of their children. If unfettered inheritance of financial wealth is added to the substantial advantages enjoyed by each succeeding generation of a wealthy family, tendencies toward ever greater inequalities of wealth are enhanced. Inequality, as has been famously observed, is unlovely.[24] An excise on the transfer of financial wealth in a political and economic system such as ours certainly does not (and arguably should not) completely offset the other forces encouraging wealth inequality; but such an excise can operate modestly to constrain the effects of those other forces.

Wealth inequality has a necessary corollary: the greater the degree of inequality, the larger the percentage of the society's wealth that will be held in the hands of a

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[21]Budget of the United States Government, Fiscal Year 2001, Table S-11 (2000).

[22]The aggregate revenue loss stemming from complete federal wealth-transfer tax repeal would have been $5.5 billion in the 2000 fiscal year, according to estimates of the Center on Budget and Policy Priorities. The potential loss of state revenue due to the repeal of federal wealth transfer taxes would rise to nearly $9 billion by 2010, when the current proposals for repeal would be complete. [Statistics from Center's web site.]

[23]For example, the Florida constitution prohibits any wealth transfer taxes in excess of what is creditable against the federal taxes. FLA. CONST. art. VII, § 5.

[24]Henry Simons, Personal Income Taxation, 18-19 (1938). In fact, Simons himself simply said that the case for progressivity must be based on the ethical or aesthetic judgment that the otherwise prevailing distribution of wealth or income would be unlovely, without actually saying that he found it so. What I assert here is that repeal of wealth transfer taxes would exacerbate wealth inequality, and so intensify any judgments that an observer might make on those ethical or aesthetic grounds.

small number of families.[25] Wealth concentration can create pressures on democratic institutions, especially within the framework of the American democracy, where free speech considerations have made it difficult to constrain the ability of the wealthy to use their wealth to influence the outcome of political contests.

Other defenses of transfer taxes have been advanced. Some argue that it complements the existing contours of the income tax, by imposing a tariff on untaxed appreciation in the assets of decedents.[26] While this is no doubt true, it is also true that a more direct and accurate approach to that goal is readily available: our income tax rules could be modified to include a realization (and taxation) at death feature.[27] And some have argued that our current wealth transfer taxes, which reach at most the wealthiest 5 percent of decedents, must contribute to the overall progressivity (measured by wealth) of the tax structure, and deserve preservation on those grounds.[28] As with the first argument in this paragraph, however, the goal of greater progressivity could be met in a variety of ways, and does not uniquely suggest the superiority of a tax system that includes a wealth-transfer tax. In the context of the present debate over the future of wealth-transfer taxes, however, this argument does make one powerful point: if repeal of wealth-transfer taxes is to be accomplished in a manner that is distributionally neutral, it must be accompanied by other changes that would restore the element of progressivity that transfer-tax repeal would delete from the system.

My sense, developed over a number of iterations in presenting this case, is that listeners either accept these arguments or not, and that more detailed elaboration is unlikely to change many minds. I believe, all else being equal, that a society that is

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[25]I am asserting here nothing more controversial than a mathematical inference. If the total wealth of a society is W, and mean wealth per person is W/ P, where P is the population, then one measure of inequality would be standard deviation of W/P, with higher standard deviations associated with higher degrees of inequality. In normal distributions, a relatively large standard deviation will also lead to a situation in which, for any arbitrarily selected top percentile threshold, the total wealth represented by the individuals above that threshold will be a larger portion of total wealth than would be the case in a distribution with a lower standard deviation. For example, if the mean wealth within the top two percent of wealth holders is ten times the overall mean wealth, then the wealthiest two percent will hold 20 percent of all wealth. Such a society would have both greater inequality and greater concentration of wealth than a society in which the top two percent of wealth-holders have mean wealth that equals only five times the overall mean.

[26]*See, e.g.*, Charles Davenport & Jay A. Soled, *Enlivening the Death-Tax Death Talk*, 84 TAX NOTES 591, 597 (1999).

[27]Of course, the one step toward such a goal that our tax system has tried proved to be unsustainable: The Tax Reform Act of 1976 incorporated a carryover basis rule that, while not taxing unrealized appreciation at death, would at least have preserved that appreciation for subsequent tax when and if the heirs realized those gains. This modest bit of reform was short-lived, however. Trust departments of banks and others complained that establishing the basis that decedents had in their assets was unreasonably difficult and uncertain. Presumably, a rule taxing unrealized appreciation at death would be subject to the same shortcoming, in which case a wealth transfer tax might be the only practicable approach to the unrealized appreciation problem.

[28]Davenport & Soled, *supra* note 26, at 598; *see also* James R. Repetti, *The Case for the Estate and Gift Tax*, 86 TAX NOTES 1493, 1500 (2000).

dominated by the unloveliness of gross wealth inequality is inferior to a society that is somewhat less marred by that defect. I also believe, all else being equal, that a society in which the wealth concentration allows the wealthy to buy grossly disproportionate political influence by exercising their rights to finance the campaigns of all candidates with any chance of success is inferior to a society that is somewhat less marred by that defect. And I believe that a tax system that distributes the burdens of government primarily on those who can afford to discharge those burdens with relative ease is superior to one that makes no such allowances. In my view, a reasonable wealth-transfer excise tax is consistent with these sentiments.

C. The Arguments for Repeal

This brings us, finally, to the main point of this paper. Even if one accepts one or more of the overall affirmative arguments for a wealth-transfer excise tax, one might still conclude that the defects of the present system call for either major reform or outright repeal. What are, then, the alleged defects in our wealth-transfer tax system?

Critics of the existing federal wealth-transfer tax system have advanced several, including the following, which appear to be of primary importance: 1) that these taxes distort economic decision-making, in particular discouraging the creation and retention of wealth; 2) that these taxes are relatively easy to avoid if sophisticated planning is undertaken; they are therefore simply taxes on the unwary (or highly–and somewhat strangely–principled); 3) that these taxes are unfair, in that they tax funds that have already been subject to income taxes during the decedent's lifetime; 4) that these taxes do not raise very much revenue; 5) that these taxes enjoy low levels of public support; 6) that these taxes are administratively inefficient, generating large public and private compliance costs; and, 7) that these taxes tend to break up family farms and other small family businesses. Each of these will be considered separately below.

1. Distortion

Some distortion of economic decision-making is inevitable in taxation. Whatever a government taxes, it tends to discourage.[29] So it might be assumed that if wealth accumulations are taxed, the taxes will discourage wealth accumulation-either by depressing initial creation of wealth, by discouraging its conservation, or both. This would obviously be regrettable because it would mean that incentives to engage in productive activity–either the provision of labor, or the investment of capital–had been lowered, while the incentives to engage in consumption were raised. (On the other hand, if one of the main goals of a wealth-transfer taxes is to reduce wealth concentration and inequality, the possibility that the looming presence of those taxes

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[29]Critics of wealth-transfer taxes have lately taken to referring to them collectively as "the death tax." In keeping with this lexicon, one might think that these taxes tend to discourage death. However, one assumes that the non-tax incentives in that direction are for most people close enough to infinite that additional incentives not to die are of little effect. And, of course, the tax is not imposed on the act of dying, but rather on the transmission of wealth from donors who may be either alive or dead, in excess of a threshold amount that is larger than all but a few families ever own. Thus, death is neither a necessary nor sufficient cause of wealth transfer tax liabilities, as has been observed by William Gale & Joel Slemrod, *We Tax Dead People*, University of Michigan Working Paper Series, number 2000-11, at 8.

might discourage some wealthy people from efforts to become even wealthier may not be an altogether adverse consequence.)

In any event, there is little if any empirical evidence that the federal wealth-transfer taxes do in fact discourage the accumulation and preservation of wealth. In his recent review of the economic literature on the federal estate and gift taxes, a Department of the Treasury economist found no evidence of any reduction in either the work effort or the savings behavior of individuals in response to these taxes.[30] Although one customarily expects incentives to have consequences, the absence of evidence to this effect in the case of wealth-transfer taxes is not completely surprising. This is because the motivations to create and preserve wealth are many and varied, and not all of those motives are impacted by transfer taxes. At least the following list of reasons to accumulate and preserve wealth can be imagined:

1. To increase and preserve the economic power of the wealth holder;
2. To protect the wealth holder from unexpected needs during retirement, such as extraordinary medical expenses;
3. To protect the wealth holder's spouse from the same contingencies;
4. To benefit charitable organizations; and
5. To benefit one's children or more remote descendants.

The first two goals can be satisfied by holding wealth during one's lifetime, and are hence unaffected by the taxes imposed at death. Because the federal estate and gift taxes have unlimited marital and charitable deductions, the third and fourth goals are similarly beyond the reach of wealth-transfer taxes under present law. So only the last of the five goals of wealth creation and preservation seems directly implicated by wealth-transfer taxes. And even in that case, the implications are unambiguous: if a wealth holder had children whose ability to provide for themselves seemed in doubt, the wealth holder might try harder to accumulate wealth when faced with an estate tax, because a larger pre-tax sum would in such a case be needed to achieve any particular target after-tax sum that was thought to be necessary.

Further, if there is any net distortion discouraging provision of labor or savings among what might be thought of in this context as the donor generation, that distortion may be partly or fully offset by responses to wealth-transfer taxes among the donee generation. Their tax-diminished expectations may help motivate wealth-generating and preserving efforts on their part.

Edward McCaffrey's variant on this argument puts it in what he labels a moral framework, saying that wealth-transfer taxes penalize the wrong thing: instead of taxing the thrifty people who produce a lot but consume little, we should be taxing precisely those who are lavish spenders, who thereby defeat the estate tax by using up their resources before death.[31] There are several responses to this. First, I do not think that much of that sort of behavior is actually observed. Among middle and upper middle income families, it is true that some save a good deal and some do not, so some end up with an estate in the low seven figures–barely above the threshold of taxability–and others do not. One doubts that explicit tax-avoidance motives have

[30] DAVID JOULFAIAN, U.S. DEPT. OF THE TREASURY, THE FEDERAL ESTATE AND GIFT TAX: DESCRIPTION, PROFILE OF TAXPAYERS AND ECONOMIC CONSEQUENCES 80 (1998).

[31] Edward McCaffrey, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994).

much to do with this. More important, it is unclear that for families in these wealth ranges saving is necessarily morally superior to spending. Family A may have spent generously on their children's orthodontia, music lessons, summer camps, and private school tuition, and have for that reason a much smaller estate than they might have been able to leave. Family B may have been more parsimonious with respect to those and other expenditures, and may therefore leave a larger estate. Wealth-transfer taxes may create distortions in this respect, favoring one form of transfer for the benefit of one's children over another. But it is difficult to see any real moral dimension to this problem; public policies can permissibly reflect the judgment that the human capital investments enjoyed by the children of family A should be modestly favored over the creation and preservation of financial inheritance enjoyed by the children of family B, which a tax on the latter transfers may accomplish.[32]

Of course, it may have been that the parents in Family A spent freely on their own consumption, rather than making super-normal investments in their children's human capital.[33] This seems less noble, to be sure. But one should not, in the context of a liberal social state, too quickly condemn decisions of a family to deploy their means to satisfy their tastes. To say otherwise is virtually to say that parents owe their children the largest inheritance that they can reasonably provide–a proposition that has support neither in law nor in moral theory.

But the primary significance of wealth-transfer taxes is not among families with wealth in range of $675,000 to $5,000,000 or so, where consumption decisions seem mostly implicated. The primary significance is in the larger estates, where spending rates have less potent effects on wealth creation and preservation. Where the wealth is quite large, it can be physically difficult to spend even the income from the portfolio, much less diminishing the capital base itself. $1 billion, invested safely in municipal bonds at the rates prevailing when this article was written, produces about $160,000 of income per day, free of any federal income taxes. Even trying to spend at this level can turn into investment, because the natural tendency is to spend it on yachts, a pied-a-terre in London or Paris, art works, antiques, oriental carpets, and the like. Even though the rental value of such items is in some sense consumed, the assets themselves frequently have investment-like qualities, and tend to appreciate, thus enriching the heirs, and Uncle Sam, against the decedent's will, as it were.

On balance, the distortion argument is one that should be watched, pending further research. It is possible that empirical work done in this area may at some point suggest that the utility loss to the society overall from transfer-tax-induced distortion is excessive, relative to the revenue and non-tax goals achieved by these taxes.[34] But that case is far from made under the present state of the evidence.

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[32]There are many reasons for this, not the least of which is an income tax that is generally ungenerous in its treatment of human capital investments.

[33]Similarly, it may be that family B doesn't really care much about leaving an inheritance to their children, but does care about accumulation of economic power.

[34]One recent study did find that: "[S]ummary measures of the [estate and gift] tax rate structure are generally negatively correlated with the reported net worth of the top estates as a fraction of national wealth." Wojciech Kopczuk & Joel Slemrod, *The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior, in* RETHINKING ESTATE AND GIFT TAXATION 299, 338-39 (William G. Gale et al. eds., 2001). The authors note that their finding is consistent either with the hypothesis that wealth-transfer taxes discourage accumulation, or that high-wealth individuals are aggressive and reasonably successful in their transfer-tax

2. Avoidance

Another major argument is that transfer taxes are "voluntary" taxes, ones that are not paid by the rich and the well advised. Harvard's James Casner made essentially this charge in hearings before the 1976 act.[35] Even after the substantial reforms of the transfer tax system enacted in that year, George Cooper wrote an article, which was later expanded into a book, whose very title suggested that wealth-transfer taxes could be easily avoided.[36] This raises a horizontal equity concern: at any given level of wealth, there might be great differences in burden between well-planned estates and ones that are unplanned or badly planned. And it raises of course vertical equity concerns as well: if the devices are so expensive that it is only economically rational to use them if one reaches some threshold wealth level, estates with wealth that is considerably in excess of the threshold save a great deal, while estates below the threshold cannot use the devices at all.

The author of this paper considered this charge extensively in a recent paper.[37] The paper concludes that wealthy individuals can indeed reduce their estates impressively by good planning. Avoidance behavior is common and to a considerable degree successful. Loopholes exist; they can and should be closed. Nevertheless, when all is said and done, individuals who have sizable fortunes, who wish to pass substantial parts of those fortunes down to their children and grandchildren, will still bear a substantial burden, either in the form of direct payments of transfer taxes, or by way of indirect burdens resulting from the avoidance strategies themselves. This is verified to some degree by the revenue generated by federal wealth transfer taxes, which, as noted above, is estimated to be $32.3 billion for the fiscal year that will end on September 30, 2001.[38] Past analyses of the Internal Revenue Service data on actual estate tax returns indicate that more than a third of this revenue will come from estates with gross values in excess of $10 million–estates that presumably had the benefit of expert estate planning, and could not be said to have "volunteered" in any meaningful sense to pay estate taxes.[39]

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avoidance efforts. Either hypothesis is troubling, though for different reasons. However, the authors also note that their findings "suggestive rather than definitive," because of data and study design problems of some importance.

[35]*Estate and Gift Taxes: Hearing Before the House Ways and Means Committee*, 94th Cong. 1335 (1976). Casner said flatly: "[Y]ou pay an estate tax if you want to; if you don't want to, you don't have to."

[36]GEORGE COOPER, A VOLUNTARY TAX?: NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE (1979).

[37]Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, *in* RETHINKING ESTATE AND GIFT TAXATION 113 (William G. Gale et al. eds., 2001).

[38]Budget of the United States Government, Fiscal Year 2001, Table S-11 (2000).

[39]For returns filed in 1997, estates with gross assets in excess of $10 million paid 32.6 percent of all estate tax revenues. Barry Johnson & Jacob Mikow, *Federal Estate Tax Returns, 1995-1997*, 19 STATISTICS OF INCOME BULL. 69, 107 (1999). This somewhat understates the costs to estates of that magnitude, since the tax no doubt induced some of the sizable charitable bequests made by estates in this group: 65.3 percent of the $14.3 billion of charitable bequests were made by these large estates. *Id.* at 105. These large estates also claimed credits against their federal estate taxes for about $1.7 billion of state death taxes,

Several factors operate to maintain significant revenue levels in the face of the admittedly porous sieve of the transfer taxes. First, the best methods for getting assets out of the estate require that the wealth holder actually part with a significant portion of those assets during life. Most individuals, however, are to a greater or lesser degree resistant to this idea. Reference to the first few items on the list above of reasons why people accumulate and preserve wealth helps to explain why: much of the incentive to create and conserve wealth comes from the pleasure and security of having it.

It is also true, however, that many of the avoidance devices are somewhat oversold, in the sense that they are not quite as useful as they may at first appear. A brief consideration of one popular device, the charitable lead trust, may be revealing. Imagine that the client is a 50-year-old man with a net worth of $20,000,000. He would like, ideally, to leave $10,000,000 to his wife and $10,000,000 to his son. How close, he might ask his estate planner, can he come to that outcome, in the face of wealth-transfer tax rates that run as high as 60 percent? To his surprise, his estate planner may say that it would be possible to do what the client seeks, without violating any laws or taking any significant tax or business risks, at a transfer tax cost of about $150,000–less than one percent of the estate. How is this possible? Here is the plan, in a somewhat simplified form. A writes a will that leaves $10,000,000 to his wife. A also sets up a charitable lead trust and transfers the other $10,000,000 of his assets to that trust. The trust will pay an income interest to a charitable organization for the remainder of A's life. At his death, the trust will terminate, distributing all of its assets (which should be at least $10,000,000, if the trustees have been careful to preserve the corpus of the trust) to A's son. The $10,000,000 that goes to A's wife is free of estate and gift taxes because of the unlimited marital deduction. The $10,000,000 that goes to the son is not completely free of transfer taxes, but it will be only lightly taxed, because the valuation of that gift will be based on its value as of the time A makes the gift, when A is 50 years old. The $10,000,000 will be discounted to reflect the fact that A's son is not expected to enjoy the proceeds of the gift during the remainder of A's life. If A's life expectancy is around 33 years at the time of the gift, and if the applicable discount rate is 7 percent–both plausible assumptions at today's mortality and interest rates,–the value passing to A's son at the time of the gift would be only $1,065,000. A would apply his unified credit against that amount, sheltering $675,000 of that transfer, and would pay a tax of about $150,000 on the remainder. When the dust clears–which is to say, when the client is dust–his wife has $10,000,000, his son has $10,000,000, and the IRS has to look elsewhere for anything more than token transfer tax revenue. Q.E.D.

As tidy as this plan looks, it really does not make much sense, at least not if transfer-tax avoidance is the primary point. The fallacy lies in the fact that A really has given away the productive power of $10,000,000 for a period lasting a third of a century. The present value of the income interest, at 7 percent for 33 years, really is about $9,000,000. And the tax potentially owed on the half of A's wealth that went to his wife has not really been avoided, but merely deferred. If A and his wife were roughly contemporaries, the IRS will still get some significant revenue out of that transfer. So A has only really "avoided" the tax on the $10,000,000 going to his son

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indicating that at least that amount was paid to state taxing authorities out of the estates of this magnitude. *Id.* at 106.

by giving away $9,000,000 of it, and paying a gift tax on the $1,000,000 of value that actually does go to the son.

This is of course something of a cartoonish sketch of a charitable lead trust plan. However, many so-called sophisticated estate plans do have trusts of this sort contained in them, and they have a lot to do with the appearance of tax avoidance.[40] In fact, however, the actual economic avoidance is often grossly exaggerated in its effect, or, if real, is costly in some other way.

Life insurance trusts are also very popular. If a client transfers all "incidents of ownership" of a life insurance policy to a trust, the payment of the death benefit will not generally be brought back into the estate of the client when she dies. Many wealthy individuals use this device to create the means to pay the expected estate tax, indirectly. The beneficiaries of the insurance–usually the client's children–receive the proceeds of the insurance and use the proceeds to buy enough of the assets of the estate to permit the executor to pay the estate tax. The remaining assets are distributed to them pursuant to the will. Again, it looks as if all the assets may end up in the hands of the beneficiaries, without diminution due to the estate tax. But this is true only if one ignores the premiums on the insurance policy. Like most investments in life insurance, these plans are a good deal if the client dies before substantially funding the policy. But if the client lives to her full life expectancy, the total of the insurance premiums may have substantially reduced the amount that would have been available to the heirs in a world free of transfer tax.

Other devices, such as family limited partnerships, and grantor-retained annuity trusts, are effective at reducing the valuation of the assets transferred. Again, however, to be most effective, they require that substantial values be transferred during the client's life; they may in some cases also have non-tax implications–reducing the marketability and flexibility of the portfolio, for example–that may be unattractive. These are the devices that are perhaps the most troublesome from a policy viewpoint; they can and should be dealt with by anti-abuse rules that could substantially reduce the availability and effect of these devices. Even without those reforms, however, these devices do not so erode the wealth-transfer tax system that it becomes impotent.

Of course, the argument that one does not have to pay estate tax if one does not want to derives some staying power from the fact that it is in some sense literally true–one can, for example, leave everything to charity. Or one can leave it all to a surviving spouse. If one does not have a surviving spouse, one can get one.[41] So the tax is voluntary in that uninteresting sense. And the case made here should not be overstated: my argument is not that estate planning devices are worthless, or a fraud on the wealthy perpetrated by a clever conspiracy of lawyers, accountants, and financial planners. My argument is simply that the effectiveness of the devices have

[40]For example, Cooper's book involves a hypothetical estate plan for the then current generation of the DuPont family, which purports to zero out their net estate tax, while passing millions on to the next generation. Its centerpiece is a 24-year charitable lead trust, containing about half of the presumed value in the relevant estates, which is quite close to the trust plan described in the text, with a few valuation-shifting devices thrown in. *See* COOPER, *supra* note 36, at 66-78.

[41]The personal ad practically writes itself: Wealthy coot seeks youthful heir; no experience necessary.

been much exaggerated, and that the total avoidance of transfer tax burden is not generally possible in the case of large estates. Interviews with estate planners of some of the wealthiest American families were undertaken in connection with the article described above, and the considered opinion of those willing to venture one was that very large estates could reasonably expect to be reduced by about a third, on average. That is a lot of avoidance, but it also leaves quite a lot in the tax base. This is a glass that is perhaps two-thirds full.

3. Unfairness

Arguments about the unfairness of wealth-transfer taxes take many forms. One is a variant of the distortion argument: that the transfer taxes reward consumption and penalize thrift. This argument has been discussed in Part Two above. Another commonly offered complaint is that wealth-transfer taxes impose a double burden on that which has already been taxed. As this argument goes, an individual earns money during life and is taxed on it. If value remains at death, it is after-tax value, and should therefore be immune to that second, doubling tax. In fact, critics have recently upped the ante on this argument, suggesting that the wealth-transfer system imposes a triple tax in many cases.[42] The triple-tax example is based on an individual whose wealth was generated through ownership of a corporate interest. The count goes: once at the corporate level; once more when the after-tax value is paid as a dividend; and still one more time when the wealth is transferred to the next generation.

A crucial problem for this argument is that its premises are often completely untrue. Imagine, for example, the profile of a typical, year-2000 person of extreme wealth in this country. It is a picture of someone who founded a company that may not actually have earned a great deal of money, but rather is simply thought by the market to have a great deal of promise. In such a case, there would not have been substantial earnings that have been taxed at the corporate level. Nor are there likely to have been any significant dividend distributions, because the companies that have made their founders rich are still in a growth mode and reinvest what little earnings they have. And the capitalists who have been made wealthy in this way will not even for the most part have realized substantial capital gains; they still have their founder's stock, and most of them expect to keep most of it until they die.[43] At that point, under present law, their heirs will receive the stock with a basis that has been stepped-up to fair market value at the date of the capitalist's death, and no individual or entity will ever pay a tax even once on the economic gains implicit in those assets.[44] Thus, there is little corporate income, few dividends, no significant realization events, and hence, remarkably little in the way of income tax payments

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[42] *See, e.g.*, Paul A. Gigot, *Potomac Watch: Fat Cat Cavalry Rides in to Rescue High Taxes*, WALL ST. J., Feb. 16, 2001, at A10.

[43] A variety of means exist to allow either diversification or consumption of some of the wealth tied up in appreciated stock, the simplest of which involve pledging the stock to secure loans that can be used to fund consumption or hedging transactions.

[44] The fair market value basis step up (or down, as the case may be, but usually is not) is contained in I.R.C. § 1014.

during the individual's lifetime, relative to the great wealth that he or she may have enjoyed.[45]

That scenario will not always apply, of course. And the competing triple-tax scenario is not impossible and presumably does accurately represent some cases. But so what? Some might like to believe that if a flow of wealth has been taxed once, it should never be taxed again, but is such a rule to be found in either the Internal Revenue Code or the Constitution? Clearly not; in fact, multiple taxation is the rule rather than the exception. If, instead of passing a marginal $500,000 to one's heirs, one buys a (rather small) vacation home in Aspen, one expects to pay a substantial local real estate tax in the current and every subsequent tax year during which that ownership continues. If one buys a Ferrari with the $500,000, one expects to pay a state sales tax, a federal gas-guzzler tax, a federal luxury tax, and, in North Carolina and a number of other states, a stiff annual state personal property tax. Use of the Ferrari will involve the payment of substantial federal, state, and local taxes for purchases of gasoline, tires, parking, road tolls, and the like. Are these taxes fair? Let me say flatly: Yes, they are. Our several levels of government provide a wide range of public services and need revenue to do so. From a number of perspectives, it makes sense to spread that revenue load around as widely as possible, rather than to impose huge tax burdens on only a few areas of economic life.

A variant on the double (or triple) tax argument is simply that, whatever the number of discrete taxable events, the overall burden on wealth creation is simply too high. But the infrequency of imposition of the wealth transfer tax makes this argument unpersuasive. If one assumes an after-tax rate of return of five percent, one can see that a 35 percent rate imposed at the end of thirty years on wealth accumulation has exactly the impact of a 1.5 percent rate imposed on the wealth each year.[46] Would we regard an annual wealth assessment of 1.5 percent as excessive? It seems doubtful. One well-regarded public finance economist estimates that the estate tax could be modeled in terms of its effects on after-tax investment returns, and that doing so adds only one or two percentage points to the effective income tax rate.[47] "Excessive" is surely in the eyes of the beholder when tax rates are evaluated, but the argument seems unconvincing in the face of a tax system that routinely imposes rates of tax on individual and corporate income of 30 to 40 percent or more.

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[45]If this description is accurate, one might well ask: How do these people live, and lavishly so? One simple solution is to borrow against the value of the stock. This produces liquidity, but not realization events. In fact, the answer is more complex, but somewhat beside the point here. The point here is that there are, in some pockets of the economy, billionaires whose aggregate taxable income may not exceed seven figures.

[46]A dollar invested at a five percent rate of return will accumulate to $4.32 after 30 years. A tax of 35 percent would reduce this sum to $2.81. If the rate of return were reduced to 3.5 percent because of an annual 1.5 percent wealth tax, the dollar would accumulate a value of the same $2.81. A rate of 35 percent seems, if anything, a generous estimate of the effective rate of the federal estate tax.

[47]JAMES POTERBA, *The Estate Tax and After-Tax Investment Returns*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 345 (J. Slemrod ed., 2000). Poterba does note that the increment to the effective income tax rate is much higher for elderly investors.

4. Revenue

Part of the affirmative case for federal wealth transfer taxes was based on the fact that they raise significant revenue–an estimated $32.3 billion in fiscal year 2001. Critics point out, however, that this sum is actually a rather small portion of the total revenue generated by federal taxes.[48] With total revenue expected to top two trillion dollars in fiscal year 2001, the transfer-tax contribution can be seen to amount to only about 1.6 percent of total federal revenues.[49] Even if social security funds are excluded (because they are largely unavailable as general revenues) the percentage only rises to 2.5 percent.[50] There can be little doubt that these revenues can be sacrificed without catastrophic losses of governmental services. On the other hand, it is useful to speculate on the effect of transfer tax repeal in terms of the impact on other taxpayers. There are fewer than one-hundred million income tax returns filed each year that show positive tax liabilities.[51] Spreading $32.3 billion among individual income taxpayers would thus produce an additional tax averaging $323 per taxpayer, per year. This additional sum could be collected from them by adding a bit under a point to their effective tax rates.[52] Or, to put this in terms of the tax reductions now under consideration, it might simply be a matter of cutting individual tax rates by perhaps a point less than we would otherwise be able to do, leaving them with the average of $323 of income tax liability that could have been eliminated, but would not be, because the wealth-transfer taxes was repealed instead.

Another way of putting the revenue loss in context would be to consider the tax expenditure budget, which provides estimates of how much revenue the government fails to collect because of taxpayer-favorable provisions in the code. The tax expenditure budget for fiscal year 2001 shows, for example, that allowing charitable contributions to be deducted cost the federal government about $26.6 billion.[53] The failure fully to tax social security benefits cost the government about $25.8 billion.[54]

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[48]McCaffrey, *supra* note 31, at 300-04; *see also* Martin Feldstein, *Kill the Death Tax Now*, WALL ST. J., July 14, 2000, at A14.

[49]Author calculations, based on "Budget of the United States Government, 2001," Table S-11. *See supra* note 38.

[50]*Id.*

[51]The number for the last year for which full detail is available was 93,471,200, according to I.R.S. Statistics of Income–Individual Tax Returns, 1997, at 27 (Table 1.1, col. 6). To compare this number to fiscal year 2001 numbers, some adjustment would be required. That adjustment, however, seems unlikely to result in a greater total of taxable returns than 100,000,000, however, based on the fact that the 1997 total was less than six million greater than the 1994 counterpart. *See* I.R.S. Statistics of Income–Individual Tax Returns, 1994, at 26 (Table 1.1, col. 6).

[52]In 1997, taxable returns reported about $3.4 trillion of taxable income; one percent of that number would slightly more than replace the $32.3 billion of revenue that would be lost if transfer taxes were repealed. I.R.S. Statistics of Income–Individual Tax Returns, 1997, at 28 (Table 1.1, col. 11). In fact, a slightly lower rate would be sufficient, since aggregate taxable income has surely grown somewhat since 1997.

[53]*See supra* note 38, at 385-86 (Table 32-4).

[54]*See supra* note 38, at 387.

Allowing home-owners to deduct their state and local property tax payments caused the loss of some $23.1 billion.[55] Repeal of any of these provisions would make a significant dent in the revenue loss created by repeal of wealth transfer taxes. That would, of course, significantly increase the tax bills of millions of taxpayers; but you can not expect to find $30 billion lying under the cushions of the federal couch; some pain will have to be inflicted somewhere else in the tax system to permit this relief.

Some critics have argued that looking at the direct revenues collected presents a misleading impression of the revenue power of the transfer taxes. One economist has even been widely quoted as saying that the estate tax loses revenue.[56] The argument is partly based on the income tax losses associated with the distortions discussed above, but also on the assumption that the estate tax encourages giving during life. Such giving, it is claimed, distributes taxable income from higher-bracket to lower-bracket returns. Finally, it is claimed that the estate planning process often results in income tax planning that would not otherwise be undertaken, but which reduces revenue nevertheless.[57]

The work in this area with which I am familiar could neither be said to prove, nor even reasonably to suggest that estate and gift taxes do lose revenue; at best, they should be read to say that such a result is not conceptually impossible. But it hardly seems plausible, either. For one thing, it depends heavily on the assumption that the donees of gifts from wealthy people are in fact in lower income tax brackets. But in families of great wealth, nearly everyone is in the top tax bracket—even minor children, partly by virtue of the so-called "kiddie tax," which taxes much of the investment income of children at their parents' marginal tax rate.[58] This argument also ignores the possibility that the repeal of the wealth transfer taxes might open up some other opportunities for abuse. This would be particularly the case if repeal were not accompanied by a general repeal of the rules currently providing that the tax bases of assets are stepped-up to fair market value as of the date of death.[59] Without that change, and in the absence of a wealth-transfer tax, large gifts to very elderly taxpayers just before their deaths could be used to cleanse an asset of gains, allowing the donor/heir to sell the asset without tax upon its return from the decedent's estate. Even with amendments to the basis rules to curtail that device, other strategies would remain available. For example, because life insurance proceeds are typically received free of income tax,[60] one might expect to see more

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[55]*See supra* note 38, at 383.

[56]Douglas Bernheim, *Does the Estate Tax Raise Revenue?*, *in* 1 TAX POLICY AND THE ECONOMY 113 (L. Summers ed., 1987).

[57]The implications of this argument are staggering, at least for tax lawyers. One such implication would be that, far from allowing a deduction for tax advice, as I.R.C. § 212(3) currently does, public policy would be better served by imposing a stiff excise tax on tax advice, to compensate for the revenue lost when information about tax avoidance gets into the wrong hands—those of the taxpayers.

[58]I.R.C. § 1(g) (1994).

[59]I.R.C. § 1014 assigns such fair market value bases in the current code. Obviously, the basis of any particular asset may be stepped either up or down, depending on the relationship of the decedent's basis to that fair market value. In fact, however, most assets reflect some market appreciation.

[60]I.R.C. § 101(a) (1994).

activity in investment-account policies, since the gains on investments within something like a universal life insurance policy will avoid the tax. Under current law, life insurance proceeds are only free of transfer tax burdens if they are owned by someone other than the decedent;[61] this provision somewhat restricts the use of such policies as a primary form of wealth holding. Without a transfer tax, this would no longer be true.

In fact, all taxes create inefficiencies, and eliminating wealth transfer taxes would no doubt create some offsetting benefits elsewhere in the system. But the evidence is unconvincing that the inefficiencies in wealth transfer taxes are any more problematic than those in other corners of the federal revenue picture. A very thorough account of the costs of the relative inefficiencies among major revenue sources has concluded that estate and gift taxes are reasonably efficient.[62] As noted above when the inefficiency point was addressed directly, this is an issue to watch; if econometric evidence develops suggesting that wealth transfer taxes are significantly less efficient than alternative sources of revenue, that would surely be an important factor to weigh in the balance.

5. Unpopularity of Wealth Transfer Taxes

If randomly selected citizens are asked if they think there should be a federal tax occasioned by the death of a taxpayer, most will reply that they do not. This is probably as true as it is meaningless. One imagines that a different answer would be elicited if taxpayers were asked: Should the average income taxpayer pay an additional $323 per year, every year, so that about 45,000 decedents each year can pass their estates, which have an average net value of over two million dollars, to their children without any excise tax?[63]

But the larger point is that survey data of this sort inevitably spins an issue one way or another, even if the survey-taker is not trying to influence the outcome. I think it is accurate to say that the estate and gift tax does not enjoy as much public support as I would expect it to. Recalling George Bernard Shaw's maxim that "a government that robs Peter to pay Paul can always count on the support of Paul,"[64] one might expect that a tax that only reaches the top two percent of all wealth holders would enjoy somewhat more support than it does. My own sense of this is that most voters simply do not know very much about the incidence of this tax. If and when they learn more about it, its public support should rise.

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[61] I.R.C. § 2042 only allows exclusion from an estate of insurance in which the decedent possessed no "incidents of ownership," such as the right to change beneficiaries, borrow against the policy, or surrender it for its cash value.

[62] Davenport & Soled, *supra* note 26, at 619-25.

[63] In 1997, returns were filed for 42,901 taxable estates. Those estates reported gross assets of $97.7 billion, and debts of $2.9 billion, for an average net value of $2.2 million. *See supra* note 12.

[64] GEORGE BERNARD SHAW, EVERYBODY'S POLITICAL WHAT'S WHAT 256 (1944).

6. Direct Public and Private Costs of Wealth-Transfer Taxes

Some have argued that the public and private costs of operating the current transfer tax system are unacceptably high.[65] This is a variant of the efficiency arguments considered earlier, but focuses distinctly on the direct costs of dealing with the tax: the costs of estate planning, and the costs of governmental administration and enforcement.[66] At least some of the criticism stems from an almost off-hand suggestion by two prominent economists nearly a decade ago to the effect that the overall wealth-transfer taxes compliance costs were "a sizable fraction" of the total revenue generated by the tax.[67] Though they did not specify how large a fraction would be sizable in this case, nor did they develop any direct estimates of compliance costs, they have nevertheless come to be cited for the proposition that the compliance costs of transfer taxes are equal to the revenue generated.[68] Even if this were true as of the date of their study (which was based on 1988 data), revenues at that time were only $6 billion. Revenues have risen much faster than inflation since then, in large part due to the extraordinary growth in real estate and stock values. But there is no reason to believe that estate planning costs have risen by a similar amount, and no convincing evidence that the presumed baseline of $6 billion was even approximately correct at the time.

Other–and in my view more reliable–estimates have shown much lower totals. Davenport and Soled did what appears to be the most complete review of the available data on this in their recent paper.[69] They estimated estate planning costs for 1999 at $1.047 billion, and estate administration costs at $856 million.[70] They estimated the public costs of administering the transfer tax system at $152 million.[71] Interviews that I did with estate planners, in which we discussed the sorts of things that could be done for clients at various levels of wealth, and the fees that those plans were likely to generate, suggested to me that the truth must surely be much closer to the Davenport and Soled estimates than to the extrapolations based on the suggestions of Aaron and Munnell.[72]

Rather than simply leaving this as a battle of the estimators, let me suggest a few parameters by which the reader might make his own armchair assessment of the reasonable range of the variables involved in these estimates. First, on the governmental side, one should note that the total budget of the IRS is only slightly in

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[65] *See*, RICHARD E. WAGNER, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, FEDERAL TRANSFER TAXATION: A STUDY IN SOCIAL COST (1993).

[66] *See, e.g.*, Astrachan & Tutterow, *The Effects of Estate Taxes on Family Business: Survey Results*, 9 FAM. BUS. REV. 303 (1996).

[67] Henry Aaron & Alicia Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 NAT'L TAX J. 119, 138 (1992).

[68] *See, e.g.*, DANIEL MILLER, THE ECONOMICS OF THE ESTATE TAX 48; REPORT OF THE JOINT ECONOMIC COMM., S. 105-89, Dec. (1998).

[69] Davenport & Soled, *supra* note 26.

[70] *Id.* at 621, 622 (respectively).

[71] *Id.* at 619.

[72] Schmalbeck, *supra*, note 37, at 57.

excess of $8 billion. Whether one looks at returns filed, returns audited, rulings requested, or revenue generated, one does not find that estate and gift taxes account for more than 1.5-2 percent of the total activity of the IRS.[73] Thus, Davenport and Soled's estimate of the public costs, which equal about 1.9 percent of the IRS budget, appears to be right on the mark.

On the private side, note that there are about one-hundred million households in the United States.[74] In light of the fact that only about two percent of decedents are actually subject to the estate tax, one may assume generously that no more than about 5,000,000 households are likely to feel sufficient pressure from the presence of the estate tax to engage in tax-motivated planning. And, of course, they do not do so every year, but more likely perhaps once per decade. That would suggest that only something on the order of 500,000 major estate-planning events take place each year. Further, it would not be appropriate to attribute all of the costs of planning to tax-related matters; if people have significant wealth, they are unlike to simply buy "Estate Planning for Dummies" at their local bookstores and do it themselves. It seems reasonable to assume that only perhaps half of the cost of estate planning is attributable to analysis of tax implications and development of tax-minimizing strategies. If one further assumes that creating the estate plan takes perhaps twenty hours of a competent professional's time,[75] and that that professional charges fees averaging $250 per hour, then the annual cost of estate planning comes to around $1.25 billion. This estimate results from a string of conjectures, so no strong claims to accuracy can be made. However, such an estimate is instructive in this sense: those who think that the private costs of estate planning are roughly equal to the $32.3 billion of revenue collected by the tax are invited to vary the parameters and reveal what underlies their estimates. The number of people who have a reasonable need for tax-motivated estate planning cannot vary greatly from what is assumed above. Neither can the hourly charges; they range as high as perhaps $450-500 per hour for senior partners in top law firms, but the average also includes the fees of less experienced lawyers, accountants, and financial planners. If $250 per hour is too low, it cannot be off by very much. That leaves the frequency with which families engage in major estate planning exercises, and amount of time spent on developing the plans as the variables that involve significant uncertainty. But even if wealthy families do extensive estate planning every three years, and if their planners spend forty hours, on average, doing the plans–both of which seem to me wildly extravagant estimates–the total costs would still come to only a bit over $8 billion. One has to conclude, as Soled and Davenport, and my earlier study do, that claims of huge private compliance costs have been grossly exaggerated. They simply do not make sense, in view of what we know estate planners can and do provide their clients.

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[73]*Id.* at 60-61.

[74]Actually, 103 million, in 1998, according to Statistical Abstract of the United States, 1999, Table No. 74.

[75]It should be noted that a lawyer would rarely draft, for example, a family limited partnership agreement from scratch. The estate planning "products" prepared for clients are items that have become largely boilerplated and are only lightly customized for each new customer, just as real estate transfer documents are not drafted anew each time a client buys a house.

7. Small Businesses and Family Farms

The notion that the federal wealth transfer taxes are depriving families of the opportunity to pass their family farms and businesses down to their children is one of the more emotionally powerful weapons available to critics of these taxes. The charges, however, are almost completely groundless. One must begin with a better sense than is usually provided of what groups we are really concerned about here. I would suggest that concern be confined to estates with gross assets of less than $5 million. Above that level, a decedent may have owned a farm, but in some sense was not so much a farmer as an agribusiness executive. Furthermore, if there are assets above that level in the estate, there will be sufficient assets even after assessment of an estate tax at current levels to provide considerable wealth to the decedent's children. I do not think that we should really be worried if someone with $5 million in farm or small business assets is able to pass "only" $3.5 million or so to the next generation–the individuals in that generation will still be wealthier than all but a tiny fraction of the population.

Within the group of estates with gross wealth of less than $5 million, what do we find? According to the Statistics of Income reports on estate tax returns filed in 1997, we find that there were about 87,000 such estates, and that they had an aggregate gross wealth of about $107 billion, or about $1,234,000 per estate.[76] They paid net estate taxes of about $8.5 billion, or about $98,600 per estate.[77] This is an effective rate of just under 8 percent. One also finds that only 3.3 percent of the assets of these estates consisted of closely-held stock;[78] only 2.6 percent of the assets of these estates consisted of farm land; and only about 1.2 percent of the assets of these estates consisted of other business or farm assets.[79] In the aggregate, this is not a group of decedents that were particularly heavily taxed, nor were very many of them heavily invested in farm or small business assets.

Of course, aggregate numbers can obscure patterns observable in the finer detail. Closer examination does reveal that there were about 8,600 estates in the below $5 million category who held farm land, and that the average value per estate of such land was about $324,000;[80] similarly, the 9,300 or so decedents in this wealth category who had closely-held stock held stock that had an average value of such stock per estate of $373,000.[81] These are groups that might present a sympathetic case for estate tax relief. One notes at the outset, however, that most of these estates turned out not to have any net estate tax liability at all. The Statistics of Income series provides data on all estates that file returns; but it separately reports data for those estates that end up having net tax liabilities. And it is certainly worth noting

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[76] Author calculations based on Johnson & Mikow, *supra* note 12, at 102.

[77] Author calculations based on *id.* at 107.

[78] Author calculations based on *id.* at 102.

[79] Author calculations based on information supplied by the Internal Revenue Service on file with the author and with the editors of the *Cleveland State Law Review*; Johnson & Mikow, *supra* note 12, at 104.

[80] Author calculations based on information supplied by the Internal Revenue Service on file with the author and with the editors of the *Cleveland State Law Review*.

[81] Author calculations based on Johnson & Mikow, *supra* note 12, at 102.

that in 1997, fewer than 3,200 estates with gross assets of less than $5 million, who had any assets categorized as "closely-held stock," had any net estate tax liability at all.[82] Even more striking, only about 2,200 estates in that wealth range who reported having "farm assets" had any net estate tax liability.[83] Thus, if–as I argue–policy makers should not be greatly concerned about imposing an estate tax on people with wealth greater than $5 million, even if their assets are farms or other family businesses; and if–as even critics would presumably concede–we are not worried about the estates that at the close of the day have no estate tax liability, then it follows that concerns about family farms and small businesses are confined to fewer than 5000 estates each year.

It should also be recognized that the Internal Revenue Code already contains a number of provisions that are designed specifically to relieve estate tax burdens on family farms and other businesses. Indeed, the success of these provisions may well explain why so few estates with such assets end up owing any estate tax at all. For example, IRC sec. 2032A allows executors to value family farm and business real estate on the basis of its value in its current use as a farm or other business;[84] thus, farm land that has become quite expensive because of the growth of a nearby urban area can be valued in terms of its productivity as farm land, which will often result in a drastically lowered value. Another provision, in section 2057, allows estates to deduct from the gross estate the value of "qualified family business interests" in amounts up to $675,000.[85]

For many estates, the most valuable form of estate-tax relief comes in the form of the opportunity to defer payment of estate tax liabilities attributable to small business assets for five years on an interest-only basis, and to spread the payments beginning in the sixth year over as many as ten additional years.[86] Further, the interest on part of the liability accrues at only a 2 percent rate, while the interest on the balance of the liability accrues at less than half of the standard rate on underpayments of tax.[87] This permits, in many cases, payment of the tax out of the continuing operating profits of the business, as it is presumably run by the decedent's heirs.

These relief provisions appear to be quite generous, especially taken together. If, however, Congress finds that these rules are providing less relief than they would like, or that some estates that were intended to benefit from such relief are not in fact able to qualify for it, then Congress clearly has the power to either increase the magnitudes of the relief provisions noted or to extend their scope to currently unqualified beneficiaries. Complete repeal of the wealth-transfer tax system seems

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[82] Author calculations based on *id.* at 102.

[83] Author calculations based on *id*. at 104.

[84] I.R.C. § 2032A (1994).

[85] There is a modest reduction in the size of the exemption for estates to which this deduction applies. Under sec. 2057(a)(3), a full $675,000 deduction would lead to capping the overall exemption at $625,000, instead of the more generally applicable $675,000 exemption.

[86] I.R.C. § 6166 (1994). Estates are eligible for this relief only if at least 35 percent of the value of the estate consists of small-business assets.

[87] I.R.C. § 6601(j) (1994).

unnecessary, and, indeed, redundant if the possible breaking-up of small family farms and businesses is the primary concern.

D. Conclusion

One of the unfortunate by-products of a free-market economy is its tendency toward wealth inequality and concentration. Markets reward winners and penalize losers. Over time, untaxed inheritance of wealth will contribute to the ever greater concentration and inequality of its distribution. What we know at this point is that the federal wealth transfer tax system has been in effect for about 85 years; produces direct federal revenues of $32.3 billion per year; contributes significantly to about $6 billion per year of state death tax collections; stimulates at least some part of the flow to charitable entities from estates of about $16 billion per year, and a smaller part of the flow to charities from living donors; and that all these flows come from the wealthiest two percent of decedents each year, or, in the case of gift tax revenues, from people who likely will be among the wealthiest two percent of decedents when they die.

From all these things, a fairly strong *prima facie* case for retention of these wealth transfer taxes emerges. It is a case that builds on both the sources and uses of the flows of wealth involved. That is, it is important that this is wealth that is taken in a way that reduces inherited advantage and wealth concentration and, important as well, that the wealth taken or deflected goes to public or quasi public purposes.

Several of the arguments for repeal seem demonstrably based on errors of fact: the problems of family farms and businesses being broken up is a small part of the picture, and substantially addressed by existing relief provisions; the supposed unpopularity of the tax seems related to the fact that public knowledge about the tax is limited. The arguments about the administrative and compliance costs and the ease of avoidance have some merit, but are much exaggerated. The argument about fairness is essentially an argument about the appropriate level of progressivity in the system overall, about which there can be no firm answer; the argument about whether the tax raises “significant” amounts of revenue similarly seems to depend on the viewpoint of the observer. One is left only with the distortion argument. And as to that argument, there is simply insufficient proof that wealth transfer taxes induce any more inefficiency per dollar of revenue than any other taxes do. It would seem that better arguments, or better proof, as appropriate, would be necessary to justify removal from the tax system of an element that has contributed so much to both the revenue and the progressivity of the tax system.