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# Estate and Gift Tax Revision

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Estate and gift tax revision presents problems of exceptional difficulty. Yet there is need for improvement. These taxes have long been subject to criticism, from many sides and for many reasons. Improvement must be possible. Why have the years —for more than two decades—passed with almost no action and yet repeated assertion that what we have suffers from many defects?

For one thing, the tax committees of Congress have faced other problems of more pressing concern. Estate-gift tax revision, not being urgently needed, has been passed over to "the next round." Moreover, the complexity of these taxes discourages efforts to tackle them. And another related reason for delay, I believe, is the lack of any general agreement on objectives of revision.

This year, perhaps, something will be done. References to this year's tax reform agenda frequently include estate and gift change. Students of these taxes make suggestions which range through a broad spectrum from truly basic issues to technical details which have no policy significance.

Congress might undertake to consider some of the fundamental issues. For example a serious study of the taxation of capital would be in order. Might we do better to abandon Federal taxation of capital gains in the income tax and capital transfers under the estate and gift taxes and introduce a new tax on capital as such? Almost 50 years ago Congress chose to tax the entire estate as a unit rather than individual inheritances; this decision should probably be reconsidered.

Other issues along the spectrum but still of great significance would include unification of the estate and gift taxes into a single levy and provisions to reduce the tax effects (advantages) of generation-skipping. And one finds considerable support for an increase in the marital deduction, perhaps to a full 100 percent from the present 50 percent. A revision of the rate and bracket structure would be in order; what we have is the result of decisions during World War II taken in response to exceptional pressures of the time. Would not some allowance for inflation be desirable?

Another "death tax" issue involves the treatment of capital gains and losses which have not been realized before death. Should they be subject to income taxation as a part of the settlement of the estate? If so, how?

Each of these issues, and others, ought to get thoughtful study, in depth. Yields for the Treasury—and burdens on owners of property—have become considerably heavier than may be generally recognized. Table 1 shows the rise since 1950 and relates the amounts to elements which deserve special

**This Issue in Brief**

Estate and gift tax revision, says Professor Harriss, presents problems of exceptional difficulty. Yet there is a need for improvement. Congress, he says, ought to consider some fundamental issues. A "serious" study of the taxation of capital would be in order, he suggests, adding that Federal taxation of capital gains in the income tax and capital transfers under estate and gift taxes might be replaced by a new tax on capital as such.

Also considered should be, he says, unification of estate and gift taxes into a single levy; increasing the marital deduction, and revision of the rate structure. "Each of these issues, and others," he says, "ought to get thoughtful study in depth."

attention—the size of these taxes on capital as related to net saving.

**TABLE 1**

**Federal and State Death and Gift Taxes, Personal Savings, Undistributed Corporation Profits, Selected Years 1950-1972**

| | Death and gift tax (millions) | | | Federal and state death and gift tax as percent of | |
|---|---|---|---|---|---|
| Year | Federal and state | Federal | State | Personal savings | Personal savings plus undistributed corp. profits |
| 1950 | $ 841 | $ 659 | $ 182 | 6.43 | 2.89 |
| 1955 | 1,267 | 982 | 285 | 8.01 | 3.92 |
| 1965 | 3,630 | 2,849 | 781 | 14,13 | 7.12 |
| 1969 | 4,668 | 3,606 | 1,062 | 12.22 | 7.95 |
| 1970 | 4,810 | 3,728 | 1,082 | 8.77 | 6.85 |
| 1971 | 5,824 | 4,615 | 1,209 | 9.56 | 7.15 |
| 1972 est. | 6,549 | 5,243 | 1,306 | 11.86 | 8.01 |

Source: Department of Commerce; Tax Foundation, Inc.

The economic and social importance of these taxes far exceeds anything one might conclude from one year's yield. Persons of property take account of prospective death taxes when arranging their affairs, many years before death. The investment and management of hundreds of billions of dollars of capital are affected by estate and gift taxes.

Deliberate, thorough analysis of the kind which seems desirable would take more time than Congress will have available this year, and next, especially if it decides to consider also even half of the other tax revision items now on its agenda. Decisions on the major issues ought not, in my view, to be made on the basis of sketchy study – nor ignored.

For the immediate future Congress could draw on the accumulated work dealing with more or less technical matters. The American Law Institute and the Treasury Department, and perhaps others, have reported on many such items. Lines will not always be clear between what is largely technical and matters more with policy significance. But many proposals result from serious efforts of experts to deal constructively with details of these highly technical taxes. Progress could be made while continuing, somehow, the Congressional scrutiny for more major restructuring.

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Revisions, especially major ones, need the guidance of principles. What roles might these taxes play in our efforts for a better economy and society?

Points of significance today include the following:

1. The yield grows at a faster rate than the GNP if only because of rate graduation and increases in wealth (in money terms, partly due to inflation). These taxes could yield more. But they are in no sense necessary to finance the Federal government.

2. In total, and per dollar of revenue, the graduation of burden from gift and estate taxes is strikingly large compared with that resulting from the progressive rates of the personal income tax.

3. A tax at death as compared with equal revenue from annual taxes on income can provide (a) a sort of full offset of losses against gains and (b) some rough, probably very crude, averaging.

4. Per dollar of revenue these taxes probably have less adverse effect on the building of businesses, and perhaps on professional incentives, than would additions to upper bracket income taxes for equal yield. This argument seems to me intuitively acceptable. But in cautiously accepting it, we must recognize that present death taxes do adversely affect a business before the owner's death, as he plans for liquidity; and demands for tax payment can badly impair a company.

5. "Both income taxes and death taxes have loopholes—but they are not the same ones." Estate and gift taxes reach property which may not be "adequately" burdened by income taxes such as municipal bonds, capital gains unrealized before death, the yield from mineral property (depletion) above the owner's cost, and art objects bringing benefits not included in taxable income. The income tax, for its part, can reach the annual benefits from property in trust which skips a generation.

6. The Federal estate tax credit reduces competition among states for persons of wealth.

7. Gift taxation provides some protection for income tax revenue by discouraging gifts of capital which would shift income to persons subject to lower rate brackets.

8. Some advocates of steeply graduated death taxes believe that the reduction of large fortunes is desirable, almost regardless of revenue. Those who endorse this argument rarely if ever explain the "why" in terms that are other than vague and incomplete. Any answers to the "how" and the "how

much" will be so imprecise that as guides to concrete action this line of argument offers little help in making major choices.

Equity underlies much of the urging for estate and gift tax revision. And equity ranks high as a goal of tax policy. Nevertheless, by all the concepts of tax equity that I can think of estate and gift taxes fall short of reasonable standards of fairness.*

Burdens are sometimes too great relative to others. But in which cases? By how much? Why?

Equity is a complex subject. Would widening of brackets or imposition of an accessions tax or altering the marital deduction make for more or less fairness? Changing the law would upset estate plans based on longstanding rules. Would inequities result? Transition problems are vastly more complicated than those normally involved in income, consumption, and payroll taxes. For example, wills by the hundreds of thousands would be made obsolete by any major change in the estate tax.

Despite its importance, equity as a principle offers less help than we should like as a guide. But another consideration may serve usefully—concern for capital formation.

Guidance can be found in respect for the effects of death taxes on productive capacity—the quantity and quality of man-made facilities for helping us, and our children, to produce goods and services to meet human needs. A dollar saved and used to finance the creation of capital facilties thereby adds to the flow of income through the years. The addition to capacity is a productive resource, like the tree which yields fruit year after year. In contrast, a dollar used for consumption, whether by an individual or collectively by government, buys current satisfactions only. Unlike new capital equipment, today's consumption does not support an enlarged flow of continuing production.

American death and gift taxes will reduce private holdings of wealth by about $6.5 billion this year. (Subjecting capital gains at death to tax would also reduce private wealth.) These taxes do not, of course, directly destroy machinery or other forms of tangible productive capacity. Nevertheless, estates (and donors) must liquidate securities and other titles to property to get cash to pay death taxes. The people who use their (new) savings to buy the assets cannot use the same dollars to pay for new capital construction (including housing), to finance businesses, to buy state-local bonds, and so on.

Death taxes do wipe out from small to large fractions of personal holdings of wealth. The things that such wealth finances will thereby be fewer and less substantial than if the tax were lower. Per dollar of revenue these taxes probably do more than do other taxes to curtail the ability to save. Every dollar of value taxable over $100,000 is subject to a rate of 30 percent or more – on capital.

### *Key Is Stock of Capital Goods*

Much of society's ability to produce depends upon its stock of capital goods. Much of the difference between our levels of living and those of our grandparents, and those of other parts of the world, depend upon more and better capital facilities. Net additions to the stock of capital consist of output which is not consumed as it is produced.

The speed of technological progress in actually benefiting mankind depends heavily upon *new* capital. Much of the contribution of science and better technology becomes available through new facilities, *i.e.*, it appears in usable form, or is transmitted in ways that bring value in actual use, in better machinery, innovative methods. New products and services require productive capacity different from that in existence. *Quality improvement* and *cost reduction* depend heavily upon research, investment, and technological advance in many forms.

Illustrations of possible magnitudes ought to be helpful. Let us assume that death taxes reduce capital accumulation by $3 billion a year more than from some realistic alternative. Labor, of course, gets the bulk of what is produced. But let us assume that the capital would have productivity *before* income tax of 15 percent. The first full-year loss of production would be $450 million; the second, without compounding, would be $900 million. After 10 years of $3 billion a year less investment, without any compounding, the "deprivation" would be $4.5 billion. A more realistic computation would include some compounding, though at a rate low enough to allow for the fact that some of the income (the $450 million in the first year, etc.) would be consumed by individuals and governments.

The pattern of investment will be changed. For reasons associated with death taxes—notably the need for liquidity—the owners of property will invest in one type of asset rather than another.

*For a discussion of what I believe are truly important matters but which space limits preclude discussing here see my essay, "Sources of Injustice in Death Taxation," in *Innovations in Tax Policy and Other Esssays, Selected Writings of C. Lowell Harriss* (John C. Lincoln Institute, University of Hartford, Conn., 1972).

In the absence of tax, there would be a most preferred pattern of capital investment related to the total productivity (broadly conceived). Tax considerations, however, lead to other choices. Any shift induced by estate tax considerations will presumably be from a pattern which would be more, to one which is less, desirable—from forms of higher, to those of lower, productivity. The general public as workers and consumers (as well as investors) will suffer.

The gross yields of property—machinery, buildings, going concerns—differ greatly. The total of property affected will be greater than the figure reported on tax returns as passing by bequest and gift in any one year. Some wealth holders plan and act many years before their death—30, 20, 10, or 5 years. Trusts can extend for decades.

Yet even an apparently small force on the property owned by persons who are potentially subject to death tax could produce distortions costly enough to be of concern to society. Even modest assumptions about differences in the investment of the hundreds of billions of property would suggest a substantial annual loss of productivity. There is large "excess burden" in the economic sense—costs (disadvantages) to the economy which bring no benefit to government treasuries. Some of the most serious problems—and greatest losses for the economy—result from the liquidity demands on closely held businesses.*

The successful enterprise uses its resources, cash included, productively. Cash or other highly liquid assets as needed for payment of death tax represent a poor, uncreative form of property. It is not one of the uses which, in conjunction with labor, produce.

Closely held businesses play a much more important role in our economy than most of us realize. A successful enterprise is *not* cash or property which can be drawn off and sold easily (if at all). To withdraw assets from the company is to force it to reduce its operations.

Another possibility is to seek to *merge* with a corporation whose securities are traded widely. The continuity of ownership and management as an independent entity will end.

To tax capital gains at death would aggravate the liquidity problem, especially where successful family enterprises are a large part of the estate. Typically, the stock of such companies will have appreciated over the years. (To considerable extent the appreciation results from the reinvestment of earnings on which the corporation has paid tax.) Valuation will be uncertain. And when each dollar or so of doubt about valuation means 30 or 50 or more cents of tax, the significance for estate planning—and for the continuity and prosperity of the company—can be determining.

### Taxes Impede Aid to Philanthropy

Estate and gift taxes impede the ability of prosperous families to aid philanthropy. The deductibility of charitable bequests, however, reduces the cost of gifts that qualify.

To call the deduction a "subsidy" seems to me misleading. The view so represented starts from an assumption—"government could take *everything*." When, by a sort of "act of grace" government takes less than all, does it make a grant—a "subsidy"—of something "belonging" to government?

The property is not government's. To speak of that which is not brought within the tax net as "tax expenditures" or "subsidies" reflects a disturbing attitude about the proper reach of government. Yet we hear arguments that Congress should obstruct philanthropic bequests by limiting deductibility for estate tax purposes.

In short, revision of these taxes should, in my view, proceed with technical modifications based on the work already done while intensified study of major issues continues. The latter involve matters of great complexity and importance. Our judgments on the equity aspects are not likely to come into full agreement, but perhaps some broader consensus might be reached on changes which would improve equity. Among the economic aspects, we ought to see more clearly the effects on capital formation, on allocation of investment, and especially the effects on closely held businesses.

*Further discussion appears in my essay "Economic Effects of Death and Gift Taxes," in Goldstein, ed., ***Readings in Death and Gift Tax Reform*** (Foundation Press, 1971) pp. 41-50.