Estate and gift tax, federal

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The federal tax treatment of wealth transferred in contemplation of, or at the time of, death.

The estate and gift tax is the only wealth tax levied by the federal government. The estate tax was first enacted in 1916 and applied to the wealth of decedents with estates in excess of $50,000. It has undergone numerous changes, especially in 1976 and 1981, and it currently applies to taxable estates in excess of $600,000, with a maximum tax rate of 55 percent.

The gift tax was first enacted in 1924, repealed in 1926, and reenacted in 1932 in an attempt to reduce estate tax avoidance via the initiation of *inter vivos* gifts. In 1976, the gift tax was integrated with the estate tax under the Unified Transfer Tax, and a common tax rate schedule with a current maximum tax rate of 55 percent was established. Cumulative transfers, *inter vivos* gifts, and testamentary bequests below $600,000 were effectively exempt from taxation because the tax provides a unified tax credit of $192,800. Both estate and gift taxes are complemented by a generation-skipping transfer tax (GSTT) with a flat rate of 55 percent for cumulative transfers in excess of $1 million per donor.

Purpose of the tax

The enactment of the estate and gift tax, and its evolving structure over the years, serve several legislative objectives. First and foremost, estate and gift taxes were enacted for their revenue yield. In 1996, these taxes yielded about $17 billion annually and accounted for about 1.2 percent of federal government receipts. The significance of this revenue source should not be understated, given that the estate tax is levied only on the wealthiest 1 percent of decedents' estates: the tax is paid by the estates of about 30,000 decedents from a decedent population of 2.2 million.

A second objective is that these taxes act as a backstop to the income tax, reducing the erosion of its base. Much of the capital income that escapes the income tax passes through the estate tax. Under the personal income tax, accrued capital gains are taxed only when realized, and interest income from state and local bonds, as well as proceeds from life insurance policies, among others, are tax-exempt. In contrast, all assets owned by decedents are likely to be included in their gross estates.

A third objective is a reduction in wealth concentration. By taxing the wealth holdings of the wealthiest estates, the estate and gift taxes are expected to reduce the size of bequests, reducing the wealth accumulated over generations. This is also accomplished by subjecting capital income that has escaped the personal income tax to estate taxation.

Another objective is taxation of each generation's wealth. Wealth transfers to grandchildren are taxed under the estate and gift taxes. However, because of the emphasis on taxing each generation, an additional tax—the GSTT—is also levied on these transfers. The rationale for the GSTT is that a tax should be levied on wealth transfers to children, coupled with another tax when they, in turn, transfer wealth to their children.

To minimize state objections to the enactment of death taxes by the federal government, the estate tax provides a tax credit for state death taxes, thereby keeping the state tax base intact. Effectively, the federal estate tax acts to minimize interstate competition for the wealthy, as the state death tax credit virtually offsets taxes levied by states on the wealthiest of estates.

The tax base

The estate tax is levied on wealth held at death. This includes real estate, cash, stocks, bonds, businesses, pensions, and life insurance policies owned by the decedent, which form the gross estate. Estates may value these assets at their market value on the date of death or six months from that date. Similar property is also taxed under the gift tax when transferred during life. Cumulative lifetime gifts are added back to the taxable estate.

Exclusions

The gift tax provides for an annual exclusion of $10,000 per donee. The estate tax provides for an exclusion of up to $750,000 for real property used on farms or in businesses. The exclusion is based on the difference between the market value of a property and the capitalized income from its use in business. Proceeds from life insurance policies on the life of the decedent but owned by others are also excluded from the estate. The GSTT provides an exemption of $1 million per donor.

Deductions

1. *Marital Deduction.* All transfers of property between spouses, either through *inter vivos* gifts or bequests, are deductible from the estate and gift tax base.

2. *Charitable Bequest Deduction.* All sums of money donated to charitable organizations are deductible from the gross estate.
3. *Debts.* The gross estate is reduced by the amount of debts held at death. These debts include mortgages and outstanding medical expenses.
4. *Other Expenses.* These consist mostly of funeral expenses and expenses involving the settlement of the decedent's estate, such as attorney and executor commissions. They, too, are deductible from the estate tax base.

Rate structure

The tax rate schedule ranges from 18 percent on the first $10,000 of taxable estate to 55 percent for the excess over $3 million of taxable estate. This rate schedule applies to the wealth at death plus the lifetime taxable gifts before credits have been applied. In 1997, taxable estates over $21 million faced a flat tax rate of 55 percent, with the benefit of the progressive rates phased out between $10 million and $21 million, creating a marginal tax rate of 60 percent. This will increase in steps to $24.1 million in 2006. Generation-skipping transfers are taxed at a flat rate of 55 percent, in addition to the estate and gift taxes.

Tax credits

Several tax credits are available under the estate and gift tax. The largest of these is the unified credit. Through 1997, the value of the unified credit was fixed at $192,800—equivalent to an exemption of $600,000—for combined estate and gift taxes. Provisions enacted in 1997 increase the effective exemption to $1 million in steps by 2006 ($625,000 in 1998, $650,000 in 1999, $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006). The second largest credit is that for state death taxes. This credit is limited to a maximum of 16 percent of the federal taxable estate. State gift taxes do not benefit from a similar credit. The estate tax also provides for a credit for previously paid death taxes in order to minimize double taxation. In computing the heir's estate tax, the credit is set equal to the parent's estate tax on bequeathed wealth phased out over 10 years from the parent's date of death. The credit is not available for the estates of heirs dying more than 10 years after the parent's date of death.

Tax deferral

Estates with closely held businesses and farmers may defer a fraction of the estate tax. This fraction is equal to the share of such assets in the estate, provided that it is in excess of 35 percent. The tax is deferred for a period of 15 years from the date of death, with the principal payable over the last 10 years. Interest payments are deductible against the estate tax, which requires filing tax returns over the deferral period. The benefit of this deferral is also available to estates that are subject to severe liquidity constraints, at the discretion of the Internal Revenue Service Commissioner.

Income distribution

The possible effect on income and wealth distribution is an important consideration when levying estate and gift taxes. These taxes are levied on wealth and typically apply to the top wealth holders of the population. The revenue obtained from the estate and gift taxes, when redistributed, could have the net effect of reducing the concentration of wealth in the hands of a few people. More importantly, if the tax were designed such that it stimulates *inter vivos* gifts and bequests to a wider number of recipients, then it could be thought of as a tool to discourage concentrations of wealth.

There are some instances in which the estate and gift tax could cause greater inequality. If the estate tax, for instance, were to reduce savings, it would lead to lower levels of capital and lower the real rate of return to labor. By lowering labor income, this reduction may exacerbate existing inequalities between those who receive income from capital and those who receive income from labor. Another possible scenario occurs when wealth is transferred by donors who are more well off than the recipients. If such transfers are reduced by the estate and gift tax, then the level of inequality increases under the tax.

Behavioral effects

Estate taxes have incentive effects for both donors and heirs. Higher estate taxes may reduce the work effort and savings of parents motivated to leave large bequests to their children. This substitution effect is the result of the tax raising the price of bequests. An offsetting effect is the income effect, whereby parents may have to increase their work efforts and savings to cover the higher taxes. It is not clear which effect dominates, and there is no empirical evidence to guide us.

Estate taxes also affect the heirs' work effort and savings. Recent evidence suggests that large inheritances may speed up the retirement decision. Even for those who remain in the labor force, one may also observe a reduction in labor supply. However, labor supply effects are generally small. Similarly, consumption is also observed to rise in the aftermath of inheritance. But, again, these effects are small.

Additional readings

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Cross references: fairness in taxation; family, tax treatment of; wealth taxation.