What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax

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I. INTRODUCTION

One of the fundamental questions that every society faces is how to shape the intergenerational transmission of wealth. It is a question that cannot be avoided. Each year many individuals die without a will. Claims on property inherited by hypothetical descendents not yet born become administratively unenforceable. Moreover, nations that apply a broad-based income or consumption tax must decide whether and to what extent they will include inherited wealth in the tax base. The issue, therefore, is not whether the law should influence the pattern of intergenerational wealth transfers, but how.

Currently, the United States is facing this question once again in the context of its tax system. With a looming fiscal gap of about $20-40


1 Among Americans aged fifty or older, 40% report not having a will. AARP Research Group, Where There Is a Will . . . Legal Documents Among the 50+ Population: Findings from an AARP Survey 1 (2000), available at http://assets.aarp.org/rgcenter/econ/will.pdf.

wealth transfers are expected to explode as the baby boom generation passes away, totaling between $40 and $135 trillion over the next fifty-five years.\textsuperscript{4} Inherited wealth is currently taxed at one-fourth the rate of earned income\textsuperscript{5} due to high estate tax exemptions and the exclusion of inheritances from the income and payroll tax bases. Moreover, under the tax cuts passed in 2001, the estate tax was scheduled to be repealed for one year in 2010.\textsuperscript{6} This temporary repeal creates untenable and gruesome incentives, but it also creates a window of opportunity to revisit the tax treatment of wealth transfers.

This Article considers how the tax system should affect the pattern of wealth transfers going forward. Taking into account existing empirical evidence, it argues that the ideal welfarist approach is to include gifts and bequests received above a basic lifetime exemption in the tax base and tax them at somewhat higher rates than other sources of income—an approach that is referred to as a \textit{comprehensive inheritance tax}.

The advantages of a comprehensive inheritance tax are threefold. First, such a tax would enhance social welfare by more accurately measuring ability to pay. The United States and most jurisdictions currently exclude financial inheritances from the income tax base of heirs. But substantial financial inheritances directly affect the well-being of the recipient. In addition, they provide valuable indirect information about the heir’s welfare because they are correlated with nonfinancial inherited assets and traits that powerfully affect earning ability—such as educational level, race, social networks, intelligence, and personality. A comprehensive inheritance tax captures this information, thereby ensuring that fiscal burdens and benefits are allocated more fairly.

By contrast, a tax system that ignores wealth transfers necessarily disregards this information. Instead it taxes heirs, as a group, at substantially lower rates than those with comparable income potential who are self-made. This inequity is partially mitigated if the tax system includes an estate tax because its economic burdens fall predomi-

\textsuperscript{3} Alan J. Auerbach, Jason Furman & William G. Gale, Facing the Music: The Fiscal Outlook as the Bush Years End, 119 Tax Notes 981, 988 (June 2, 2008) (estimating the fiscal gap at $20 to $40 trillion over a seventy-five year period, depending on the assumed revenue and spending baseline).

\textsuperscript{4} John J. Havens & Paul G. Schervish, Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy, 1999 B.C. Soc. Welfare Res. Inst. 1, 1-2. These estimates assume a 2% and 4% secular growth rate, respectively. Id. at 2 tbl.3.

\textsuperscript{5} See Figure 7 and accompanying text.

nantly on heirs. But an estate tax provides only a “rough justice” accounting of inheritances when measuring economic status because it applies to the amount transferred, rather than the amount received. In individual cases, it systematically misallocates fiscal burdens. For example, Surachai Khitatrakun and I estimate that about 22% of heirs burdened by the U.S. estate tax have inherited less than $500,000, while 21% of heirs who inherit more than $2,500,000 bear no estate tax burden. A comprehensive inheritance tax would measure ability to pay much more precisely.

In addition, a comprehensive inheritance tax creates a more equitable, efficient, and simple pattern of incentives for donors and heirs than the estate tax. On the one hand, its exemption protects a basic level of familial economic support that one hopes all parents will provide so that each child has a reasonable opportunity to grow and flourish. On the other hand, by gradually taxing inherited wealth in excess of this amount, a comprehensive inheritance tax encourages extraordinarily wealthy donors to share further wealth transfers with individuals who have fewer opportunities than their children. It also encourages their children to earn additional wealth rather than relying on their parents’ largess. Neither an estate tax, nor a tax system that ignores wealth transfers, can create this pattern of incentives. Neither is clearly more efficient or administrable and, for a variety of technical reasons, a comprehensive inheritance tax may be simpler.

The final advantage of a comprehensive inheritance tax is that it should improve public understanding of the taxation of wealth transfers. The fact that an estate tax focuses by design on the donor leads the public to believe that its economic burdens fall on donors in practice. In addition, public awareness of the income tax exclusion for inherited wealth is limited. These misperceptions have been exploited by opponents of the estate tax, who have framed the estate tax as a double tax on frugal, hard-working donors who are ruthlessly taxed right at the moment of death. An inheritance tax would help make clear that this is a mischaracterization at every point. The estate tax instead is a single tax (and the only tax) imposed on the fortunate few in our society who inherit extremely large amounts of money. By expressly taxing the heir, an inheritance tax should enable the public to make more informed decisions about how much society should expect from heirs of large fortunes.

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7 See notes 19-31 and accompanying text.
9 See, e.g., Michael J. Graetz & Ian Shapiro, Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth 82 (2005).
While the key normative claim of this Article is that a comprehensive inheritance tax is the best approach to taxing wealth transfers, much of the article is devoted to describing the structure and advantages of a specific proposal. The Article proposes replacing the U.S. estate tax system on a revenue-neutral basis with a comprehensive inheritance tax. This new tax would exempt from taxation a high amount—roughly $2 million in gifts and bequests received over one’s lifetime. Inheritances received above this amount would be taxed at the heir’s income tax rate plus fifteen percentage points, resulting in a top marginal tax rate of 50%.

This proposal is not advanced as an ideal, but as an improvement in light of the unique administrative and political constraints of the United States. In particular, the Article assumes that there is little political appetite for raising more revenue from wealth transfers than under the 2009 estate tax,\textsuperscript{10} taxing inherited wealth at a rate higher than 50%,\textsuperscript{11} or taxing accrued gains on inherited wealth at the same point in time as inheritances. Finally, given the politically explosive debate about family businesses and farms, it assumes that any proposal must eliminate the possibility that an heir would ever need to sell an inherited family business to pay the associated tax liability. Notably, this Article does not adopt the assumption embodied in some important prior work that constitutional, administrative, or political constraints prevent the United States from taxing capital income at socially-desirable rates through the income taxes or a periodic wealth tax, thereby leaving wealth transfer taxes as the third best option.\textsuperscript{12}

The primary contribution of this Article is to expand on my prior joint and solo work on wealth transfer taxes. To my knowledge, no other work has argued that a comprehensive inheritance tax is the ideal approach to taxing wealth transfers from a welfarist perspective.\textsuperscript{13} In addition, none has maintained that wealth transfer taxes predominantly burden heirs,\textsuperscript{14} or provided estimates of the distributional effects of wealth transfer taxes at an heir level. While the pro-

\textsuperscript{10} The 2009 estate tax law—with a $3.5 million exemption and a 45% rate—appears to be the most likely political compromise. See note 221.
\textsuperscript{11} Roughly speaking, the top rate applied to earned income is 50%. See note 223 and accompanying text.
\textsuperscript{13} But see Joseph M. Dodge, Comparing a Reformed Estate Tax with an Accessions Tax and an Income Inclusion System and Abandoning the GST, 56 SMU L. Rev. 551 (2003); Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L.J. 283 (1994). Both articles allude to the possibility that a comprehensive inheritance tax (in an income or consumption tax context respectively) may be the best approach.
\textsuperscript{14} Some have raised the possibility that heirs bear most of the burden of wealth transfer taxes, but have not discussed the issue in any detail. See, e.g., N. Gregory Mankiw, Remarks by Dr. N. Gregory Mankiw, Chairman Council of Economic Advisers, at the Na-

The Article proceeds as follows. Part II explains why a comprehensive inheritance tax is the best approach to taxing wealth transfers in light of existing evidence on wealth transfers. Part III outlines the benefits and drawbacks of the current U.S. estate tax. Part IV presents the proposal to replace the estate tax with a comprehensive inheritance tax. Part V provides suggestions for how to address a variety of related issues, including the tax treatment of appreciated assets, illiquid assets and family businesses, charitable contributions, retirement savings, and life insurance. Part VI concludes.

II. Why Tax Wealth Transfers?

Over time, scholars and politicians have offered a number of rationales for and against taxing wealth transfers. Some have argued that taxing wealth transfers is essential for democracy in that it reduces concentrations of power in family dynasties.\footnote{See, e.g., Alexis de Tocqueville, Democracy in America 48 (Henry Reeve trans., Alfred A. Knopf 1945) (1835) (describing laws regulating inheritance as part of the “moving and impalpable cloud of dust, which signals the coming of Democracy.”); Harry J. Rudick, What Alternative to the Estate and Gift Taxes?, 38 Cal. L. Rev. 150, 158-59 (1950). Cf. Michael J. Boskin, An Economist’s Perspective on Estate Taxation, in Death, Taxes and Family Property 56, 63-65 (Edward C. Halbach, Jr. ed., 1977) (arguing that estate taxes may be useful in breaking up extreme concentrations of wealth but that they have done very little to decrease total inequality).} Others have argued for and against wealth transfer taxation as a method for equalizing opportunity.\footnote{For example, John Stuart Mill advocated sharply limiting inheritances because “accidents of birth” have no normative place in the liberal social order. Beckert, note 2, at 167 (citing John Stuart Mill, Principles of Political Economy 889 (Augustus M. Kelley 1968) (1848)). Similarly, Franklin D. Roosevelt maintained that “inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our Government.” Franklin D. Roosevelt, Message to the Congress on Tax Revision (June 19, 1935), in 4 Public Papers} This Article, by contrast, adopts a welfarist approach.\footnote{For example, John Stuart Mill advocated sharply limiting inheritances because “accidents of birth” have no normative place in the liberal social order. Beckert, note 2, at 167 (citing John Stuart Mill, Principles of Political Economy 889 (Augustus M. Kelley 1968) (1848)). Similarly, Franklin D. Roosevelt maintained that “inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our Government.” Franklin D. Roosevelt, Message to the Congress on Tax Revision (June 19, 1935), in 4 Public Papers}
Before considering what welfarism implies about the ideal taxation of wealth transfers, however, it is first necessary to understand who would bear the burden of any tax imposed.

A. Who Bears the Burden of Wealth Transfer Taxes?

Wealth transfers, or inheritances, may be defined as gratuitous financial gifts and bequests that are not transferred to one's spouse, to charity, or for certain other purposes that generally are not taxable, including education, health care, and support of a minor child. This definition accords with current law and the academic literature. Given that no existing income tax provides a deduction to donors for wealth transfers made (unless to a charitable organization), a wealth
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Transfer tax may be defined as any direct, additional tax or subsidy on wealth transfers beyond inclusion in the donor’s income tax base.\(^{20}\)

Theoretically, wealth transfer taxes may burden a variety of individuals. The most obvious candidates are donors and heirs, but they may also burden those who would benefit from the donor spending the amount of tax due in other ways. This distinction mirrors the distinction in the economic literature on tax incidence between partial and general equilibrium analysis.\(^{21}\) Partial equilibrium analysis considers the distribution of the burdens of a tax by looking at its effects only on the two parties to the relevant transaction—in this case the donor and heir. General equilibrium analysis is more comprehensive, considering the impact of a tax in multiple markets simultaneously.\(^{22}\)

As Surachai Khitatrakun and I have argued elsewhere in more detail, it is reasonable to assume that the economic burdens of wealth transfer taxes are borne predominantly by heirs.\(^{23}\) This is the case first because general equilibrium analysis is not very relevant for wealth transfer taxes. The main way in which a wealth transfer tax could impact people and markets beyond donors and heirs is if it affected the amount of saving or giving. The two main empirical studies to date, however, suggest that the magnitude of reported wealth transfers declines only slightly in response to wealth transfer taxes.\(^{24}\) Moreover, the results of these studies are fragile and may be the product of tax avoidance responses rather than real changes in the magnitude of wealth transfers.\(^{25}\) Thus, donors do not appear to save substantially less. Alternately heirs might save less because the tax should reduce the amount they inherit. But it is unclear whether the marginal propensity to save is greater among heirs or the government. (The government effectively saves the funds raised if it uses the revenues to reduce budget deficits.) Finally, wealth transfer taxes theoret-

\(^{20}\) This Article does not consider the ideal consumption tax treatment of wealth transfers but it should broadly mirror the ideal income tax treatment. For a more detailed discussion, see Lily L. Batchelder, How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers? (manuscript, 2008).

\(^{21}\) Tax incidence is the study of the effect of a tax on the distribution of economic welfare.

\(^{22}\) Don Fullerton & Gilbert E. Metcalf, Introduction, in The Distribution of Tax Burdens (Gilbert E. Metcalf & Don Fullerton eds., 2003).


\(^{25}\) Joulfaian, note 24, at 266; Kopczuk & Slemrod, note 24, at 331.
ically could reduce the amount of giving to tax-exempt beneficiaries, principally charities. But existing evidence suggests that they actually tend to increase charitable contributions. Accordingly, it is unclear whether wealth transfer taxes burden any parties other than heirs and donors.

Turning to the partial equilibrium context, the absolute and relative burden imposed on heirs and donors depends critically on the reasons why the donor worked for and saved the funds ultimately transferred. These motives matter in determining the incidence of the tax because they affect how much the donor values transferring the wealth, and how she responds to the tax. As we will see, they also are critical in determining the ideal taxation of wealth transfers.

Briefly, there are six potential wealth accumulation motives. As discussed below, most wealth transfers presumably stem from some combination, but it is useful initially to understand each potential motive separately.

The first three motives all involve the donor accumulating wealth without regard to the amount her heirs ultimately will receive. Such wealth transfers therefore are referred to as involving no bequest motive or as inelastic transfers. First, a donor may have worked and saved in order to insure herself against various risks for which private insurance is unavailable, such as uncovered health care costs or the possibility of outliving her savings. If fewer risks materialize than feared, she will have savings left at death. The resultant bequest is then considered an accidental bequest or the product of life cycle saving. Second, a donor may have accumulated wealth simply because she enjoyed working or being known as rich and wealthy, and not because she wanted to spend it in any particular way. Transfers from such wealth are referred to as egoistic or derived from the capitalist spirit. Third, the donor may have saved the funds due to a pretax warm glow. In this case, she saved because she derived utility from the thought of transferring wealth, but was unconcerned with the specific amount that her heirs ultimately inherited.

The remaining potential motives, by contrast, all involve the donor actually caring how much her beneficiaries will receive after tax. In the case of purely altruistic transfers, the donor accumulated wealth because her utility is a direct function of her heirs’. That is, she experiences their well-being from the transfer as if it were her own to some degree. Alternatively, a donor’s utility may be unrelated to her heirs’ but still a function of how much they can ultimately spend. In this case, the transfer stems from an after-tax warm glow motive. For simplicity, warm glow transfers are generally ignored here, on the as-

\[26\] See notes 314-15.
sumption that pretax warm glow transfers are identical to egoistic transfers, and after-tax warm glow transfers are identical to altruistic ones for practical purposes. Finally, a donor may have worked or saved in exchange for something the heir provided to her, such as taking care of her in old age. Then the transfer would be *compensatory* or *exchange-motivated*. While this final category of gifts and bequests is not a wealth transfer as defined above (because such transfers are not gratuitous), it remains empirically relevant.

The reason wealth accumulation motives matter in determining the incidence of a wealth transfer tax is that donors are only burdened by the tax to the extent that they care how much their beneficiaries receive. If some share of a donor’s wealth transfers is completely inelastic, the donor does not care and her heirs should bear the entire tax burden on those funds. By contrast, if some share is exchange-motivated, the donor does care because the amount of services she can obtain depends on how much the heir will receive after tax. As with all compensation, the burden should then be split between the donor and her heirs based on their relative elasticities of labor supply and demand. Finally, if some share is altruistic, the incidence of the tax remitted on that portion should actually fall on both the donor and her heirs because the donor’s utility is a function of her heirs’. But even in this case, her heirs should bear a larger burden. Her heirs are burdened by the entire estate tax remitted on the amount they inherit, plus any reduction in the amount the donor gives on a pretax basis in response to the tax. But the donor is only burdened by the tax to the extent that she values transferring the wealth to her heirs more than she values spending it on herself.

Putting all these possibilities together leaves only one scenario in which donors could bear more of the burden of wealth transfer taxes: The vast majority of wealth transfers would have to be exchange-motivated, and donor demand for such labor would have to be relatively inelastic. This hypothesis is unsupported by existing evidence. Instead, it suggests that compensatory transfers compose a very small

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27 This assumes that the heir does not benefit from the donor spending more money on personal consumption, for example, if the donor pays more for nursing home care instead of relying on the heir to do so or to take care of her in old age. As discussed in note 48, however, the vast majority of wealth transfers flow downwards, not upwards, generationally. I am grateful to Ethan Yale for this point.

28 This presumes that donors respond to a tax on altruistic transfers by giving less, not more, as appears to be the case. See Joulfaian, note 24; Kopczuk & Slemrod, note 24, at 317-18, 321. If a donor instead responded by giving more, the relative burden on her heirs would decline. At the extreme, the donor could increase her pretax transfers to a point that fully offset the tax. Then the heir would bear no burden, and the donor’s burden would be the value she previously placed on her forgone consumption. I am grateful to David Kamin for this point.
share of gifts and bequests, and altruistic transfers only a somewhat larger portion. Egoistic and accidental transfers appear to make up the majority of wealth transfers. Thus, in the real world, heirs should bear the majority of wealth transfer tax burdens—and perhaps the lion’s share.

Because the literature on wealth accumulation motives is essential to much of this Article, it is worth addressing two common misperceptions about it before moving on. The first is that most wealth transfers must be altruistic. For example, it might be argued that any donor with a will has demonstrated that she is concerned about how much her heirs inherit, and donors who die intestate probably care as well. While true, such transfers are not altruistic in the technical sense. The question posed by this literature (and important for determining the incidence of wealth transfer taxes) is what motivated the donor to accumulate the funds transferred in the first place. It is not whether she cares about who inherits the funds once she has already accumulated them.

The second misperception is that this literature assumes that individuals accumulate wealth only for one reason. In fact, much of the literature is preoccupied with determining what share of an individual’s saving is attributable to each motive, which presumes that individuals save for multiple reasons. Nevertheless, the literature does assume that each dollar transferred is attributable to a unique motive. As an example of how these motives can be disaggregated at a theoretical level, suppose all bequests were the product of a combination of altruism and life cycle saving. Then, the share that is accidental would be the share that donors would still transfer even if they knew that all bequests were going to be expropriated (because accidental

29 See Table 3.
30 Id. Empirical studies to date generally look at the relative share of total, not marginal, wealth attributable to different wealth accumulation motives. In fact, it is the relative share of marginal wealth accumulation motives that determines the incidence of the tax on donors versus heirs. Theoretically, donor motives could operate sequentially and compensatory transfers could be marginal for some or all of the population, which would alter the conclusion here. It is unclear, however, whether donors save sequentially and, if so, which order dominates. For further discussion, see Batchelder & Khitatrakun, note 23.
31 This assumes, as is the norm, that the economic incidence of a tax is independent of its statutory incidence so that it does not matter whether the donor or heir remits the tax. But see note 120 and accompanying text.
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bequests are perfectly inelastic).\textsuperscript{32} The remaining portion would be altruistic.\textsuperscript{33}

With a clearer sense of who bears the burden of wealth transfer taxes, I now turn to the question of whether and how we should tax wealth transfers.

B. Ideal Wealth Transfer Taxation

Within a welfarist framework, the goal of government and the fiscal system is to maximize some function of individual well-being. For example, a utilitarian social welfare function aims to maximize total utility. A maximin welfarist seeks to maximize the well-being of the least well-off person. An egalitarian welfarist seeks to equalize the welfare of all. Theoretically, the focus can be on dynastic rather than individual well-being, for example by treating the Smiths and the Joneses each as one unit over time, regardless of their number. Such a dynastic focus raises interesting questions, but is not the focus here.

Welfarism has been criticized as a theory of justice on a number of fronts. For example, some object that welfarism implies rewarding people with expensive tastes at the expense of ascetics who are perpetually dissatisfied. Others criticize welfarism for implying that "utility monsters"—people who seem to have an endless ability to convert money into more and more well-being—should end up with the lion's share of society's resources. Still others argue that it is impossible to compare interpersonal well-being. Perhaps most significantly for the subject here, some argue that it pays inadequate attention to social equality, which requires some degree of economic equality, but also the absence of inequalities stemming from a hereditary class structure, whether based on family, religion, or race. While important objections, all but the last can be bracketed by focusing on a narrower question: What tax treatment of wealth transfers maximizes social welfare

\textsuperscript{32} A more persuasive version of the previous two objections is that although a certain portion of a wealth transfer may be perfectly inelastic, the donor may nonetheless gain some welfare from its transfer. For example, the donor may have valued the insurance that the wealth provided enough that he would still have saved that amount even if it was going to be expropriated at death. But he may also have valued the possibility of it going to his heirs, implying that he derived a large amount of consumer surplus from the saving absent wealth transfer taxes. If this is the case, the donor could suffer some welfare loss if his accidental bequest were expropriated. Nevertheless, his welfare loss still should be significantly smaller than the heir's for the reasons explained above. See notes 27-28 and accompanying text.

\textsuperscript{33} This is the amount by which the donor would reduce her wealth transfers if she knew they were going to be expropriated.
if all individuals have the same utility function for potential material resources, or *endowment*, which exhibits declining marginal utility?\(^{34}\)

The assumption of identical individual utility functions with declining marginal utility is standard in the optimal tax literature, dating back at least to Mirrlees\(^ {35} \) and implicit in work by Ramsey.\(^ {36} \) In some sense, it is akin to resource egalitarianism.\(^ {37} \) It does not mean that everybody likes the same mix of apples and oranges (or work and leisure, or risk and certainty). Instead it implies that two people with the same potential material resources at their disposal have the same aggregate and marginal utility, even if they choose to spend their funds in different ways. It also implies the more potential resources the better. This assumption has the advantage of bracketing some of the more controversial issues for welfarists, and effectively collapsing several social welfare functions. For example, the utilitarian goal of equalizing marginal utility and the egalitarian goal of equalizing individual well-being become identical.

Where this Article diverges from the optimal tax literature is in its second assumption. Traditionally, optimal tax analysis assumes that individual endowments differ only in one imperfectly observable and exogenous dimension that determines the degree to which individuals are well-off. This dimension is variously termed potential earnings, talent, or ability. This Article posits instead that individuals differ in two such dimensions that together constitute endowment: first, potential earnings, talent, or ability, and second, material inheritances.

Given these assumptions, the following discussion tracks the standard optimal tax analysis, with a twist. In the standard analysis, ability is the ideal tax base. It is perfectly efficient in the sense that one cannot change one’s ability, so taxing it does not generate any efficiency losses. Moreover, unlike other perfectly efficient tax bases like a head tax, it is the perfect measure of individual well-being, and thus the perfect basis for redistribution. Ability, however, is not observable directly. The basic question posed by the optimal tax literature is thus what tax system is optimal given the informational constraint that we cannot tax ability. The obvious alternatives are proxies for ability—

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\(^{34} \) The objection to inequalities stemming from a hereditary class structure is beyond the scope of the welfarist focus of this Article but would tend to strengthen the argument for taxing wealth transfers. For a very thoughtful treatment, see Thomas Nagel, Liberal Democracy and Hereditary Inequality, 63 Tax L. Rev. 113 (2009).


such as market earnings, consumption, or income. But, unlike an ability tax, individuals can respond to these taxes by earning or saving less, thereby potentially generating efficiency losses for the individual or others. The problem optimal tax analysis attempts to solve is what level and structure of this proxy tax, which I will refer to as the underlying tax, will maximize social welfare given this equity-efficiency trade-off.\(^{38}\)

The twist here is that this Article assumes that the ideal tax base from a fairness perspective is not just ability, but ability combined with inheritances. Such a tax base, however, is not necessarily optimal from an efficiency perspective. Unlike ability, the magnitude of material inheritances may respond to taxation because inheritances may benefit a party who has control over them: the donor. Moreover, even if this combined tax base were perfectly efficient, it would remain unattainable because ability continues to be unobservable. Inheritances may provide some information about ability, though, to the extent that the two variables are correlated. Thus, the new problem this Article attempts to solve is what level and structure of taxation of inheritances (if any) will maximize social welfare in light of these additional equity and efficiency considerations. The following discussion considers the fairness and efficiency implications in turn.

1. *Fairness*

Regardless of the social welfare function, welfarist approaches require a method for measuring how well-off different people are. This measure is the basis for redistribution. The most equitable level of redistribution depends, in turn, on the theory of justice underlying the social welfare function. But the ideal tax base depends only on this measure of well-being, and does not require specifying the social welfare function.

Few would dispute that inheritances should be part of any measure of an heir's well-being.\(^{39}\) Purely from a fairness perspective, they therefore should be included in the tax base of heirs. The more complicated questions that arise when inheritances are included in an optimal tax framework are instead twofold. First, should inheritances also be included in a measure of well-being of the donor? Second, should they be considered to confer more well-being on heirs or donors than

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\(^{38}\) For further discussion of how the ideal tax treatment of wealth transfers might differ under an income versus consumption tax, see Batchelder, note 20.

other sources or uses of income? This Section considers each issue in turn.

a. Inheritances as Consumption by the Donor

Starting with the first issue, any measure of the well-being of donors should include funds they use for wealth transfers. Welfarists are interested in consumption opportunities when measuring how well-off an individual is. When a donor accumulates and transfers wealth for altruistic or egoistic reasons, she is giving up the opportunity to spend the money on herself. It follows that she values making the wealth transfer as much as if she spent the money on more traditional types of personal consumption. Similarly, when a donor leaves an accidental bequest, she must have valued the insurance provided by the wealth as much as if she had spent the money on herself. In fact, for all three motives, she must value the funds accumulated and transferred slightly more than market consumption, or she would not have saved for these reasons in the first place.

There may be efficiency reasons to subsidize a donor’s decision to transfer wealth, as discussed in the next Section. For example, a donor may have saved altruistically and benefit someone who otherwise would be dependent on the state. Absent such information, though, the welfare-maximizing proxy measure of endowment should include funds used for wealth transfers.

Many find this argument surprising because consumption, in the colloquial sense, typically involves using up resources, not sharing them. But actual use is irrelevant in a welfarist framework. Instead, the goal is to measure well-being, and market consumption is only used as a proxy. The key feature of wealth transfers making them consumption by the donor is the fact that the donor owns the assets, and therefore has the power to decide who receives them.

Nevertheless, there is a more powerful version of this objection. While voluntarily transferring a dollar must confer as much well-being on a donor as spending it, wealth transfers may provide additional information about the donor that is relevant in measuring her well-being. In particular, inheritances have historically functioned as a form of social insurance, providing cross-generational support within the extended family. Moreover, Ann Mumford has argued that modern society increasingly expects parents to provide continuous

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40 See, e.g., McCaffery, note 13, at 336-45. McCaffrey does, however, appear to support an inheritance tax in the context of a consumption tax. Id. at 350.

41 Beckert, note 2, at 18-19.
care to their children, even to their own detriment.\textsuperscript{42} Drawing on Anne Alstott's work, she argues that this expectation stands in contrast to prior generations when children were generally an economic boon to their parents, providing labor during working years and supporting them in old age.\textsuperscript{43} As a result, substantial wealth transfers could be a sign of greater financial demands upon the donor.\textsuperscript{44}

The problems with this argument are threefold. First, within the extended family, the role of inheritances as a form of social insurance appears to be declining.\textsuperscript{45} With the creation of modern insurance products and the welfare state, individuals have become less and less dependent on extended family members for support and employment.\textsuperscript{46}

At the same time, while societal expectations of parents may have risen, it is unclear whether this has any implications for how heavily wealth transfers specifically should be taxed, as opposed to how parents should be taxed in general. Wealth transfers are by no means limited to parents. Indeed, childless adults appear to accumulate wealth for altruistic reasons just as often as parents,\textsuperscript{47} and about 30\% of wealth transfers come from donors without children.\textsuperscript{48}


\textsuperscript{43} Mumford, note 42, at 583.

\textsuperscript{44} Admittedly, this argument deviates from this Article's general assumption of identical individual utility functions for potential material resources.

\textsuperscript{45} Cf. J. Bradford DeLong, A History of Bequests in the United States, in Death and Dollars: The Role of Gifts and Bequests in America 33, 40, fig.2-1 (Alicia Munnell & Annika Sunden eds., 2003) [hereinafter Death and Dollars] (estimating that more than 90\% of wealth was acquired through inheritance before the Industrial Revolution, as opposed to slightly more than 40\% today).

\textsuperscript{46} Beckert, note 2, at 18-19. Relevant programs and products include Social Security, welfare, public employment, unemployment insurance, disability insurance, health insurance, and life insurance.


\textsuperscript{48} See Figure 14 and Table A9. In the United States children receive about 70\% of inheritances and in Europe they receive between 60\% and 90\%. See Table A10; Claudine Attias-Donfut, Jim Ogg & François-Charles Wolff, Financial Transfers, in Health, Ageing and Retirement in Europe: First Results from the Survey of Health, Ageing and Retirement in Europe 179, 181 (Axel Börsch-Supan, Kirsten H. Alscer, Hendrik Jörges, Johan Mackenbach, Johannes Siegrist & Guglielmo Weber eds., 2005). At least in Europe, the next largest group of heirs is composed of nieces and nephews, and the remainder is generally siblings, grandchildren, and parents. Hendrik Jörges, Gifts, Inheritances and Bequest Expectations, in Health, Ageing and Retirement, supra, at 186, 188 (finding that nieces and nephews account for about 8\% of the recipients of gifts or bequests exceeding €5,000, and that siblings, grandchildren, and parents account for about 6\%). It appears to be quite rare for nonrelatives to receive inheritances, and when nonrelatives or parents do receive inheritances, it is more often due to financial need than is the case with children and other beneficiaries. See Attias-Donfut et al., supra, at 181-82.
Finally, there is little evidence that wealth transfers are targeted on needy family members. At least among donors who are parents, the vast majority of bequests are split evenly between children. While it is much more common for inter vivos gifts to be targeted on children who are lower-income in a given year, gifts comprise only about 10% of wealth transfers. It is also unclear whether parents actually split inter vivos gifts unequally once one looks over a longer time horizon.

Despite these objections, it may be appropriate to exempt relatively small inheritances to needy beneficiaries from the donor's tax base because such wealth transfers may signify lower well-being on the part of the donor. Inheritances presumably continue to play some social insurance function, even if it is much smaller than in the past. Such transfers may be evidence that the donor feels obliged to fill in cracks in the welfare state, and is worse off than others with similar consumption potential. As discussed later, such an exemption also may be important on political grounds.

Together these considerations therefore imply that the most accurate proxy measure of endowment—and the fairest tax base—should

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50 Kathleen McGarry, Inter Vivos Transfers and Intended Bequests, 73 J. Pub. Econ. 321, 335-36 (1999) (finding that only 6% to 25% of gifts are shared evenly between children in a given year).


52 McGarry finds that parents tend to transfer more inter vivos to children who are low-income in a given year, but also more to those who are more educated. Thus, it is possible that parents equalize inter vivos transfers over time, but give larger amounts to more talented children when they are in school and larger amounts to lower-skill children later on. McGarry, note 50, at 335-40.

53 One also could argue that such transfers should be considered payment on an insurance contract that the heir implicitly entered into with his family. If so, this would be another argument for a basic exemption from the donor perspective. Within an income tax and most consumption taxes, however, it would still imply including the transfer in the heir's tax base.

54 See note 222 and accompanying text.
include wealth transfers in the tax base of both the donor and heir, potentially with a basic exemption per heir.55

b. Effects of Inheritances on the Income Distribution

Currently almost all jurisdictions do not include inheritances in the tax base of both the donor and the heir. Indeed, despite the more straightforward equity case for including wealth transfers in the tax base of heirs, most paradoxically include inheritances in the tax base of donors, but not recipients.56 This exclusion of inheritances from the heir's tax base has important distributional effects. As a result, this Section shows that it is not only normatively troubling, but practically significant.

Unless otherwise noted, all the estimates that follow are based on joint work with Surachai Khitatrakun.57 Details on our methodology are provided in Appendix A. Tables with data underlying the graphs in the text are provided in Appendix B.58

In 2009, annual bequests will total about $400 billion in the United States. To give a sense of the relative magnitude of this figure, $400 billion represents about 4% of all household income and, among households will receive an inheritance in 2009, about half of their receipts that year. While the expected flow of gifts is unclear, it should be smaller by an order of magnitude.59

In addition to being substantial in size, inheritances are distributed very unequally. Data on lifetime inheritances is limited, but existing evidence suggests that about 40% never receive a bequest,60 and

55 As a practical matter, this implies that wealth transfers should be included in the heir's income and (in most circumstances) should not be deductible by the donor if the underlying tax is an income tax. If it is a consumption tax, wealth transfers should be treated as two consumptions: one by the donor when she transfers the funds, and a second by the heir when he spends them. Technically, under a prepaid consumption tax, this can be accomplished by treating inheritances as labor earnings of the heir and taxing donors on their labor earnings regardless of use. Under a cash-flow consumption tax, it can be achieved by treating the transfer of wealth as dissaving, and the receipt of inheritances as income.

56 See Appendix C.

57 Batchelder & Khitatrakun, note 23.

58 These estimates are very rough because of data limitations that require multiple levels of imputation and because they rely in part on data from 1992. See Appendix A.

59 As noted, gifts comprise only about 10% of wealth transfers. See note 51.

60 Beckert, note 2, at 15 (citing Marc Szydlik, Erben in der Bundesrepublik Deutsch-land. Zum Verhaltnis van Familiare Solidaritaü t und so Zialer Ungleicheit 93 (1999)) (55% of Germans receive an inheritance); see also Luc Arrondel, Andre Masson & Pierre Pestieau, Bequest and Inheritance: Empirical Issues and France-U.S. Comparison, in Is Inheritance Legitimate? Ethical and Economic Aspects of Wealth Transfers 89, 101 (Guido Erreygers & Toon Vandevelde eds., 1997) (60% of French descendents receive bequests); Hurd & Smith, note 49, at 9 (finding that 60% of children receive a bequest whether their last parent dies).
about two-thirds never receive a substantial gift.\textsuperscript{61} Moreover, among those lucky enough to receive an inheritance, the amount inherited varies widely. As illustrated in Figure 1, about two-thirds of bequest recipients in 2009 will inherit less than $50,000. Meanwhile, the top 1% will inherit more than $1 million each, and together will inherit a quarter of the value of all bequests received. This elite group will also probably inherit even more in the future because the more one has inherited in the past, the more likely one is to inherit in years to come.\textsuperscript{62}

\textbf{Figure 1}

\textbf{Share of 2009 Bequests Received by Number of Heirs and Value}

Theoretically, the exclusion of inheritances from the tax base of heirs might not matter if inheritances received did not alter the pretax income distribution.\textsuperscript{63} In reality, though, they alter the income distribution in important and unpredictable ways. The direction and magnitude of these effects depends on the measure.

On the one hand, if one focuses on the amount inherited, inheritances tend to widen economic disparities considerably. As illustrated

\begin{itemize}
  \item Michael Hurd, James P. Smith & Julie Zissimopoulos, Inter-vivos Giving over the Life Cycle 1-2 (RAND Working Paper No. WR-524, 2007), available at http://www.rand.org/pubs/working_papers/2007/RAND_WR524.pdf. (about one-third of elderly parents make gifts to children with an average gift of $12,000); see also Attias-Donfut et al., note 48, at 179 (about 28% of Europeans report having given more than €250 to someone in their social network within the last twelve months); Jürges, note 48, at 186 (about one-third of European households report having received inheritances worth more than €5,000 at least once).
  \item Jürges, note 48, at 189.
  \item This would also require that the income tax was the only federal tax and that it applied only one set of rates.
\end{itemize}
in Figure 2, lifetime inheritances are more or less evenly distributed among the roughly 97% of households with income from labor and saving (referred to as *earned income*) of less than $200,000. But the average bequest increases rapidly with earned income thereafter. Moreover, earned income poorly measures economic well-being and understates the regressivity of inheritances, in part because it ignores the value of inherited income itself. To partially correct for this distortion, Figure 3 provides estimates of lifetime inheritances by a more comprehensive definition of income that includes annual earned income plus the annuitized value of any bequest received over the recipient's remaining life expectancy (referred to as *economic income*). Under this partially adjusted measure, the average lifetime inheritance increases from about $50,000 for households with economic income of less than $500,000, to ten times this amount for households whose economic income is greater. Under an even more accurate measure of economic status, one would find that inheritances are distributed even more regressively.

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64 Figures 2 through 4 are even rougher than our other estimates because they assume that all individuals receive no gifts and no more than one bequest over their lifetime, and that the roughly 40% of individuals who never receive an inheritance are distributed in proportion to those not receiving a bequest in a given year.


66 The specific measure of earned income used is cash income, whose definition is available at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=574.

67 The advantage of this measure is that it fully converts the stock of an inheritance into an annual income flow. The disadvantage is that spreading inheritances over a lifetime, while not applying the same treatment to noninherited income (because we are unable to do so), will tend to make the distribution of inheritances more equal than the distribution of noninherited income because lifetime income is distributed considerably more equally than annual income. Don Fullerton & Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?* 26 (1993). Arguably, spreading bequests over a shorter period of time would therefore be more reasonable. Alternate estimates in which inheritances are spread over five years are provided in Batchelder & Khitrakun, note 23, at 31.

68 If bequests excluded from this Article's definition of a wealth transfer (for example, educational expenditures) were included, the average bequest would be higher. It is worth noting, though, that only 59% of eighteen to nineteen-year olds were attending college as of 2008 (the 17% of those still in high school are excluded). U.S. Census Bureau, Table A-5b: The Population 18 and 19 years old by School Enrollment Status, Sex, Race, and Hispanic origin: October 1967-2008, available at http://www.census.gov/population/www/socdemo/school.html/TableA-5b.xls.

69 See Appendix B, Table A3.

70 Figures 2 through 4 do not include gifts, multiple bequests, or accrued gains, all of which are highly concentrated among those receiving the largest inheritances, and thus among the most affluent. In particular, in the United States a couple can make up to $26,000 in nontaxable gifts each year to each heir, which can add up to roughly $6 million in gifts to each heir over the couple's life. Rev. Proc. 2008-66, 2008-45 I.R.B. 1113. (This assumes the donor couple makes gifts over 50 years, the annual exemption remains constant, and the interest rate is 5%). The likelihood that an heir will receive such gifts rises dramatically if the donor is exceptionally wealthy. For example, Joulfaian and McGarry
find that the average ratio of actual gifts transferred to potential tax-free gifts was approximately 4% overall in 1992, but 56% among donors with wealth of more than $1.5 million. Joulfaian & McGarry, note 51, at 436 tbl.3.

On the other hand, if one is concerned with the relative share of income that different individuals have, inheritances tend to narrow economic disparities to some degree. Figure 4 shows that the share of economic income that inheritances comprise gradually declines as economic income rises. Once again, this estimate is probably biased to make inheritances appear more redistributive. Nevertheless, it implies, at the very least, that inheritances do not dramatically widen inequality in the share of economic income. Thus, depending on whether one is concerned more by disparities in income levels or income shares, bequests either substantially magnify or slightly narrow income inequality.

71 Annuited bequests are included in both the numerator and denominator.
72 See note 70. In fact, there is limited evidence that the share of income derived from inheritances is constant across the income distribution once one adjusts for heir labor supply effects. See Edward N. Wolff, The Impact of Gifts and Bequests on the Distribution of Wealth, in Death and Dollars, note 45, at 345, 371 tbl.10-9 (finding that the share of net worth derived from inheritances is constant or declines with years of education).

The decline is also presumably due to regression to the mean, whereby children of the highest earners do not tend to earn as much as their parents. For children of the super rich, the gap between parent and child earned income may be especially large given the long tail of the income distribution that represents the top 1%.

73 Inheritances tend to have similar effects on wealth disparities as they do by income. The average amount inherited rises sharply with household wealth, especially at the high end. Id. at 368-69 tbl.10-8; see also Jürges, note 48, at 188. At the same time, the share of wealth that is inherited tends to gradually decline as household wealth rises. Wolff, note 72, at 371 tbl.10-9; Jürges, note 48, at 188 fig.2; Pirmin Fessler, Peter Mooslechner & Martin Schürz, How Inheritances Relate to Wealth Distribution? Theoretical Reasoning and Empirical Evidence on the Basis of LWS Data 10 (Luxembourg Wealth Study, Working...
Regardless of which distributional measure one finds most persuasive, inheritances alter the economic distribution even more substantially at an individual level. The prior aggregate statistics mask the fact that within each earned income class, only some receive inheritances. Consequently, when a tax system excludes inheritances from the tax base of heirs, it effectively treats heirs as relatively worse-off—and non-heirs as relatively better-off—than each group is in reality.

c. Inheritances as Tags for Utility and Ability

Thus far, I have argued that the fairest proxy for endowment would include inheritances in the tax base of the donor and the heir, perhaps with a basic exemption for transfers to the needy. But there are two reasons to believe that this treatment is overly generous, and noncompensatory wealth transfers should be weighted more heavily in the tax base of the recipient than earned income.

First, heirs should typically derive more well-being from inherited income. Unless a wealth transfer is compensatory, heirs do not have to work in order to receive it. Most people do not like working.74 Accordingly, the well-being generated by earned income is the utility generated by the amount received minus the worker’s disutility from

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having to earn it. For inherited income, it is simply the amount inherited.

Second, financial inheritances are correlated with a variety of nonfinancial inherited assets and traits that powerfully affect earning ability. For example, Edward Wolff has found that the present value of the average inheritance is 50% higher for whites relative to African-Americans and 270% higher for college graduates relative to high school dropouts. As illustrated in Figure 2 above, inheritances are also directly correlated with earnings, especially at the high end. Accordingly, inheritances are a useful “tag” indicating unobserved earning potential.

George Akerlof has shown that the traditional Atkinson-Stiglitz result in which a single tax on labor earnings is optimal does not hold when an immutable characteristic is correlated with unobserved earning ability. The tag can then be used as a basis for redistribution without any efficiency cost, unlike, for example, a tax on earnings. This result accounts for both equity and efficiency effects.

While inheritances do not fit perfectly into this theory because they are mutable, the theory still has important implications for the taxation of wealth transfers. It potentially applies to elastic wealth transfers due to the information they provide about unrealized earning potential. Moreover, it certainly applies to inelastic wealth transfers, such as egoistic and accidental wealth transfers. As a result—even if ability were the only component of endowment and inheritances had no direct effect on heir welfare—the ideal proxy for endowment would include some or all inheritances received.

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75 See, e.g., Fessler et al., note 73, at 15 (finding that heir households are better educated controlling for age); Robert B. Avery & Michael S. Rendall, Lifetime Inheritances of Three Generations of Whites and Blacks, 107 Am. J. Soc. 1300, 1332 tbl.5 (2002) (finding that the mean lifetime inheritance discounted to age 55 is approximately $54,000 for whites and $12,000 for blacks).

76 Wolff, note 72, at 368-69 tbl.10-8.


78 See generally Logue & Slemrod, note 77.

79 Cf. Mikhail Golosov, Narayana Kocherlakota & Aleh Tsyvinski, Optimal Indirect and Capital Taxation, 70 Rev. Econ. Stud. 569, 570-71, 577 (2003) (demonstrating that the optimal tax on all capital income may be positive due to the information it provides about hidden skills).
d. Effects of Inheritances on Earning Ability

The extent to which inheritances should be weighted more heavily than earned income in the tax base depends on how much disutility people experience from working and how closely inheritances are correlated with earning ability. This Subsection focuses on the latter. Data on intergenerational economic mobility suggests that there is a surprisingly close relationship between inheritances and earnings potential, and thus that inherited income should potentially be weighted quite heavily in any measure of how well-off different people are.

One of the most commonly-cited measures of intergenerational economic mobility is the correlation between the log of parent and child income or consumption. This figure is between 0.7 and 0.8 in the United States—quite a depressing figure for those who believe in equal opportunity. A correlation of 0.7 implies that if A’s parents are ten times richer than B’s, A will, on average, be five times richer than B. Moreover, this correlation is even higher at the ends of the income distribution. For example, children born in the top decile are fifty-three times more likely to end up in the top decile than children born to the bottom.

There are many factors driving the high intergenerational correlation between parent and child economic status, and probably all could be considered a form of inheritance. Some, such as parental education and race in a discriminatory society, presumably are not taxable on political grounds. Others are difficult to identify, such as inherited personality traits. Nevertheless, financial inheritances may be the single largest driver of the high correlation between parent and child income. Taken together, the correlation between parent and child IQ, personality, and schooling accounts for only about 18% of this correlation. Financial inheritances account for up to 30%.

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80 Thomas Piketty, Theories of Persistent Inequality and Intergenerational Mobility, in Handbook of Income Distribution 429, 437 (Anthony B. Atkinson & François Bourguignon eds., 1998); Bhashkar Mazumder, The Apple Falls Even Closer to the Tree than We Thought: New and Revised Estimates of the Intergenerational Inheritance of Earnings, in Unequal Chances: Family Background and Economic Success 80, 92 (Samuel Bowles, Herbert Gintis & Melissa Groves eds., 2005) [hereinafter Unequal Chances] (for those whose fathers are in the bottom decile of the earning distribution, 80% are estimated to have income below the sixtieth percentile).

81 Mazumder, note 80, at 80.

82 Tom Hertz, Rags, Riches, and Race: The Intergenerational Economic Mobility of Black and White Families in the United States, in Unequal Chances, note 80, at 184.

83 Samuel Bowles, Herbert Gintis & Melissa Osborne Groves, Introduction, in Unequal Chances, note 80, at 1, 18-20 (estimating that these factors account for 25% of the intergenerational earnings correlation).

84 See Bowles et al., note 83, at 16; Piketty, note 80, at 446; see also Mazumder, note 80, at 94.
The powerful impact of financial inheritances on child income and earnings appears to operate in several ways. First, as discussed, inheritances can be viewed as a form of income. As such, they directly limit intergenerational economic mobility by preventing an heir who receives a substantial inheritance from falling below a certain threshold of income. This increases the likelihood that he will rank highly in the economic distribution and decreases the likelihood that others will rank highly.

Second, and perhaps more importantly, inherited wealth is a form of insurance and opportunity. It can prevent downward spirals in earnings when an individual hits hard times—staving off bankruptcy, foreclosure, and the need to accept a new job quickly after unemployment even if it pays less. At the same time, inheritances may boost earnings potential by relaxing real or perceived liquidity constraints that people face when deciding whether to obtain higher education or start a business venture. These dynamics may influence earnings well before inherited wealth is received. The mere knowledge of roughly how much one will inherit presumably affects earnings because those anticipating large (or small) inheritances feel more (or less) comfortable taking risks, knowing that they have (or do not have) family members upon whom they can rely financially if the risks they take do not pan out. Given that inheritances account for only about 4% of lifetime income but up to 30% of the correlation between parent and child income, this second factor appears to be quite powerful.

To sum up, financial inheritances represent a meaningful share of household income, and are an even stronger indicator of ability to pay. They alter the economic distribution at both an aggregate and individual level. And they limit intergenerational economic mobility substantially by increasing the likelihood that a child’s economic status will resemble that of his or her parents.

85 Haslett, note 17, at 130.
86 See, e.g., Philip Oreopoulos, Marianne Page & Ann Huff Stevens, The Intergenerational Effect of Worker Displacement 14-16 (NBER, Working Paper No. 11587, 2005), available at http://www.nber.org/papers/w11587 (finding that, in Canada, family income of households in which the father experiences a job loss is 15% lower eight years after the job loss than what it would have been if the displacement had not occurred, that the subsequent income of children from such families is 8% lower, and that these results are driven by lower-income households); Ann Huff Stevens, Long-Term Effects of Job Displacement: Evidence from the Panel Study of Income Dynamics 23 (NBER, Working Paper No. 5343, 1995), available at http://www.nber.org/papers/w5343 (finding that six or more years after an involuntary job loss, wages and earnings remain reduced by approximately 9% and that these effects are generally larger for workers with less than a college education).
Given these effects, the most accurate proxy for endowment should include inheritances in the tax base of the heir and donor (perhaps with a basic exemption for transfers to the needy). It should also weight noncompensatory inheritances received more heavily than earned income. In short, all else equal, it should include a comprehensive inheritance tax.

2. Efficiency

All else is, of course, rarely equal. Most importantly for this discussion, the amount of inheritance flows may respond to the tax rate. This is where efficiency concerns come into play, the subject of this Subsection.

An efficient tax is one that maximizes the size of the pie for a given distribution between those who are better-off and worse-off. It does so by minimizing undesirable, tax-induced distortions to individual choices, and by correcting for market failures, such as externalities, both of which result in less consumer and producer surplus.

Efficiency concerns imply a number of adjustments to the above analysis under any welfarist perspective. The main individual choices that are affected by wealth transfer taxes are those regarding work, saving, and giving. In addition, wealth transfers generate both positive and negative externalities. As noted above, the presence and size of these externalities and effects depends critically on the donor’s motives for accumulating the wealth transferred.

a. Compensatory Transfers

Starting with compensatory transfers, it is efficient to tax such wealth transfers as income of the donor and, separately, as income of heir—just like spending on all personal services is taxed. As argued above, this tax treatment is also the fairest. No additional tax should apply on equity grounds, unless there is reason to believe that compensation disguised as inheritances is more likely to be received by those with larger endowments. There is no evidence that this is the case. Thus, the welfare-maximizing treatment of compensatory transfers should be including them in the tax base of both the transferor and recipient (referred to as an inclusion tax), but not to subject to them any further taxation.


89 It certainly could become the case, though, if the gift tax were eliminated and the income tax exclusion for gifts and bequests received were retained.
b. Inelastic Transfers

Efficiency considerations imply that inheritances stemming from egoistic transfers, by contrast, should be taxed at a confiscatory rate of 100%. By definition, such a confiscatory tax should have no particular impact on a donor's motivation to work, save, or give because she did not accumulate such wealth with an eye to how much heirs would receive. Moreover, such a confiscatory tax should be efficiency-enhancing with respect to her heirs. Heirs tend to respond to receiving a large inheritance by working less because inheritances create an income effect but no offsetting substitution effect (because heirs do nothing in order to receive egoistic wealth transfers). This implies that taxing inheritances, conversely, will induce heirs to work more. A confiscatory tax on egoistic transfers is thus efficiency-enhancing because it raises revenue, both from the inheritance and the heir's additional earnings, without generating efficiency losses. This new revenue can be used to lower the underlying tax, thereby reducing its inherent distortions.

The same argument applies to accidental bequests, with two caveats. First, in the case of accidental bequests, confiscatory taxation is only a second-best solution. The first-best approach is to eliminate accidental bequests entirely by correcting the market failures in the annuity and retiree health insurance markets that give rise to them. In practice, however, it is unlikely that the government can fully correct for these market failures. Government intervention in private insurance markets through pooling arrangements and default rules might address adverse selection problems and inertia. But it is difficult for private insurers to insure against serially-correlated risks that extend far into the future, such as changes in the rate of growth of inflation, longevity, and health care costs. Individuals therefore may fail to insure adequately out of a justifiable fear that the insurer will go bankrupt or cut back on their benefits once the time for payment arises. The main alternative would be to expand mandatory governmental programs (such as Social Security and Medicare in the United States) in order to provide for all retiree income and health needs. But the optimal level of these programs presumably would strike some middle ground between individuals' differing preferences regarding health insurance and income replacement rates in retirement. As a result,

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90 As noted above, egoistic and warm-glow pretax saving are both referred to as egoistic transfers.
92 See note 70.
wealth transfers from life-cycle savings will likely remain a part of an ideal fiscal system and, once they exist, confiscatory taxation becomes the welfare-maximizing response.

The other potential objection to confiscatory taxation of accidental bequests is that doing so can increase inefficiencies associated with redistributive aspects of the underlying tax through interactions with labor supply and saving decisions.\textsuperscript{94} For example, suppose that there are three generations and some members of the first leave accidental bequests to some members of the second. These bequests are confiscated and redistributed pro rata. If the labor supply of the new heirs in the second generation is more elastic, the earnings of the second generation will fall in response to this new pro rata distribution of bequests. As a result, the third generation will receive fewer accidental bequests. Similarly, if the second generation’s new heirs have a lower propensity to save inherited wealth, the savings rate could fall, reducing the supply of accidental bequests. Either way, the third generation is worse off.\textsuperscript{95}

While theoretically possible, the limited existing evidence on the labor supply of heirs appears to cut against this theory. Those receiving ordinary inheritances appear not to change their labor supply; instead the negative labor supply response is concentrated among those inheriting very large amounts.\textsuperscript{96} At the same time, it is unclear whether non-heirs would save inherited wealth at lower rates.\textsuperscript{97} Moreover, many would argue that the social welfare function should not weight the welfare of generations far into the future as heavily as current generations, given generally rising standards of living as a result of economic growth.\textsuperscript{98}

Most importantly, this objection ignores a potential justification for taxing accidental bequests—and all inheritances with no bequest motive—at rates even higher than 100%. As argued, such inheritances are powerful “tags” for an heir’s unobserved earning ability.\textsuperscript{99} Accordingly, taxing some or all of inheritances also as earned income


\textsuperscript{95} Cf. Blumkin & Sadka, note 94, at 11 (describing such a model for bequests).

\textsuperscript{96} Joulfaian, note 70, at 15.


\textsuperscript{99} See text accompanying notes 75-79.
would render the tax system simultaneously more equitable and more efficient. The portion of the inheritance included should generally depend on the amount inherited or perhaps the amount of the donor’s wealth transfers. For accidental bequests it should probably depend on this amount adjusted for the donor’s age because the donor will spend her wealth down over time.\footnote{If accidental bequests were not adjusted for the donor’s age, the tag would depend in part on when the donor died, not on the amount the heir potentially could have received, which is the best tag for unobserved earning ability.}

Thus, unlike compensatory transfers, taxing inelastic transfers partially as earned income and also separately at a rate of 100% should be the welfare-maximizing approach.

c. Altruistic Transfers

The final potential wealth accumulation motive is altruism.\footnote{As noted above, altruistic and warm-glow after-tax saving are both referred to as altruistic transfers.} This is the only scenario in which a gratuitous wealth transfer responds to the tax rate. Thus, a threshold question arises as to whether such transfers should ever be subject to tax given the potential long-run effects on saving and giving. In particular, Chamley and Judd have shown that if one assumes that donors value the well-being of their descendents for an infinite number of generations (“Barro-type” altruism), the optimal tax on inheritances may be zero. Any positive redistributive effects for the current generation are outweighed by the compound effects on future generations of current donors who respond by saving and giving less.\footnote{Blumkin & Sadka, note 94, at 2; Christophe Chamley, Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives, 54 Econometrica 607, 619 (1986); Kenneth Judd, Redistributive Taxation in a Simple Perfect Foresight Model, 28 J. Pub. Econ. 59, 80-81 (1985). I am grateful to Kevin Hassett and Dan Shaviro for raising this point.}

While theoretically possible, the argument for disregarding altruistic transfers on these grounds is problematic on several fronts. First, the evidence of Barro-type altruism is weak.\footnote{See, e.g., Joseph G. Altonji, Fumio Hayashi & Laurence J. Kotlikoff, Is the Extended Family Altruistically Linked? Direct Tests Using Micro Data, 82 Am. Econ. Rev. 1177, 1196 (1992); see generally notes 129-46 and accompanying text and table.} Individuals do not appear to optimize over several generations or even, in most cases, their own. In addition, the model assumes that the private discount function and social discount function are the same. Even if individuals did heavily weight the effects of their decisions on generations far into the future, it is unclear why the social welfare function should. After all, future generations presumably will be much better off as a result of economic growth. Finally, the model assumes that each individual’s en-
dowment is composed solely of ability and that no individual characteristics provide information about unobserved earning potential. This Article more realistically assumes that inheritances are a second fundamental component of endowment and provide a useful tag for ability.\textsuperscript{104} If they are a useful tag, taxing the inheritances can enhance efficiency and fairness even under Barro-type altruism.\textsuperscript{105} Thus, the case for ignoring altruistic wealth transfers within an optimal tax system (that is, neither taxing nor subsidizing them) seems wrong in light of existing empirical evidence.

Instead the analytic framework developed so far suggests that on fairness grounds altruistic wealth transfers should be treated as income of both the heir and donor (perhaps with a basic exemption for transfers to the needy), and taxed at a higher rate than earned income. Efficiency considerations, however, imply at least three substantial adjustments to this tax treatment.

First and most importantly, altruistic inheritances create altruistic externalities. For example, suppose an heir gains fifty units of well-being from a $100 inheritance and the donor values the heir's well-being as if it were her own. The transfer then generates fifty units of well-being for the donor, and she will make the transfer so long as using the money in any other way generates less than fifty units of well-being for her. In reality, though, the transfer results in 100 units of well-being—fifty for the donor and fifty for the heir. The fifty units that the heir gains are the \textit{altruistic externality} that the donor does not adequately take into account.\textsuperscript{106} This altruistic externality underlies the Chamley-Judd model, but here I consider a more plausible scenario where the donor only takes into account the well-being of her beneficiary, not an infinite number of potential descendents thereafter.

The efficient way to correct for this altruistic externality is to provide the donor with a subsidy equal to the welfare-weighted value of the heir receiving the inheritance, and to exclude the inheritance from the heir's underlying tax base.\textsuperscript{107} (The inheritance should not be included in the heir's tax base because doing so burdens both the donor and the heir, due to the fact that the donor's welfare gain is a function

\begin{itemize}
  \item \textsuperscript{104} See text accompanying notes 75-79.
  \item \textsuperscript{105} Cf. Golosov et al., note 79, at 570-71, 577 (reaching this result with respect to savings if it provides information about an individual's underlying ability over time).
  \item \textsuperscript{106} It is worth emphasizing that the altruistic externality is not the value the donor assigns to the transfer because she presumably takes this value adequately into account.
  \item \textsuperscript{107} Cf. Louis Kaplow, A Note on Subsidizing Gifts, 58 J. Pub. Econ. 469, 472-76 (1995) [hereinafter Subsidizing Gifts] (arguing that the efficient subsidy is 100% for the least altruistic donors and should fall as altruism rises). Wojciech Kopczuk develops the point that the subsidy should be welfare-weighted. Wojciech Kopczuk, Economics of Estate Taxation, Review of Theory and Evidence, 63 Tax L. Rev. 139, 141-42 (2009).
\end{itemize}
of the heir's.)\(^{108}\) For example, if the donor transfers $100 and society values her heir receiving that amount at $100, the donor should receive a $100 subsidy so that she makes the transfer as long as spending $100 in any other way generates less value to her than transferring $200 to her heir.

In order to ensure that such an altruistic subsidy is strictly efficiency-enhancing, though, it should not alter the general distribution of tax burdens and benefits between those who are better-off and worse-off in the process of correcting the price of wealth transfers. This can be accomplished by financing the subsidy through what Louis Kaplow terms a "benefit-offsetting tax."\(^{109}\) Such a tax should mimic the incidence of the subsidy. That is, it should have the same aggregate incidence by endowment\(^{110}\) as the new consumer and producer surplus created by the subsidy.\(^{111}\) But it should not be based on the amount of wealth transfers that a specific donor chooses to make.

The ideal altruistic subsidy should therefore decline as the economic status of the heir increases for two reasons: It should be welfare-weighted. Lower-income heirs also should bear less of the benefit-offsetting tax.\(^{112}\) The net result of this altruistic subsidy would be greater social welfare and a lower cost of giving.\(^{113}\)

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\(^{108}\) This might not be the case if the donor grossed up the inheritance for the heir's underlying tax burden on it, but as discussed above, see text accompanying notes 24-25, this does not appear to be the norm empirically. I am grateful to David Kamin for this point.


\(^{110}\) For purposes of the benefit-offsetting tax, the endowment of the heir should include his inheritance, not just the proxy for his ability (for example, income or consumption). The endowment of the donor should also include the amount transferred.


\(^{112}\) Lower-income heirs should bear less of the benefit-offsetting tax because donors gain more from altruistic subsidies. Donors gain the entire value of the subsidy, while heirs only gain to the extent that the donor responds by giving more. In addition, wealth transfers tend to flow down the economic distribution so heirs are disproportionately lower-income.

\(^{113}\) An example may help illustrate the social welfare benefits. Suppose society initially consists of five individuals. \(L_1\) and \(L_2\) have $100, \(M_1\) and \(M_2\) have $200, and \(H_1\) has $300. \(M_1\) plans to give $50 to \(L_1\) for altruistic reasons. A 100% subsidy for altruistic transfers is offered to the donor because the social welfare function highly values \(L_1\) receiving more income. In response, \(M_1\) gives \(L_1\) $100 instead. As a result, \(L_1\) ends up $50 better off than he would be without the subsidy, and \(M_1\) ends up $100 better off (the amount of the subsidy). Moreover, \(L_1\) now effectively has $200 and \(M_1\) now effectively has $300 ($200 of utility from market consumption and $100 from altruistic consumption), which moves them into the middle class and upper class respectively. One-third of the benefit-offsetting tax should therefore be allocated to the middle class (due to \(L_1\)'s $50 gain) and two-thirds to the upper class (due to \(M_1\)'s $100 gain). The results are as follows. The subsidy improves social welfare because all of the losses are matched or exceeded by gains from someone who was lower-income.
Several objections typically arise to subsidizing altruistic externalities. Later Sections will discuss those that involve administrative or political constraints. But even in this highly idealized scenario, one objection is that altruistic subsidies can become infinite. For example, in the above hypothetical, the donor could decide to transfer the subsidy as well, in which case she would be eligible for a further subsidy. But this process would not continue indefinitely. As the heir’s income continues to rise, the heir and donor will both receive less well-being from such transfers, the welfare-weighted marginal subsidy will become smaller, and their share of the benefit-offsetting tax will increase. Together, these factors will reduce the donor’s post-tax incentive to give until there is none.

In addition to altruistic externalities, altruistic wealth transfers create a second type of positive externality if the donor is better-off than the heir: a redistributional externality. Specifically, if the heir would have been an object of redistribution under the social welfare function, the transfer eliminates this need, thereby permitting lower underlying tax rates, which benefit society as a whole. The efficient way to correct for this externality is through another subsidy that is largest for transfers to the least well-off and declines to zero as the

<table>
<thead>
<tr>
<th>Person</th>
<th>Initial</th>
<th>After-Subsidy</th>
<th>After Offsetting Tax</th>
<th>Net Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Endowment</td>
<td></td>
<td></td>
<td>(Loss)</td>
</tr>
<tr>
<td>LI (heir)</td>
<td>$100/150</td>
<td>$200 (Middle-income)</td>
<td>$183.4</td>
<td>$33.4</td>
</tr>
<tr>
<td>L2</td>
<td>100</td>
<td>100 (Low-income)</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>M1 (donor)</td>
<td>200</td>
<td>300 (High-income)</td>
<td>250 (incl. heir's tax)</td>
<td>50</td>
</tr>
<tr>
<td>M2</td>
<td>200</td>
<td>200 (Middle-income)</td>
<td>183.4</td>
<td>(16.6)</td>
</tr>
<tr>
<td>HI</td>
<td>300</td>
<td>300 (High-income)</td>
<td>266.6</td>
<td>(33.3)</td>
</tr>
</tbody>
</table>

Another example may illustrate why lower-income heirs will bear less of the benefit-offsetting tax. Suppose in the above example that HI also planned to transfer $50 to M2. HI is only offered a 50% altruistic subsidy because transfers to M2 are valued less than transfers to LI. HI responds to the 50% subsidy by transferring $100 instead. M2 then ends up $50 better off and HI ends up $50 better off, moving them into the upper class and rich class, respectively. The $150 benefit-offsetting tax would be allocated one-fifth to the middle class (LI's $50 gain), three-fifths to the upper class (M1's $100 gain and M2's $50 gain), and one-fifth to the rich (HI's $50 gain). The net subsidies are as follows. The benefit offsetting tax paid by heir M2 is $45, while it is only $30 for heir L1. Note that all of the losses are again matched or exceeded by gains from someone who is lower-income.

<table>
<thead>
<tr>
<th>Person</th>
<th>Initial</th>
<th>After-Subsidy</th>
<th>After Offsetting Tax</th>
<th>Net Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Endowment</td>
<td></td>
<td></td>
<td>(Loss)</td>
</tr>
<tr>
<td>LI (heir 1)</td>
<td>$100/150</td>
<td>$200 (Middle-income)</td>
<td>$170</td>
<td>$20</td>
</tr>
<tr>
<td>L2</td>
<td>100</td>
<td>100 (Low-income)</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>M1 (donor 1)</td>
<td>200</td>
<td>300 (High-income)</td>
<td>225 (incl. heir's tax)</td>
<td>25</td>
</tr>
<tr>
<td>M2 (heir 2)</td>
<td>200/250</td>
<td>300 (High-income)</td>
<td>255</td>
<td>5</td>
</tr>
<tr>
<td>HI (donor 2)</td>
<td>300</td>
<td>350 (Rich)</td>
<td>275 (incl. heir's tax)</td>
<td>(25)</td>
</tr>
</tbody>
</table>

114 See notes 219-20 and accompanying text.

115 The redistributional externality could be thought of as part of the altruistic externality. The only difference is that altruistic subsidies address the benefits to society of transfers that society otherwise might not force for efficiency reasons, while redistributional subsidies address the social benefits of transfers that substitute for governmental redistribution that would occur otherwise.

116 See Kaplow, Subsidizing Gifts, note 107, at 474; Kaplow, note 91, at 200.
heir's economic status rises. Once again, it should be financed by a benefit-offsetting tax.\textsuperscript{117}

Finally, altruistic transfers create a negative revenue externality because heirs tend to respond to receiving a substantial inheritance by working less,\textsuperscript{118} thereby depressing revenues from the underlying tax. The size of this externality turns on the heir's marginal tax rate and the elasticity of his labor earnings with respect to inherited income. As a result, the efficient way to correct for it is to include a portion of the heir's inheritance in his underlying tax base. The specific portion included should be the amount by which his labor earnings are expected to decline. Doing so makes the donor internalize the effect of her altruistic transfer on her heirs' contribution to the fisc.

Pulling all of these fairness and efficiency considerations together, the welfare-maximizing treatment of altruistic wealth transfers has three components. First, on fairness grounds, such inheritances should be included in the tax base of the donor, perhaps with a basic exemption for transfers to those most in need. Second, they should be partially included in the heir's tax base because they are powerful "tags" for an heir's unobserved earning ability, and to correct for the revenue externality. Finally, in order to address altruistic and redistributitional externalities, such transfers otherwise should be excluded from the heir's tax base and eligible for a subsidy that declines from more than 100% to zero as the heir's income rises. In short, altruistic transfers should be included in the donor's tax base, partially included in the heir's, and subsidized at a net rate that declines from around 100% to below zero as the heir's economic status increases.

To be clear, none of these efficiency adjustments are warranted when a wealth transfer is compensatory, egoistic, or accidental. Each of these adjustment is intended to alter the price of altruistic transfers relative to other consumption options so that the donor makes the choice based on all of the well-being generated by the transfer, not just her own. In the case of exchange-motivated transfers, these adjustments are inappropriate because the recipient has actually worked for the transfer and the donor does not care about the heir's well-being. In the case of inelastic transfers, they are unnecessary because the donor by definition will not respond.

3. \textit{With Perfect Information}

Having considered each of the potential wealth accumulation motives, this Subsection can now summarize the ideal taxation of wealth

\textsuperscript{117} See notes 109–11 and accompanying text.
\textsuperscript{118} See note 70.
transfers in a world with perfect information. There are five potential forms a wealth transfer tax can take, as listed in Table 1.

<table>
<thead>
<tr>
<th>Type of Tax</th>
<th>Include in Underlying Tax Base</th>
<th>Separate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>No wealth transfer tax</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Estate and gift tax</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Accessions tax</td>
<td>Yes</td>
<td>Amount received</td>
</tr>
<tr>
<td>Inheritance tax</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Comprehensive inheritance tax</td>
<td>Yes</td>
<td>Amount received</td>
</tr>
</tbody>
</table>

A tax system can ignore wealth transfers and thus have no wealth transfer tax. In this case, donors make wealth transfers with after-tax earnings but inheritances received are excluded from the heir’s underlying tax base. A tax system can subject wealth transfers to an estate and gift tax, which taxes the amount transferred based on a separate rate schedule. Alternatively, it can apply an inheritance tax, of which there are three types. An accessions tax imposes a separate tax based solely on the amount the heir receives, typically over his lifetime, without regard to his underlying tax base. Conversely, an inclusion tax applies no separate tax but includes all or a portion of the inheritance in the heir’s tax base. Finally, a comprehensive inheritance tax is a hybrid of the two. For inheritances above an exemption, it includes some portion of the inheritance in the underlying tax base of the heir, and taxes it at a higher rate than other income, with that higher rate depending on the amount inherited.

In a world with perfect information, the ideal wealth transfer tax is always some type of inheritance tax if the fairness and efficiency arguments laid out above and summarized in Table 2 are accepted. Table 2 illustrates that the specific form, level, and sign of the ideal inheritance tax turns on the donor’s marginal wealth accumulation motive, the economic status of the heir, the amount of information provided about the heir’s unobserved ability, and the structure of the underlying tax. If a donor’s marginal wealth accumulation motive is compensatory, the ideal approach is a positive inclusion tax. If it is inelastic, a
positive and extremely high comprehensive inheritance tax is ideal.\textsuperscript{119} And if it is altruistic, the ideal is a negative comprehensive inheritance tax. In all three scenarios, though, the ideal approach is neither an estate tax, nor to disregard wealth transfers entirely.

\textbf{Table 2}
\textit{Welfare-Maximizing Wealth Transfer Tax by Wealth Accumulation Motive}

<table>
<thead>
<tr>
<th>Donor Motive</th>
<th>Form of Wealth Transfer Tax</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensatory</td>
<td>Full inclusion tax</td>
<td>• Identical to other earnings</td>
</tr>
<tr>
<td>Egoistic</td>
<td>100% accessions tax + Small comprehensive inheritance tax (depends on amount inherited)</td>
<td>• 100% tax because no behavioral distortions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Partial inclusion tax to address correlation with ability and greater utility generated</td>
</tr>
<tr>
<td>Life-cycle</td>
<td>100% Accessions tax + Small comprehensive inheritance tax (depends on amount inherited adjusted for donor age)</td>
<td>• 100% tax because no behavioral distortions</td>
</tr>
<tr>
<td>savings</td>
<td></td>
<td>• Partial inclusion tax to address correlation with ability and greater utility generated</td>
</tr>
<tr>
<td>Altruistic</td>
<td>Small comprehensive inheritance tax + Subsidy declining from (-100%) to (&lt;0%) as heir's economic income rises</td>
<td>• Partial inclusion tax to address revenue externality, correlation with ability, and greater utility generated</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Subsidy declining from (100%+) to zero as heir's economic income rises to address altruistic and redistributional externalities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Benefit-offsetting tax on donor's and heir's endowment class</td>
</tr>
</tbody>
</table>

This case for an inheritance tax is strengthened by considering how wealth transfer taxes operate in the real world. Basing the tax on the circumstances of the heir, as under an inheritance tax, is desirable because, contrary to conventional economic wisdom, there is some evidence that the statutory incidence of a tax affects its excess burden because people appear to irrationally respond more to a tax they nominally pay.\textsuperscript{120} If this is the case, placing the statutory incidence on the

\textsuperscript{119} The ideal may be a positive and extremely high hybrid inclusion-estate tax if estate size is a better tag for the heir's unobservable earning ability than the amount inherited. Most likely the ideal is actually a hybrid inclusion-accessions-estate tax. I am grateful to Aviva Aron-Dine for this point.

\textsuperscript{120} This could occur because the tax is more salient or because the person bearing the statutory burden remits the tax. See, e.g., Joel Slemrod, Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance, 61 Nat'l Tax J. 251, 272-73 (2008); Raj Chetty, Adam Looney & Kory Kroft, Salience and Taxation: Theory and Evidence, 99 Am. Econ. Rev. 1145, 1175-76 (2009); Amy Finkelstein, E-Z Tax: Tax Salience and Tax Rates, 124 Q.J. Econ. 969, 1008-09 (2009).
heir should reduce the excess burden, because any deadweight loss associated with wealth transfer taxation arises from the behavioral response of donors. Basing the tax on the circumstances of the heir also makes sense because heirs bear the burden of wealth transfer taxes in general.\textsuperscript{121}

4. With Imperfect Information

Unfortunately, the world is full of imperfect information, including about marginal wealth accumulation motives. Accordingly, the ideal just summarized is impossible. Thus, it is necessary to consider existing evidence and the implications of empirical uncertainty in order to gain a clearer sense of the ideal form and level of wealth transfer taxation in reality.

Some of the evidence on relevant parameters can be summarized briefly. As discussed, inheritances have a meaningful effect on the income distribution, and are powerfully correlated with earning ability.\textsuperscript{122} Accordingly, it matters whether they are taxed. Similarly, low-income tax units appear to receive a larger share of their income from inheritances,\textsuperscript{123} implying that redistributive externalities may exist to the extent that transfers are altruistic. In addition, inheritances appear to induce heirs to earn less, producing a revenue externality, but the estimated effect is relatively small. For example, Holtz-Eakin, Joulfaian, and Rosen find that heirs' labor earnings tend to decline by only about 2% for each unit of the natural log of inheritance, with inheritance measured in millions of dollars.\textsuperscript{124} Less than 1% of heirs inherit more than $1 million dollars in a given year.\textsuperscript{125}

Regrettably, the most important parameter for determining the ideal wealth transfer tax, however, is the most contested: the share of wealth transfers attributable to different wealth accumulation motives. Table 3 illustrates this point by partially summarizing the empirical literature on the issue. It shows that there is a long history of research on wealth transfer motives. Initially researchers obtained widely divergent estimates. For example, Kotlikoff and Summers estimated that only 19% of U.S. wealth is attributable to life-cycle saving.\textsuperscript{126} Hurd countered that households with children do not save more and, on this basis, concluded that bequests are largely acciden-

\textsuperscript{121} See text accompanying notes 19-31.
\textsuperscript{122} See notes 56-87 and accompanying text.
\textsuperscript{123} See Figure 4.
\textsuperscript{124} Holtz-Eakin et al., note 70, at 432 tbl.V.
\textsuperscript{125} See Table A1.
Still later work questioned Hurd’s logic because many childless adults appear to transfer wealth intentionally. Still later work questioned Hurd’s logic because many childless adults appear to transfer wealth intentionally.

**TABLE 3**
Partial List of Studies of Wealth Accumulation Motives

<table>
<thead>
<tr>
<th>Study</th>
<th>Accidental</th>
<th>Egoistic &amp; Pretax Warm Glow</th>
<th>Exchange</th>
<th>Altruistic &amp; After-Tax Warm Glow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kotlikoff &amp; Summers(^\text{129})</td>
<td>19%</td>
<td>81%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hurd (1987)(^\text{130})</td>
<td>Most bequests</td>
<td>Minority of bequests</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Modigliani(^\text{131})</td>
<td>&gt;80%</td>
<td>&lt;20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hurd (1989)(^\text{132})</td>
<td>Most</td>
<td>Small</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bernheim(^\text{133})</td>
<td>&lt;70-84%</td>
<td>&gt;16-30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Altonji et al(^\text{134})</td>
<td>Most</td>
<td>Model rejected</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wilhelm(^\text{135})</td>
<td>Most</td>
<td>Little evidence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Laitner &amp; Juster(^\text{136})</td>
<td>77-82%</td>
<td>18-23%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Laitner &amp; Ohlsson(^\text{137})</td>
<td>Most</td>
<td>Some evidence</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^{127}\) Hurd, note 47, at 306-08 (finding no support for a bequest motive given declining wealth in retirement and lower savings rates among households with living children).


\(^{129}\) Kotlikoff & Summers, note 126, at 721, 725 (finding life-cycle savings accounts for only 19% of wealth).

\(^{130}\) Hurd, note 47, at 306-08.

\(^{131}\) Franco Modigliani, The Role of Intergenerational Transfers and Life Cycle Savings in the Accumulation of Wealth, J. Econ. Persp., Spring 1988, at 15, 38 (pure bequest motives do not account for more than one-fifth of bequests; pure bequest motive more common among most wealthy).

\(^{132}\) Michael D. Hurd, Mortality Risk and Bequests, 57 Econometrica 779, 779-81 (1989) (estimating that most bequests are accidental and finding no evidence of a bequest motive by looking at the consumption paths of the elderly relative to individual mortality risk).

\(^{133}\) Bernheim, note 128, at 923-24.

\(^{134}\) Altonji et al., note 103, at 1178 (strongly rejecting the altruistic model in general and finding that extended family resources only modestly predict household consumption).

\(^{135}\) Wilhelm, note 49, at 874 (finding little support for the altruistic model).


Nevertheless, over time this literature has begun to reach a fragile consensus that altruistic and compensatory transfers represent a minority of wealth transfers. For example, Laitner and Justner found that donors exhibit a wide array of motives but estimated that, among their relatively high-income sample, only about 20% of wealth accumulated is attributable to a bequest motive. Similarly, Kopczuk and Lupton estimated that 47% of bequests are attributable to life-cycle savings by examining the consumption patterns of the elderly. They also found evidence of altruistic and exchange-motivated transfers, but it was not statistically significant. On this basis, they concluded that much of the remaining 53% of bequests is probably egoistic. Overall, the literature seems to suggest, very roughly, that about 50% of wealth transfers are accidental, about 20% altruistic, and the bulk of the remainder egoistic.

Ideally, the level and form of wealth transfer taxes would be calibrated to each donor’s marginal wealth accumulation motive. Given that such perfect information is unavailable, the second-best option

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138 Karen E. Dynan, Jonathan Skinner & Stephen P. Zeldes, The Importance of Bequests and Life-Cycle Saving in Capital Accumulation: A New Answer, 92 Am. Econ. Rev. 274, 276 (2002) (reporting survey results that nearly 50% consider leaving an inheritance their heirs to be important or very important, but only 8% list saving for an estate as one of their top five reasons for saving).


142 Kopczuk & Lupton, note 128, at 209, 223 (estimating that 47% of wealth transfers by single households aged seventy and older are attributable to life-cycle savings, and concluding that egoistic saving is the most plausible explanation for the remainder because evidence of altruistic and compensatory transfers is statistically insignificant).

143 Laitner & Justner, note 136, at 906.

144 Kopczuk & Lupton, note 128, at 209.

145 Id.; see Page, note 140, at 1219 (finding a positive relationship between the marginal tax rate on bequests and inter vivos gifting, implying that some portion of bequests is altruistic or exchange-motivated).

146 Kopczuk & Lupton, note 116, at 209.
would be for any tax to vary with various "tags" correlated with different wealth accumulation motives. Unfortunately this information is unavailable as well. Despite progress in determining the aggregate share of wealth transfers attributable to different bequest motives, existing studies do not appear to permit one to draw any conclusions about how to identify these motives at an individual level. Indeed, the difficulties in identifying wealth accumulation motives at an individual level are part of the reason why the literature on the aggregate prevalence of different bequest motives has been so contested.

Most of the most obvious proxies for a donor's bequest motive have been largely disproven empirically. For example, having living children appears not to provide any information about wealth accumulation motives. The studies to date find that childless adults save for altruistic reasons just as often as parents. Likewise, expected remaining wealth in very old age is not well correlated with the share of bequests that are accidental because a large share of life-cycle savings may be for unexpected health care costs at the end of life, not day-to-day retirement consumption needs.

Other potential proxies for wealth accumulation motives simply have not been studied enough to draw any conclusions, however rough. For example, it is possible that marginal wealth accumulation motives vary with the wealth of the donor. Perhaps individuals start by accumulating wealth to provide for themselves in old age, then save for their children, and only finally save for egoistic reasons if and when they have accumulated an extraordinary amount of wealth. But this is pure speculation and other possibilities are equally plausible. For example, donors might instead aim to provide their children with some standard of living that is a function of their own, in which case the share of their saving that is altruistic would be invariant with wealth.

It also seems possible that altruism is correlated with transferring wealth as a gift, given that gifts should not be accidental and donors are more likely to give to heirs with lower earnings during life than at death. But again there are no studies directly on the issue. Moreo-

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147 I am grateful to David Schizer for raising this issue.
150 They may be if the donor saves for future potential personal consumption needs and then discovers new information about her mortality risk, for example that she has a terminal illness. Wojciech Kopczuk, Bequest and Tax Planning: Evidence from Estate Tax Returns, 122 Q.J. Econ. 1801, 1801-02 (2007).
151 See, e.g., Altonji et al., note 103, at 1188-94; McGarry, note 50, at 321-24.
ver, other evidence suggests that gifts may stem less often from altruism than bequests. For example, gifts are far more prevalent among the wealthiest donors. This may be because the wealthiest donors altruistically respond to existing estate tax incentives to transfer wealth as a gift. But it also may be because they may save mainly for egoistic reasons, in which case they would be indifferent between transferring wealth before or after death. Thus, even this potential proxy for wealth accumulation motives is unsupported to date.

For the time being, therefore, we have a rough sense of what share of inheritances are attributable to different wealth accumulation motives in aggregate, but no sense of which inheritances stem from which motive at the individual level. Future research on this issue would be a valuable contribution. But, until then, even the second-best solution of calibrating wealth transfer taxes to “tags” correlated with the different motives remains unattainable.

Faced with such empirical uncertainty, it is tempting to throw up one’s hands and decide to ignore wealth transfers entirely. For the numerous reasons set forth above, this would be a mistake. When the empirical evidence relevant to structuring a tax or subsidy is unclear, the best solution is not to assume there are no empirical effects. Instead, it is to structure the tax or subsidy optimally based on the best evidence to date. Doing so minimizes the expected deadweight loss of the tax system given that the cost of a poorly calibrated tax or subsidy rises with the square of the error.

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152 See, e.g., Joulfaian & McGarry, note 51, at 436 tbl.3.
153 See note 208 and accompanying text.
154 Cf. Kopczuk, note 150, at 1801 (finding evidence of “deathbed” estate planning).
155 Another possibility is that transfers of property with annuitized characteristics, such as a remainder interest in a house, are a useful tag for altruistic transfers. Once again, there is no evidence on this issue. In addition, historically such transfers may have stemmed from a lack of financial products permitting donors to avoid such transfers, given the fact that reverse mortgages are a relatively recent innovation. See Patrick S. Duffy, Reverse Mortgages Provide More Seniors with a Safety Net, L.A. Times, Feb. 24, 2008, at K1. I am grateful to David Schizer for this point.
156 Cf. Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 Stan. L. Rev. 23, 44-46 (2006) (making this argument in the context of uncorrected externalities). One caveat to this conclusion is that this assumes linearity of the relevant supply and demand curves. I am grateful to Louis Kaplow for this point. Another caveat is that it may be optimal to more heavily weight behavior that is relatively inelastic or a complement to leisure. See id. at 45; Emmanuel Saez, The Optimal Treatment of Tax Expenditures, 88 J. Pub. Econ. 2657, 2666-67 (2004). These latter considerations, however, have been taken into account through the efficiency-motivated confiscatory tax on egoistic and accidental transfers, and the additional tax imposed to account for the correlation between inheritances and unobserved earnings ability.
For example, suppose that the optimal tax on wealth transfers is a subsidy of 100% for 70% of wealth transfers and a tax of 100% for 30% of wealth transfers, but the two types cannot be separated. If the tax system ignores all inheritances, the expected deadweight loss will be 19% larger than if it applies a 40% subsidy to all.¹⁵⁷ This is because ignoring wealth transfers would result in the tax system applying a tax rate that is more inaccurate in most cases and less inaccurate in a few cases. The greater deadweight loss associated with the former would exceed the smaller deadweight loss associated with the latter. In order to minimize the expected deadweight loss, the subsidy instead should be set at the probability-weighted average.¹⁵⁸

5. Form of Tax

Applying this theory to the evidence on wealth accumulation motives implies that the ideal form for taxing wealth transfers should be the probability-weighted average of the ideal tax treatment for each motive for accumulating wealth—which turns out to be a comprehensive inheritance tax. As Table 2 showed, the ideal form is an inclusion tax if transfers are compensatory, a negative comprehensive inheritance tax if transfers are altruistic, and generally a positive and extremely high comprehensive inheritance tax if transfers stem from egoism or life-cycle savings. Moreover, the literature on wealth accumulation motives, summarized in Table 3, suggests that actual inheritances stem from some mix of all four of these motives, and that the motive for a specific wealth transfer cannot be identified. As a result, the probability-weighted average is some type of comprehensive inheritance tax (whether positive or negative), regardless of the relative proportions of each motive in aggregate.

The existing evidence on these relative proportions permits us to draw some further conclusions about the ideal form. In particular, it should make a difference as a theoretical matter whether a wealth transfer tax is structured as a comprehensive inheritance tax, and both its accessions tax and inclusion tax elements should be significant.

Starting with the first claim, the form of a wealth transfer tax only matters if the ideal rate structure is not flat (otherwise, all of the types

¹⁵⁷ In the former case, the deadweight loss would be 10,000 (0.7*(-100²) + 0.3*(100²)). In the latter case it would be 8,400 (0.7*(-60²) + 0.3*(140²)). A 40% subsidy is the probability-weighted average of the ideal subsidy (1*(70)-1*(30)).

¹⁵⁸ One objection to an inheritance tax in this respect is that it will result in more variance in tax rates because the rate depends on the number of heirs. See James R. Hines Jr., Taxing Inheritances, Taxing Estates, 63 Tax L. Rev. 189, 202 (2009). This is only practically relevant, however, in the case of altruistic transfers. While generally greater variance in tax rates results in larger deadweight losses, this is not the case when the variance stems from taxes and subsidies correcting for externalities, as is the case with altruistic transfers.
are identical). This is highly likely to be the case. One component of the probability-weighted ideal could be flat—the efficiency-motivated 100% tax on inheritances from egoistic and accidental transfers. But the other components should not be.

For example, a number of elements of the ideal wealth transfer tax should turn on the heir’s economic status. These include the basic exemption, altruistic subsidy, and redistributional subsidy for altruistic transfers.\(^{159}\) Meanwhile, several other components turn on the rate structure of the underlying tax, including the tag-motivated comprehensive inheritance tax for egoistic, accidental, and altruistic transfers, the inclusion tax for compensatory transfers, and the tax correcting for revenue externalities associated with altruistic transfers. While the literature on the shape of the optimal underlying tax is highly contested, no studies to date suggest that it should exhibit a flat rate structure.\(^{160}\) Therefore, these components of the ideal wealth transfer tax should not be flat either.

Turning to the second claim, the ideal wealth transfer tax form should also contain substantial elements of both an accessions tax and an inclusion tax, thereby rendering it functionally distinct from both. Admittedly, the validity of this contention depends in part on definitions. Thus far, an accessions tax has been defined as a separate tax based solely on the amount the heir receives, while an inclusion tax has been defined as one that applies no separate tax but includes the inheritance in the heir’s underlying tax base.\(^{161}\) Under these defini-

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159 The altruistic subsidy should not be flat because it should be welfare-weighted. A flat net altruistic subsidy would also require the benefit-offsetting tax to be flat. As implied in note 113, the benefit-offsetting tax could only be flat if donors passed on the entire amount of the altruistic subsidy to heirs, and if inheritances were just as likely to flow up the economic distribution (to heirs who were more affluent than the donor) as downward. There is no evidence on the former question and the latter is contradicted by the existing empirical evidence. See Figure 4.

160 Early work by Mirrlees and others suggested that the optimal consumption tax has declining marginal rates, with all the revenue used to finance a basic cash grant that everyone receives (a “demogrant”). See, e.g., Mirrlees, note 35, at 207-08; see generally N. Gregory Mankiw, Matthew Weinzierl & Danny Yagan, Optimal Taxation in Theory and Practice (NBER, Working Paper No. 15071, 2009), available at http://www.nber.org/papers/w11587. More recent work, deriving optimal tax rates from labor elasticities, has suggested that the optimal income tax may be U-shaped, with declining marginal rates between low and moderate levels of income, but rising marginal rates between moderate and high levels of income. See, e.g., Emmanuel Saez, Using Elasticities to Derive Optimal Income Tax Rates, 68 Rev. Econ. Stud. 205, 223 (2001). Still other work has found that if labor supply decisions tend to be made at the extensive margin (whether to work or not), the optimal rate structure may also rise at lower levels of consumption, potentially starting with a negative marginal rate for those with the least earnings. See, e.g., Emmanuel Saez, Optimal Income Transfer Programs: Intensive versus Extensive Labor Supply Responses, 117 Q.J. Econ. 1039, 1059-65 (2002); Peter Diamond, Income Taxation with Fixed Hours of Work, 13 J. Pub. Econ. 101, 109-10 (1980).

161 See Table 1 and accompanying text.
tions only a small portion of the ideal tax would be a pure inclusion tax: the portion attributable to compensatory transfers, a somewhat minor phenomenon. Nevertheless, a substantial portion of the ideal would not be an accessions tax under these definitions either. Instead, it would be a hybrid of the two—a tax that includes a portion of the amount inherited in the underlying tax base, with that portion based on the amount inherited. This could be considered akin to an alternate income tax schedule for certain kinds of income, like the alternative minimum tax, the rate schedule for long-term capital gains, or the penalty rates that apply to early withdrawals from retirement savings vehicles.

In short, existing imperfect information suggests that the ideal wealth transfer tax form should be a comprehensive inheritance tax. As a theoretical matter, this form should make a difference. It should also make a difference empirically as illustrated below. A comprehensive inheritance tax should therefore be essential for achieving the welfare-maximizing distribution of fiscal burdens more generally.

6. Level of Tax

It addition to form, the other essential feature of a tax is its level. Indeed, one could argue that the level of the ideal wealth transfer tax is more important from a social welfare perspective. After all, it is possible that the ideal would raise so little revenue that it matters little if that approach is adopted, or if wealth transfers are disregarded entirely.

This Article cannot claim to provide a precise estimate of the optimal level of wealth transfer taxation. The nominal level of the optimal underlying tax is a hotly-contested issue, and the ideal wealth transfer tax level is linked to this underlying rate structure. It also depends on some unexamined questions, such as how much well-being heirs gain from not having to work for their inherited consumption. Nevertheless, this Article can offer some preliminary thoughts on the sign and order of magnitude of the ideal tax, and whether current fiscal systems are close to or far from it.

The most important determinant of whether the ideal wealth transfer tax is positive or negative across the economic distribution is the prevalence of different wealth accumulation motives. In particular, two features—the tax of 100% or more on egoistic and accidental transfers and the subsidy of up to about 100% for altruistic transfers—

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162 See Table 3.
163 IRC §§ 55-59.
164 IRC § 1(h).
165 IRC § 72(t).
should determine the ideal level of tax for regular heirs to a large degree. As noted above, a very rough summary of the literature suggests that about 50% of wealth transfers are accidental, about 20% altruistic, and the bulk of the remainder egoistic. This implies that the probability-weighted ideal tax rate would start at a rate on the order of 60%, and rise with inheritance size and heir earned income as the tag-motivated comprehensive inheritance tax rises and the altruistic subsidy rate declines.\(^6\) It should top out at a rate on the order of 80% because, for the most affluent heirs, the altruistic subsidy should effectively be zero.\(^7\)

This very rough conclusion could certainly change in light of further empirical evidence, especially that altruistic or compensatory transfers are more prevalent. Nevertheless, so long as the existing evidence does not change dramatically, the analytical framework developed here suggests that the ideal inheritance tax is positive and quite large.

Further evidence could also change the form of ideal wealth transfer taxation. But so long as wealth transfers exhibit some mix of donor motives and the underlying tax is not flat, it always will entail some inclusion and accessions elements. Thus, the superiority of a comprehensive inheritance tax to no tax on wealth transfers—or to an estate tax standing alone—seems robust to however the relevant empirical parameters are expanded or modified.

Having established this general picture of the ideal, the next Part summarizes the structure, advantages, and disadvantages of existing wealth transfer taxes, focusing on the U.S. estate tax system. Doing so permits Parts IV and V to turn to how these taxes might be improved in the real world, given its often strict administrative and political constraints.

III. **Wealth Transfer Taxation**

Currently no jurisdiction in the world imposes a wealth transfer tax on the order of 80% to the largest inheritances and none applies a comprehensive inheritance tax.\(^8\) Most developed countries do apply some wealth transfer tax but, as illustrated in Figure 5, the most common form is an annual inheritance tax. This is an accessions tax that

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\(^6\) If these assumptions held, the deadweight loss would be 6,400 (0.8*(40\(^2\)) + 0.2*(160\(^2\)), as compared to 10,000 if wealth transfers are ignored (0.2*(-100\(^2\)) + 0.8*(100\(^2\)).

\(^7\) The top rate should be above 80% because altruistic transfers to extremely wealthy heirs should be subject to a partial inclusion tax to correct for revenue externalities, and to incorporate the information they provide about the heir's unobserved earnings ability.

does not aggregate inheritances over time, but rather applies a new rate schedule to inheritances received each year.

**Figure 5**

Form of Wealth Transfer Tax in OECD Countries

<table>
<thead>
<tr>
<th>None</th>
<th>Estate and Gift Tax</th>
<th>Annual Inheritance Tax</th>
<th>Accessions Tax</th>
<th>Inclusion Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>10</td>
<td>16</td>
<td>12</td>
<td>8</td>
</tr>
</tbody>
</table>

In addition, Figure 6 shows that most OECD countries raise between .5% and 2% of revenues from wealth transfer taxes. Given that inheritances compose about 4% of household receipts this implies that inheritances are taxed at much lower rates than earned income, and nowhere near 60%. Indeed, the U.S. effective tax rate on inheritances is about 4%, or one-quarter of the rate applied to earned income. Comparisons to existing tax rates are inherently suspect because there is little reason to believe that any country's existing tax

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170 The average effective tax rate on income in OECD countries ranges from 20% to 50%. OECD, Revenue Statistics 1965-2006, at 39 chart A (2007).
A. The U.S. Estate Tax System

Focusing on the current U.S. federal tax treatment of wealth transfers, there are five elements, together referred to as the U.S. estate tax system. They are the estate tax, the gift tax, the generation-skipping transfer tax, the basic income tax treatment, and the income tax treatment of accrued gains.

The first element, the estate tax, was enacted in 1916 shortly after the income tax. As of 2009, it taxes lifetime gifts and bequests transferred in excess of $3.5 million at a 45% rate. Effectively, this means that a married couple can transfer $7 million to their children or other beneficiaries over their lifetimes, and all of the transfers will be tax-free. The estate tax is scheduled to disappear in 2010. As
illustrated in Table 4, it is then reinstated in 2011 at its 2001 levels, with a $1 million exemption and a top marginal tax rate of 55%.\textsuperscript{175}

The second component of the U.S. estate tax system is the gift tax. It has been a stable fixture of the U.S. tax system since its enactment in 1932, and prevents donors from avoiding the estate tax by making transfers to their heirs during life.\textsuperscript{176} As of 2009, gifts exceeding $1 million over the donor’s lifetime are subject to a 41% tax rate, with the tax rate rising to 45% for the portion of gifts in excess of $1.5 million.\textsuperscript{177} In addition, each year a donor can disregard $10,000 of gifts to a given heir, indexed for inflation (currently $13,000), meaning that these gifts do not count toward the lifetime exemption.\textsuperscript{178} Unlike the estate tax, the gift tax is scheduled to stay fairly constant in the coming years, although the top marginal rate is also scheduled to rise to 55% in 2011.\textsuperscript{179}

### Table 4

#### Scheduled Changes to the U.S. Estate Tax System

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Rate</th>
<th>Exclusions</th>
<th>Basis Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Estate &amp; GST</td>
<td>Gift</td>
<td>Annual Estate &amp; GST</td>
</tr>
<tr>
<td>2009</td>
<td>45%</td>
<td>41-45%</td>
<td>$13,000</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>35%</td>
<td>13,000</td>
</tr>
<tr>
<td>2011 onward</td>
<td>41-55%</td>
<td>13,000</td>
<td>$1 million</td>
</tr>
</tbody>
</table>

Third, there is the generation-skipping transfer (GST) tax. Congress enacted the GST tax in 1976 in response to concern that transfers di-

\textsuperscript{175} Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150. In 2011 and on, for estates between $1 million and $3 million, the marginal tax rate will rise from 41% to 55%. IRC § 2001 (c); Pub. L. No. 107-16, § 901, 115 Stat. 38, 150. For estates exceeding $3 million, the marginal tax rate will generally be 55%. A surtax that eliminates the lower brackets technically will result in an effective marginal tax rate of 60% on taxable estates between $10 million and $17.184 million. IRC § 2001(c)(2).

\textsuperscript{176} McDaniel et al., note 172, at 5; Revenue Act of 1932, Pub. L. No. 72-154, § 501, 47 Stat. 169, 245.

\textsuperscript{177} IRC §§ 2001(c), 2502, 2505.

\textsuperscript{178} IRC § 2503(b); Rev. Proc. 2008-66, 2008-2 C.B. 1107.

\textsuperscript{179} IRC §§ 2001(c), 2502.

\textsuperscript{180} The annual gift tax exclusion is inflation-adjusted so it may rise above $13,000 after 2009.
rectly to a donor's grandchildren were taxed only once under the estate and gift taxes, while transfers to a donor's grandchildren through her children were taxed twice.\textsuperscript{181} The GST tax imposes a second layer of tax on transfers to recipients who are two generations younger than the donor, and additional layers if the recipient's generation is further removed.\textsuperscript{182} Its exemptions and rates mirror those of the estate tax.\textsuperscript{183}

Collectively, these three taxes are traditionally referred to as the U.S. wealth transfer taxes. Under all three, a large portion of wealth transfers are tax-exempt. Transfers to spouses and charities are not taxed.\textsuperscript{184} Amounts paid during life for education, medical, or basic support expenses of heirs are similarly tax-exempt.\textsuperscript{185} There are also special provisions for transfers of certain closely held businesses to address concerns that the tax might otherwise force the sale of the business, as explained in more detail below.\textsuperscript{186}

In addition to these three wealth transfer taxes, the estate tax system includes the basic income tax treatment of gifts and bequests, and the income tax treatment of accrued gains on wealth transfers. As discussed, donors do not receive an income tax deduction for wealth transfers (other than those to charitable organizations). Recipients, however, may exclude amounts inherited from taxable income.\textsuperscript{187} Accrued gains on assets gifted during life receive carryover basis while bequests receive stepped-up basis.\textsuperscript{188} Like the estate tax, stepped-up basis is scheduled to disappear in 2010 and then return in 2011.\textsuperscript{189} During the bizarre year of 2010, recipients of bequests are scheduled to receive a carryover basis, but the tax due on up to $4.3 million in accrued gains on inherited property will be forgiven.\textsuperscript{190}

At the state level, roughly half of states have a wealth transfer tax, and the vast majority of these apply an estate and gift tax.\textsuperscript{191} Seven, however, apply annual inheritance taxes.\textsuperscript{192} Historically, the federal

\begin{footnotesize}
\begin{enumerate}
\item See Staff of the Joint Comm. on Tax’n, 94th Cong., General Explanation of the Tax Reform Act of 1976, at 564 (Comm. Print 1976).
\item IRC § 2611.
\item IRC §§ 2631(c), 2641.
\item IRC §§ 2055, 2056.
\item IRC §§ 2503(c), (e).
\item See notes 299–301.
\item IRC § 102(a).
\item IRC §§ 1014, 1015.
\item IRC §§ 1014(f), 1022.
\item Id. For this purpose, an inheritance tax is defined as a tax on gifts or bequests that is lower in certain circumstances if the donor gives to more donees. In all seven states, the tax only applies to bequests and a representative of the estate files the return. The seven
\end{enumerate}
\end{footnotesize}
estate tax offered a dollar-for-dollar credit for state wealth transfer taxes up to a limit, which effectively shared federal estate tax revenue with the states. This credit was repealed at the beginning of 2005 and replaced with a deduction for state wealth transfer taxes, although the credit is scheduled to reappear in 2011.\(^\text{193}\) Because the deduction is worth less than the credit, a number of U.S. states have repealed their wealth transfer taxes or allowed them to lapse in recent years, although fewer have done so than anticipated.\(^\text{194}\)

\[\text{WHAT SHOULD SOCIETY EXPECT FROM HEIRS?}\]

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\[\text{B. Benefits and Drawbacks}\]

The ongoing uncertainty about the future of the U.S. estate tax system creates large and costly tax planning incentives over the next several years, as well as morbid incentives on the eve of 2011. The need for legislative action is unfortunate, but it does create a window of opportunity for reform. This opportunity should be grasped because, while the current system has a number of advantages, it also has a number of disadvantages that can and should be addressed.

\[\text{I. Better Measuring Ability to Pay in Aggregate}\]

The principal advantage of the current estate tax system is its effect on the distribution of tax burdens at an aggregate level. Indeed, one could argue that its only flaw on this dimension is that it is not large enough. As illustrated in Figure 7, the average effective tax rate on inherited income in the United States will be about 4\% in 2009. This stands in contrast to the average tax rate of 18\% on income from work states with an inheritance tax are Indiana, Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania. CCH, Financial Planning Toolkit, Nebraska Estate Taxes, [http://www.finance.cch.com/pops/c50s15d170_NE.asp](http://www.finance.cch.com/pops/c50s15d170_NE.asp) (last visited Sept. 13, 2009); Comptroller of Maryland, Inheritance Tax, [http://individuals.marylandtaxes.com/estatetax/inherit.asp](http://individuals.marylandtaxes.com/estatetax/inherit.asp) (last visited Sept. 13, 2009); Indiana Dept’ of Revenue, Indiana Inheritance Tax: General Instructions (2001), [http://www.in.gov/dor/taxforms/pdfs/ih-fininst.pdf](http://www.in.gov/dor/taxforms/pdfs/ih-fininst.pdf); Iowa Dep’t of Revenue, An Introduction to Iowa Inheritance Tax (2007), [http://www.state.ia.us/tax/educate/78517.html](http://www.state.ia.us/tax/educate/78517.html) (last visited Sept. 13, 2009); Kentucky Revenue Cabinet, A Guide to Kentucky Inheritance and Estate Taxes (2003), [http://revenue.ky.gov/individual/inherittax.htm](http://revenue.ky.gov/individual/inherittax.htm) (follow “Guide to Kentucky Inheritance & Estate Tax” hyperlink); New Jersey Div. of Tax’n, Transfer Inheritance and Estate Tax (2008), [http://www.state.nj.us/treasury/taxation/pdf/other_forms/inheritance/itrbk.pdf](http://www.state.nj.us/treasury/taxation/pdf/other_forms/inheritance/itrbk.pdf); Pennsylvania Dep’t of Revenue, Instructions for Form Rev-1500: Pennsylvania Inheritance Tax Return, Resident Decedent (2006), [http://www.revenue.state.pa.us/revenue/lib/revenue/rev-1501.pdf](http://www.revenue.state.pa.us/revenue/lib/revenue/rev-1501.pdf).

\[\text{193} \quad \text{IRC \S\ 2058; Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, \S 532, 115 Stat. 38, 73.}\]

\[\text{194} \quad \text{By 2009, approximately twenty-three states still had wealth transfer taxes. Lokman, note 191. In the states that no longer had wealth transfer taxes, repeal largely occurred because their prior taxes were tied to and contingent on the federal estate tax credit. Robert Yablon, Defying Expectations: Assessing the Surprising Resilience of State Death Taxes, 59 Tax Law. 241, 245-46, 278 (2005).}\]
and saving (earned income) and the ideal posited above of a tax on the order of 60–80%.

**Figure 7**

Average Estate, Income, and Payroll Tax Rate on Inheritances and Earned Income

Notwithstanding its low effective rate, the estate tax does contribute importantly to the fairness of the tax system as a whole. As discussed, the estate tax system predominantly burdens very wealthy heirs, not donors. In doing so, it partially offsets the income and payroll tax advantages accorded to inherited income, especially among high-income and high-inheritance heirs. It also tends to mitigate the effect of inheritances on economic disparities and intergenerational mobility.

As illustrated in Figure 8, the effective estate tax rate on heirs with less than $200,000 of economic income is close to zero, but it rises rapidly with economic income thereafter. Thus, the estate tax system reduces the extent to which inheritances widen economic disparities by taxing high-income heirs much more heavily.

The estate tax also reduces the negative effect of inheritances on intergenerational mobility. Figure 9 shows that heirs inheriting less than $2.5 million bear little or no estate tax burden, but those inheriting even larger amounts often face substantial tax burdens. Given that intergenerational mobility is lowest at the ends of the economic distribution, the estate tax system appears to mitigate perhaps the most important contributor to the remaining elements of a hereditary class structure in the United States—extremely large inheritances.

195 The data is from Batchelder & Khitatrakun, note 23.
These effects of the estate tax system are especially important because otherwise extremely large inheritances are would receive the largest subsidies under the income and payroll taxes. As illustrated in

196 Id.
197 Id.
Figure 10, the income and payroll tax burden on households generally rises with economic income. This means the income and payroll tax exemptions for inherited income are most valuable for the most affluent heirs. The benefits of stepped-up and carryover basis (which are not included in Figure 10) are also much more valuable for them. Moreover, this calculation disregards the additional information that inheritances provide about an heir's ability and well-being. As argued above, if anything heirs should be treated as having more ability to shoulder fiscal burdens than individuals who earn the same amount but inherit less or nothing.

The estate tax system steps in to partially offset these tax preferences among high-income heirs. Figure 10 shows that it more than offsets the direct benefits of the income and payroll tax exclusions for inherited income among households with economic income in excess of $500,000. That is, the estate tax rate on inherited income is higher than the income and payroll tax rate on earned income among these

198 Untaxed appreciation represents about 35% of the value of all bequests and about 55% of the value of bequests exceeding $10 million. James M. Poterba & Scott Weisbener, The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death, in Rethinking Estate and Gift Taxation, note 24, at 422, 439-40.
199 The data is from Batchelder & Khitatrukun, note 23. Figure 10 somewhat overstates the income and payroll tax rates of low-income households because the income tax rate included is always non-negative.
WHAT SHOULD SOCIETY EXPECT FROM HEIRS?

households. Once one takes into account stepped-up basis, carryover basis, and the information inheritances provide about ability and well-being, however, the estate tax probably only partially offsets these tax preferences.\footnote{For example, if untaxed appreciation represents 55\% of the value of the inheritances of high-income heirs (the average percentage for bequests exceeding $10 million), then the average tax rate on inherited income should fall by roughly 8\% if the appreciation represents long-term capital gains, and by 14\% if it represents ordinary income. Poterba & Weisbenner, note 198, at 439.} Households that are less affluent, meanwhile, effectively retain most or all of the value of existing tax preferences for inheritances.

The estate tax, therefore, effectively reduces the extent to which heirs, as a group, are taxed at substantially lower rates than those who are self-made, given what we know about each group's endowment. And it does so especially among the extremely high-income and high-inheritance heirs whose economic status is most strongly influenced by the family into which they are born. These advantages stem from the fact that the estate tax's economic burdens fall predominantly on heirs, and it is the only component of the federal tax system that directly takes inherited wealth into account.

2. Inequities for Individual Heirs

While the estate tax does a good job of making the tax system more equitable at an aggregate level, it is intrinsically much less effective at doing so among individuals. Figures 11 and 12 illustrate this point. Figure 11 shows the number of heirs burdened by the estate tax by inheritance size, and Figure 12 shows the percentage of heirs inheriting different amounts who are burdened by the estate tax. Together, they illustrate that about 22\% of heirs burdened by the estate tax have inherited less than $500,000, while about 21\% inheriting more than $2,500,000 bear no estate tax burden. Further estimates in Appendix B illustrate that about one-half of heirs subject to the estate tax have economic income under $200,000. While these heirs account for only 10\% of estate tax revenue, the point remains that many low-income and low-inheritance heirs are burdened by the estate tax, while many heirs who are much better off are not.
FIGURE 11
Number of Heirs Burdened by 2009 Estate Tax by Inheritance Size

FIGURE 12
Percentage of Heirs Burdened by 2009 Estate Tax by Inheritance Size

The source of these individual-level inequities is the fact that the estate tax applies to the amount transferred rather than the amount received. Surprisingly, estate size is not a very good proxy for inheritance size. Figure 13 illustrates this point by plotting the inheri-

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201 The data is from Batchelder & Khitrakun, note 23.
202 Id.
tance of each heir relative to the size of the estate from which he inherited. The correlation is only .66. This divergence does not occur because parents treat children differently. Most wealth transfers are made to children and split evenly between them. Instead, it appears to be driven by the fact that donors have different numbers of children, and a substantial share have none. For example, Figure 14 shows that about 30% of inheritances come from donors with no children, and the plurality of these donors give to five or more beneficiaries. The net result of these varied giving patterns is that the estate tax system provides a rough justice approach to distributing tax burdens according to a comprehensive measure of income. But it systematically misallocates fiscal burdens at an individual level.

Figure 13
Inheritance Size versus Donor’s Taxable Estate Size

![Inheritance Size versus Donor’s Taxable Estate Size](image)

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203 The correlation remains surprisingly low at .83 if the data are weighted by inheritance size in order to focus on bequests with more revenue potential.

204 See Appendix B, Table A9.

205 To improve readability, current inheritance amounts over $10 million and distributable estates larger than $20 million are excluded. The donor’s taxable estate is the donor’s gross estate before taxes but after other expenses and spousal and charitable transfers. The diagonal lines in the scatterplot are the result of our imputation strategy described in Appendix A.
3. **Unnecessary Complexity**

In addition to creating inequities at the individual level, the current estate tax system involves a fair amount of unnecessary complexity. There is little evidence to suggest that the estate tax (or any wealth transfer tax) is systematically more complex than the income tax at comparably high income levels.\(^{206}\) Nevertheless, it is worth considering whether complexity can be reduced as part of any reform effort. There are five principal sources of complexity within the current estate tax system.

First, spouses presently face an incentive for each to transfer an amount equal to the lifetime exemption to their heirs in order minimize to their joint tax liability. This incentive arises because any unused exemption does not carry over from one spouse to the other. For those who take advantage of this incentive, complexities arise. For example, if a surviving spouse may need access to some of the transferred assets, tax advisors typically advise couples to create a credit shelter trust. This permits the first to die to treat assets as going to their heirs even though the surviving spouse still has some ongoing control.\(^{207}\)

Second, gifts generally are taxed much more lightly than bequests under current law. Gifts below the annual exclusion are tax-free, and

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\(^{206}\) Gale & Slemrod, note 70, at 1-2.

the estate tax applies to the pretax transfer, while the gift tax does not. As a result, the current estate tax rate on a pretax transfer is 45%, while the top gift tax rate on the same transfer is effectively 31%.208 Gifts are also tax preferred because only the nominal value of gifts counts toward the lifetime exemption. This means that a donor can use gifts to avoid paying tax on the asset’s appreciation between the time of transfer and her death.

To confuse matters further, while gifts generally are taxed more lightly than bequests, this is not always the case. Currently, the lifetime exemption under the estate tax is larger than under the gift tax. In addition, when transferred property is appreciated, bequests may be taxed more lightly because any tax due on the accrued gains is forgiven through stepped-up basis, but only deferred in the case of gifts.209

Fourth, current law creates substantial incentives to transfer wealth in the form of closely-held businesses.210 For example, certain business assets can be valued at less than their normal market value.211 There is also a special deduction for certain qualified family-owned business interests, which sunset in 2004 but is scheduled to return in 2011.212 In addition, payment of most estate taxes attributable to a closely held business can be deferred for five years and then spread over ten more years at a below-market interest rate.213 While ostensibly intended to protect family businesses from forced sales, these provisions tend to subsidize closely-held businesses, thereby creating incentives to invest in such assets purely for tax reasons.

Finally, a substantial portion of the complexity of our current system arises from the fact that wealth transfer taxes are imposed at the time of transfer, not when inheritances are received. While this feature does not necessarily create opportunities to undervalue transferred assets overall, it does create opportunities to allocate an unreasonably large proportion of the amount transferred to tax-exempt beneficiaries or beneficiaries subject to low tax rates. In response to such tax planning in the past, an enormously complicated body of rules has developed over time. For example, the rules governing grantor trusts, charitable trusts, spousal trusts, generation-skip-
ping trusts, and Crummey trusts are all designed, to some extent, to prevent donors from using split, contingent, revocable, or future interests in order to maximize the portion of their transfers subject to a low or zero tax rate.\textsuperscript{214}

4. \textit{Lack of Transparency}

The final disadvantage of the current estate tax system is political transparency. The fact that the estate and gift taxes focus by design on the donor drives the public to believe that their economic burdens also fall on donors in practice. Because all other major sources of income are subject to the income tax, many also erroneously may believe that heirs are taxed on their inherited income under the income tax.

These understandable misconceptions have been exploited by advocates of estate tax repeal who have framed the estate tax as a double tax on the frugal, hard-working, generous donor who is confronted by the taxman at the moment of death.\textsuperscript{215} This portrayal is far from accurate. As explained, the estate tax in fact predominantly burdens heirs. And it is generally the only tax that applies to extraordinarily large inheritances.\textsuperscript{216}

Nevertheless, the public could probably better understand the estate tax system's effects if its form more transparently embodied its function. Doing so would enable the public to make a more informed decision about how much resources heirs should have to share with society relative to those who personally earn their wealth.

IV. \textbf{A Better Way}

The U.S. estate system is thus clearly far from the ideal outlined in Part II. Its rates turn on the amount transferred rather than the amount received or the heir's total income. Its rates are also far below the level that existing empirical evidence suggests would be welfare-maximizing. While the estate tax contributes critically to the fairness of the tax system in aggregate, it creates a variety of inequities at an individual level. It entails a fair amount of unnecessary complexity. And it may distort public decisionmaking. Many of these disadvantages are understandable given administrative and political constraints. But there is a better way.

\textsuperscript{214} E.g., IRC §§ 676, 664, 666, 678.
\textsuperscript{215} See, e.g., Graetz & Shapiro, note 9, at 81-82.
\textsuperscript{216} The income and payroll taxes also may burden inheritances to the extent that donors reduce wealth that is ultimately transferred in response to them.
A number of commentators have proposed replacing the estate tax with an accessions or inclusion tax.\textsuperscript{217} The remainder of this Article proposes replacing it with a new option—a comprehensive inheritance tax—instead.\textsuperscript{218} For the reasons explained above, this type of inheritance tax should be more equitable and efficient than a pure accessions or inclusion tax. More importantly, the specific tax proposed would build on the strengths of the current system, while addressing its weaknesses wherever possible.

A. Ideal Taxation with Administrative and Political Constraints

Part II argued that the ideal wealth transfer tax given existing imperfect information is a comprehensive inheritance tax with an initial rate on the order of 60\% after a basic lifetime exemption. The real world, however, also involves administrative and political constraints. In order to develop a viable proposal, it is necessary to take these restrictions into account.

Administratively, there are several limits on any wealth transfer tax. First, it must include a significant annual exemption. The fact that transfers to spouses and support expenses for minor children are not counted as wealth transfers addresses this issue to a large extent. Nevertheless, an annual exemption is necessary even for adult children and other relatives to prevent individuals from having to keep track of ordinary gifts, such as those for holidays, birthdays, and weddings.

In addition, it is questionable whether the ideal altruistic subsidy would be administrable. One issue is the possibility of gaming. For example, two friends might each “give” each other the same $100 back and forth 1,000 times in order to generate $100,000 worth of subsidies. Theoretically, this strategy could be prevented by disregarding reciprocal gifts altogether because they may not be altruistically-motivated. But administratively this might be difficult, especially if more than two parties are involved. If so, the ideal subsidy would be smaller across the board.\textsuperscript{219} Another issue is whether the perfect benefit-offsetting tax could be implemented as a practical matter. If not,


\textsuperscript{218} Some commentators have favorably alluded to the possibility. See, e.g., Dodge, note 39, at 1177-79; Becker, note 217.

\textsuperscript{219} In the extreme, if the altruistic subsidy was based on gross and not net transfers and there were enough circular transfers, the subsidy could become infinite.
the ideal subsidy would be even smaller. Current empirical evidence, however, implies a positive tax on inheritances, and does not suggest any ways to disaggregate altruistic transfers. These challenges with respect to altruistic transfers are therefore not a practical issue.

Thus, once administrative constraints are taken into account, the probability-weighted ideal wealth transfer tax becomes a comprehensive inheritance tax with a basic lifetime exemption and a small annual exemption as well.

Accounting for political constraints modifies the ideal tax even more dramatically. As summarized at the outset, this Article assumes multiple political constraints, including that any reform proposal cannot raise more revenue than the 2009 estate tax. This appears to be the most likely political compromise if the estate tax is not replaced. It also assumes that there must be very large annual and lifetime exemptions. Such exemptions appear to be necessary for maintaining wealth transfer taxes given the emotional reaction they generate. Further, the Article assumes that the top marginal rate applied to inherited wealth cannot exceed 50%—both because it is a highly salient point for opponents and because it is, roughly speaking, the top rate

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220 Theoretically, it is not clear whether the optimal subsidy should be smaller or larger if the benefit-offsetting tax is not implemented; the answer depends on whether the actual financing structure is more or less distortionary than the benefit-offsetting tax. If, however, all taxes entail administrative and compliance costs, then it generally should be smaller. See Batchelder et al., note 156, at 44-46.

221 The conclusion is based on conversations with various individuals involved in the estate tax debate, as well as the fact that it is the proposal advanced by the current Administration. See Office of Management and Budget, A New Era of Responsibility: Renewing America's Promise 121 n.1 (2009), available at http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf.

222 This reaction may stem in part from the value many place on privacy within the family. It also may stem from the historic function inheritances served as form of social insurance, and the socially valuable role that parental support of children continues to serve.

As Mumford argues, the state may be sending conflicting messages when it taxes wealth transfers. On the one hand, the state appears to expect parents to support their children and extended family members to their own detriment. On the other hand, taxing ordinary wealth transfers sends a signal that they are frowned upon. Mumford, note 42, at 583. While it is certainly a controversial proposition that modern parents raise children to their own detriment, limited evidence from life satisfaction surveys and declining fertility rates suggests that this could be the case. See, e.g., Rafael Di Tella, Robert J. MacCulloch & Andrew J. Oswald, The Macroeconomics of Happiness, 85 Rev. Econ. & Stat. 809, 812 tbl.3, 813 tbls.4 & 5; Kahneman & Krueger, note 74, at 13 tbl.2; Daniel Gilbert, Does Fatherhood Make You Happy?, Time, June 19, 2006, at 70.

A third potential explanation for the emotional reaction many have against wealth transfer taxes, however, is that it is ephemeral—the result of effective lobbying and framing of an issue, which otherwise would not be very publicly salient. See generally Graetz & Shapiro, note 9, at 126-29.
applied to earned income.\textsuperscript{223} Finally, it assumes that accrued gains on inherited wealth generally cannot be taxed at the same point in time as the inheritance is taxed (though, perhaps, later),\textsuperscript{224} and that any proposal must eliminate the possibility that an heir would ever need to sell an inherited family business to pay the associated tax liability. The debate about family businesses and farms is simply too explosive.

Notably, this Article does not adopt the assumption embodied in some important prior work that constitutional, administrative, or political constraints prevent the United States from taxing capital income at socially-desirable rates through income taxes\textsuperscript{225} or a periodic wealth tax, thereby leaving wealth transfer taxes as the third-best option.\textsuperscript{226} This choice was made in part to avoid the debate about whether an income or consumption tax is superior.\textsuperscript{227} In addition, the first or second-best options appear to be constitutional, administrable,

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{223}] For example, if a married couple has $360,000 of capital income and the husband decides to work, his marginal federal tax rate initially will be about 47.6% (15.3% payroll tax plus 35% income tax on his earnings excluding the employer half of the payroll tax). Actually it would be somewhat higher due to the personal exemption phase-out, and somewhat lower if their other income was labor earnings so they exceeded the payroll tax wage base. See IRC § 151; Rev. Proc., 2009-50, 2009-45 I.R.B. 617 (Nov. 9).
\item[\textsuperscript{224}] This assumption is based in part on the Canadian experience where many view wealth transfer tax repeal as a reaction to the enactment of realization at death. See, e.g., Richard M. Bird, Canada's Vanishing Death Taxes, 16 Osgoode Hall L.J. 133, 137 (1978) (citing E.J. Benson, Summary of 1971 Tax Reform Legislation 33 (1971)); David G. Duff, The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand, 3 Pitt. Tax Rev. 71, 99-107 (2005). It is also based on the fact that repeal of stepped-up basis is often considered as the principal alternative to the estate tax in the U.S. context.
\item[\textsuperscript{226}] See, e.g., Andrews, note 12, at 589-91; Michael J. Graetz, note 12, at 284-85.
\item[\textsuperscript{227}] Such an argument for wealth transfer taxes is based on the assumption that an income tax or hybrid income-consumption tax is optimal.
\end{enumerate}
\end{footnotesize}
and potentially politically feasible.\textsuperscript{228} The implications if they are not, have been well addressed by others.\textsuperscript{229}

These assumptions obviously limit the reform options considerably. They imply that the ideal approach should be a comprehensive inheritance tax that is expected to raise the same amount of revenue as 2009 law, has large annual and lifetime exemptions, and tops out at a rate around 50%. The ideal tax also should not treat transferring wealth as a realization event or entail forced sales of illiquid assets. With these numerous constraints in mind, the specific proposal is outlined next.

B. A Proposal for a Comprehensive Inheritance Tax

1. Overview

The inheritance tax system proposed here represents a fundamental shift in the approach to taxing wealth transfers. There would no longer be a wealth transfer tax system that operates independently of the income tax, and the focal point of taxation would no longer be the amount transferred. Instead, the focus would be the amount received. To address the political constraints described above, the proposed comprehensive inheritance tax would include inheritances above a large lifetime exemption of $1.9 million in income and subject them to a 15% surtax. The lifetime exemption level was selected because the proposal would then raise approximately the same amount of revenue as the 2009 estate tax.

The specific features of the proposal are as follows: First, if a taxpayer inherits more than $1.9 million over the course of his lifetime, he would be required to include amounts inherited above this threshold in his taxable income under the income tax. The portion above

\textsuperscript{228} For example, at least four countries (France, Norway, Spain, and Switzerland) currently apply a periodic wealth tax, and many others have in the recent past (for example, Finland, Iceland, Luxembourg, Sweden). See Int'l Bureau of Fiscal Documentation, European Tax Surveys, note 164. At least five countries (Australia, Canada, Estonia, Ireland, and the United Kingdom) tax accrued gains on gifts or bequests at the time of transfer. See Appendix C. In addition, capital income could be taxed at higher effective rates through such strategies as raising income tax rates on capital gains, dividends, and interest, repealing business tax expenditures, ending deferral for foreign source income of U.S. residents, and more far-reaching business income tax reform. See, e.g., Impact of International Tax Reform on U.S. Competitiveness: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means, 109th Cong. 109-82 (2006) (statement of Stephen E. Shay, Partner, Ropes & Gray LLP); Harry Grubert & Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, in Fundamental Tax Reform: Issues, Choices, and Implications 319 (John W. Diamond & George R. Zodrow eds., 2008); Edward D. Kleinbard, Rehabilitating the Business Income Tax (Brookings Inst., Hamilton Project Discussion Paper No. 2007-09, 2009), available at http://brookings.edu/papers/2007/06corporatetaxes_kleinbard.aspx.

\textsuperscript{229} See, e.g., Andrews, note 12; Graetz, note 9.
this $1.9 million threshold would also be subject to a 15% surtax.\textsuperscript{230} To state the obvious, $1.9 million is a lot of money. An individual who inherits $1.9 million at age twenty-one can live off his inheritance for the rest of his life without him or his spouse ever working, and his annual household income will still be higher than that of nine out of ten American families.\textsuperscript{231} Thus, the proposal would effectively exempt all transfers that are conceivably made to take care of a low-ability relative. The exemption permits any heir to live quite well, without ever working.

If political interest in raising revenue through wealth transfer taxes increases, a lower exemption would be preferable. Table 5 lists the lifetime exemption that would be revenue-neutral against alternative baselines. For example, a lifetime exemption of $1 million would raise $29 million, 66% more than 2009 law. An heir receiving this amount would still be able to purchase of a lifetime annuity providing annual income well above the median household.\textsuperscript{232}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
\textbf{Law} & \textbf{Exemption (millions)} & \textbf{Rate} & \textbf{Bush Income Tax Cuts} & \textbf{Exemption (millions)} & \textbf{Surtax} & \textbf{Revenue (billions)} \\
\hline
Proposal & $3.5$ & 45\% & Yes & $1.9$ & 15\% & $17.5$ \\
2009 & 3.5 & 45\% & Yes & 1.6 & 10\% & 17.5 \\
2008 & 2.0 & 45\% & Yes & 1.1 & 15\% & 26.2 \\
2008 & 2.0 & 45\% & Yes & 1.0 & 10\% & 26.2 \\
2011 & 1.0 & 41-55\% & No & 0.5 & 15\% & 50.2 \\
2011 & 1.0 & 41-55\% & No & 0.4 & 10\% & 50.2 \\
2011 & 1.0 & 41-55\% & Some** & 0.5 & 15\% & 50.2 \\
- & - & - & Yes & 1.0 & 15\% & 29.0 \\
\hline
\end{tabular}
\caption{Estimated Revenue Effects in 2009 of Estate Tax System and Proposal Under Alternate Revenue Baselines*}
\end{table}

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

\textsuperscript{230} While the proposed top marginal tax rate of 50\% exceeds that imposed on the vast majority of earned income due to the regressivity of the payroll tax, it is theoretically possible that an individual's earned income can be subject to this marginal tax rate if he has a large amount of capital income. See note 223.

\textsuperscript{231} Author's calculations based on a 7\% inflation-adjusted interest rate and U.S. Census Bureau, Table A-3: Selected Measures of Household Income Dispersion 1967 to 2008, http://www.census.gov/hhes/www/income/histinc/IE-1.pdf. An inheritance of $1.9 million would produce inflation-adjusted annual income of about $125,000 to age ninety-seven.

\textsuperscript{232} Author's calculations based on identical assumptions as in note 231. An inheritance of $1 million would produce inflation-adjusted annual income of about $66,000 to age ninety-seven. In 2007, median household income was $55,233 and mean household income was $67,609. U.S. Census Bureau, Table H-6: Regions—All Races by Median and Mean Income 1975-2007, http://www.census.gov/hhes/www/income/histinc/h06AR.html.

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Under the proposal, bequests that are included in income could be spread out over the current year and the previous four years in order to smooth out the income spike and corresponding tax burden, while minimizing work disincentives. Losses would be disregarded in calculating the tax rate on inherited income in order to limit tax planning incentives. In addition, each year $13,000 in gifts and $65,000 in bequests could be disregarded entirely, meaning that they would not count toward the $1.9 million exemption. This would effectively lower the current annual exclusion for couples (because it applies on a per donor basis), while maintaining some continuity with current law. It also would eliminate reporting obligations for more than two-thirds of the individuals who actually receive a bequest. In order to further limit reporting obligations for wedding gifts and the like, a taxpayer would not have to count toward the annual exclusion gifts received from a given donor over the course of the year that totaled less than $2,000, even if the annual sum of such gifts from multiple donors exceeded $13,000. All of these thresholds and the amount of prior inheritances would be adjusted for inflation.

The following example illustrates how the proposal would work for a regular heir.

Example 1: Regular Beneficiary. Heir A receives a bequest of $3 million above the $65,000 annual exemption and has not received inheritances exceeding the annual exemptions in any prior year. Heir A would include only $1.1 million of the bequest in his taxable income. The $1.1 million would be taxed under the same rate structure as his other ordinary income plus 15 percentage points. Because the income tax brackets rise with income, this might mean that the taxable portion of his bequest would fall within a higher tax bracket because he received it all at once. To limit this effect, the taxpayer could elect to file as if he received only $220,000 of taxable inheritance in the current year and the same amount the previous four years.

From an administrative perspective, the heir would be responsible for filing an annual return reporting cumulative gifts and bequests exceeding the annual exemptions. Because third-party reporting is essential for maximizing compliance, donors or their estates also would have to report information on transfers above these annual exemp-

\[233\] Otherwise, heirs who knew when they were likely to receive a bequest would face incentives to generate losses, for example from closely-held businesses, in the years running up to receiving the inheritance.

\[234\] See Figure 1.
tions and remit a withholding tax. The heir would be responsible for claiming any excess tax withheld and paying any excess tax due if his lifetime reportable inheritances exceeded $1.9 million.

Despite this fundamental change in the form of wealth transfer taxation, the proposal would continue to rely on much of the extensive body of laws, regulations, and guidance that have been developed under the U.S. estate tax system. For example, the existing rules governing when a transfer has occurred, how it is valued, and what transfers are taxable would remain unchanged. The proposal would not tax a large portion of wealth transfers, as under current law. Transfers from spouses and for basic support expenses for minor children would continue to be disregarded entirely. In addition, the income tax treatment of donors would remain unaltered. To the extent that the current tax treatment of accrued gains, generation-skipping transfers, income in respect of a decedent, illiquid assets, charitable contributions, and gifts made during life for education and medical expenses are considered desirable or politically necessary, these exemptions could be maintained. These issues, however, are considered in the next Part.

Moving to a comprehensive inheritance tax, however, would permit a different and simpler method for taxing split or contingent transfers, for example through trusts. As explained above, such contingent transfers are the source of some of the greatest complexity in current law. Rather than following the current approach, the proposal would apply an approach developed by William Andrews and wait to see who gets what before taxing transfers for which the taxable status of the beneficiary is unclear. In the meantime, it would impose a withholding tax that would incorporate any relief provisions for illiquid assets generally. When an heir eventually received his inheritance, he would receive a refund if the amount withheld on his share of the funds was more in present-value terms than the tax he actually owed (using an interest rate equal to the rate of return earned on the transferred assets). Essentially, this approach is economically equivalent to the tax system having perfect foresight regarding which potential beneficiaries will receive what. Example 2 illustrates how it would work.

Example 2: Contingent Beneficiary. Donor B transfers $10 million above the annual gift exclusion of $13,000 to a trust and the trustee has discretion to determine the ultimate ben-

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eficiary. Ten years pass, the trust assets double, and the trustee distributes all the trust assets to Heir C.

At the time of the transfer, a withholding tax would be imposed on the amount above a single beneficiary’s lifetime exclusion, or $8.1 million, at the highest possible rate of 50%. Thus, the amount withheld would be $4.05 million, the effective withholding tax rate would be 40.5%, and the trust assets after the withholding tax would be $5.95 million.

After ten years, the trust assets double to $11.9 million. Heir C would calculate a credit ratio equal to the amount of tax withheld ($4.05 million) divided by the trust value after the withholding tax ($5.95 million), or 68%. He would then receive a refundable credit equal to the amount distributed ($11.9 million) times the credit ratio (68%), or $8.1 million. The refundable credit would be considered part of his inheritance, bringing his taxable inheritance on the distribution to $20 million. He would then pay tax on his taxable inheritance with the exemption amount equal to the exemption in place at the time of the transfer to the trust, but indexed to the rate of return on the funds, or $3.8 million.

Suppose his effective tax rate on inheritances with this exemption is 30% because he is in a low income tax bracket. Then he would initially owe $6 million in taxes. After claiming the credit, however, he would receive a net refund of $2.1 million (the $8.1 million refundable credit minus the $6 million initially owed in taxes). His after-tax inheritance would be the amount distributed ($11.9 million) plus the refund ($2.1 million), or $14 million. In present value terms, this is the same amount he would have received after tax if Donor B had transferred the original $10 million to him directly, instead of through a discretionary trust, and if his effective tax rate was also 30% at that time.

Finally, the proposal would tax transfers to grandchildren (and more distant lineal descendants) as if the amount inherited had first passed first to their parents (and any additional skipped generations), and only then to the actual heirs. In practice, this would be accomplished by applying an implicit tax to the skipped heir at the top tax rate, unless the recipient presented evidence of what the skipped heir would have owed if the funds had actually passed to them initially.237

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236 This would, admittedly, result in substantial overwithholding.
237 For example, a grandchild might show that his parent died before the transfer by the grandparent and had not received any other substantial inheritances. In this case, the grandchild would also have to agree with his siblings, if any, how their parent’s lifetime
This treatment should apply regardless of whether the transfer is made directly or through a trust. The rationale for retaining a tax on generation-skipping transfers is explained below.

Table 6 summarizes the main differences between the proposal and current law.

<table>
<thead>
<tr>
<th></th>
<th>2009 Law</th>
<th>Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on bequests</td>
<td>45% to extent lifetime gifts and bequests made exceed $3.5 million</td>
<td>Income tax rate plus 15 percentage points to extent lifetime gifts and bequests received exceed $1.9 million</td>
</tr>
<tr>
<td>Tax on gifts</td>
<td>45% to extent lifetime gifts made exceed $1 million</td>
<td></td>
</tr>
<tr>
<td>Annual exclusion</td>
<td>$13,000 of gifts made per recipient</td>
<td>$13,000 of gifts received; $65,000 of bequests received</td>
</tr>
<tr>
<td>Transfers where</td>
<td>Rules governing grantor trusts,</td>
<td>Wait and see.</td>
</tr>
<tr>
<td>tax rate of beneficiary</td>
<td>marital trusts, charitable trusts, and Crummey trusts</td>
<td></td>
</tr>
</tbody>
</table>

2. **Advantages**

Shifting from the current system to the proposed inheritance tax would have a number of advantages. It would more fairly allocate economic burdens among heirs. It would improve the incentives faced by donors and heirs, and likely reduce the level of tax complexity to some degree. Finally, by more transparently taxing heirs, it could strengthen political support for taxing inheritances in the first place. Over time, the wealth transfer tax system might then move closer to the unconstrained ideal.

a. **More Equitable**

The most important benefit of the proposal is that it would enhance social welfare by more accurately measuring ability to pay. By directly including large inheritances in the tax base, it captures the information about endowment that large inheritances provide both directly and indirectly. As a result, it generates a more equitable allocation of fiscal burdens and benefits. As explained above, the estate tax does a

exemption would be allocated among them. For further details on implementing a generation-skipping transfer tax within an inheritance tax adopting the wait-and-see approach, see Edward Halbach, Jr., An Accessions Tax, 23 Real Prop. Prob. & Tr. J. 211, 240-48 (1988).
good job of performing this function within the federal tax system as a whole. But the proposal would do a much better job.

**Figure 15**

*Average Tax Rate on All Inheritances by Heir’s Economic Income*\(^{238}\)

**Figure 16**

*Average Tax Rate on All Inheritances by Inheritance Size*\(^{239}\)

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\(^{238}\) The data is from Batchelder & Khittrakun, note 23.

\(^{239}\) Id.
In aggregate, the distributional effects of the proposal are fairly similar to the estate tax system. As illustrated by Figures 15 and 16, the proposal is somewhat more progressive by economic income and inheritance size, but the differences are not dramatic. Heirs with economic income of less than $500,000 or inheritances below $2.5 million bear higher average tax rates under the estate tax. Meanwhile, those with economic income or inheritances exceeding these amounts bear higher burdens under the proposal.

In reality, the proposal would probably be even more progressive than the current system because these estimates assume no behavioral response. To the extent that donors respond to the incentives created by the proposal to give more widely and to those with less pre-inheritance income, pretax inheritances should become more progressive. As explained below, there is little, if any, evidence on which to base an estimate of this response.

While the two approaches have fairly similar distributional effects in aggregate, however, the proposal would allocate burdens much more fairly at an individual level.241 For example, Figure 17 shows that, among all of the heirs who would be burdened by either tax in 2009, only 30% would be burdened by both. Indeed, a full 63% of

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240 Id.

241 Interestingly, these individual-level differences between the estate tax and the proposal would not be narrowed if the estate tax were revised so that the donor could claim exemptions for the number of children she had in addition to an exemption for herself. See id.
heirs who are burdened by the estate tax would bear no tax burden whatsoever under the proposal. This implies that about two-thirds of those burdened by the estate tax have inherited less than $1.9 million. Meanwhile, another large group—one-quarter of the number burdened by the estate tax—would only be burdened by the proposal, implying that they have inherited more than $1.9 million but bear no estate tax burden presently.

The essential reason why these differences arise is that not all large inheritances come from the largest estates, and not all smaller inheritances come from smaller ones, as illustrated in Figure 13 and explained by Figure 14. For example, consider two taxable estates of $9 million where the donors have not made any prior gifts. Both would be subject to an average estate tax rate of 28%. One estate could be left entirely to a single heir who is in the top income tax bracket and who has received $1 million in prior inheritances, while the other could be left pro rata to six heirs with no prior inheritances. In the former case, the inheritance tax rate would be 45%, but in the latter it would be zero.

Taking the opposite perspective, suppose two heirs both have economic income of $1.2 million if one-fifth of bequests are included when measuring economic income. One might have earned $200,000 in income and inherited $5 million from an estate worth $5 million. The other might have the same amount of earned income and inheritance, but have inherited from an estate worth $30 million. Both would bear the same inheritance tax burden of 31%, but the former's estate tax rate would be 14%, while the latter's would be 40%.

In aggregate, if there were roughly the same amount of heirs in both of these categories, the estate and inheritance tax rates would be quite similar. But at an individual level, their tax rates would vary dramatically.

The differences between the estate tax system and the proposal can be understood still further by considering the effects on heirs who would be burdened by both taxes. These heirs account for the lion's share of revenue raised under either tax (about 90%). Many, however, would be subject to a very different tax rate under the proposal. As a result, 30% of the burden of the new tax in dollar terms would fall on different heirs.
Figure 18
Average Tax Rate on Inheritance of Individual Heirs Under Estate Tax and Proposal (Weighted by Inheritance Size)

This variance in tax burdens can be seen in Figure 18, which focuses on those heirs who would be burdened by either tax (that is, in one of the circles in Figure 17) and plots the average tax rate under the estate tax and proposal that each heir would face.\textsuperscript{242} Along the y-axis are heirs who are burdened only by the inheritance tax. Along the x-axis are heirs who are burdened only by the estate tax. In between are heirs burdened by both. On average, the estate tax rate rises with the inheritance tax rate, and vice versa. Figure 18 illustrates, however, that the 30% of individual heirs who are burdened by both tax systems often face dramatically different rates under one system versus the other. Indeed, the correlation\textsuperscript{243} in Figure 18 is only .71 when weighted by inheritance size (or .33 when not),\textsuperscript{244} which is quite low.

\textsuperscript{242} Each point represents an heir and each circle represents multiple heirs. Every point in between the two axes represents the 30% of burdened heirs who are subject to both taxes.

\textsuperscript{243} Correlation is a measure of the tendency of two variables to increase or decrease together.

\textsuperscript{244} It is more appropriate to weight the figure by inheritance size if one is interested in how many inherited dollars, versus people, are taxed at different rates. In addition, weighting by inheritance size may be more appropriate if donors tend to allocate a fixed dollar amount to heirs receiving small bequests (with the remainder going to their more important heirs) or if donors respond to the incentives created by an inheritance tax to give
The square (the $R^2$) suggests that only 50% of the inheritance tax rate of individual heirs is directly accounted for by factors that determine the heir’s estate tax rate, and vice versa.245

Finally, the individual-level differences between the two systems can be understood by considering the estimated winners and losers from the proposal. Overall, there would be more than twice as many heirs who are winners (18,000) as there are losers (8,000) each year. The vast majority of winners would be individuals inheriting less than $2.5 million. Moreover, as illustrated by Figures 19 and 20, the amounts gained and lost would be substantial. Heirs who inherit more than $50 million would owe about $5.3 million more in taxes on average. Similarly, those with economic income of more than $5 million who lose under the proposal would pay about $2.2 million more on average. On the other hand, heirs with economic income of less than $200,000 on average would save $62,000—more than one-third of their income. While very few in this group are burdened by the current estate tax system, this group represents about 95% of heirs.

Figure 19
Average Change in After-Tax Income of Winners and Losers by Economic Income

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more to more people. In the former case, heirs receiving relatively small bequests bear no tax burden under the estate tax or the proposed inheritance tax. In the later case, heirs receiving relatively small bequests benefit rather than being burdened by the inheritance tax. Either way, they should be weighted less heavily than heirs receiving relatively large inheritances.

245 The figure is 11% if the variables are not weighted by inheritance size.
FIGURE 20
Average Change in After-Tax Income of Winners and Losers by Inheritance Size

These substantial distributional differences in the burdens of the estate tax and the proposal essentially quantify the proposal’s advantages from a fairness perspective. Each time the proposal applies a higher or lower tax rate to an heir, it is more accurately measuring economic income. In doing so, it is more equitably allocating fiscal burdens and benefits.

b. Better Incentives

In addition to the advantages just described, the proposal could result in a fairer allocation of pretax income by creating a more equitable and efficient pattern of incentives for donors and heirs. On the one hand, its substantial exemption would protect and encourage all of the familial economic support that an individual could conceivably need. On the other hand, by gradually taxing inherited wealth in excess of this amount, it would encourage extremely wealthy donors to direct further wealth transfers to individuals who otherwise would not be so fortunate. It would also encourage their existing heirs to use their talents to earn additional wealth themselves. Neither an estate tax, nor a tax system that ignores wealth transfers, can create this pattern of incentives.

How much donors would actually respond to these changed incentives is uncertain—there are essentially no studies regarding the price elasticity of how wealth transfers are distributed among nonspousal, nonlineal heirs. Some donors do seem willing to adjust gifts for their children’s income, but doing so is much less common for bequests.\footnote{\textsuperscript{246}\textsuperscript{246} See, e.g., McGarry, note 50, at 321-24.}
which comprise the vast majority of wealth transfers. Instead, the norm for bequests is equal sharing among children, presumably because donors are concerned about sibling tensions or hurt feelings that they cannot discuss after death. There is also some evidence that donors are willing to transfer more to grandchildren and other lineal descendents when they face financial incentives to do so. For example, donors frequently use up the generation-skipping tax exemption.\textsuperscript{247} The proposal, however, would only create incentives to give to nonlineal relatives and nonrelatives, and donor responsiveness on this margin may differ systematically. Finally, there is limited evidence that wealth transfers are distributed more broadly in countries with an inheritance tax than in the United States.\textsuperscript{248} But this may stem from the fact that these other countries tend to have lower levels of economic inequality more generally. As a result, even if wealth is only transferred to children, inheritances should be distributed more evenly in these countries.

In short, there is no empirical basis for estimating how much donors would respond to the proposal’s incentives to give more broadly. This is why such a behavioral response is not included in the revenue and distributional estimates of the proposal. Nevertheless, given the general human tendency to respond to financial incentives, donors should respond by distributing inheritances more widely, if only slightly. To the extent they do, pretax inheritances would be distributed more equally, and the fairness advantages of the proposal would increase.

c. Less Complex

The third subtle but important advantage of the proposal is its potential for simplification. In general, there are two types of costs that taxpayers bear. A tax system can impose direct compliance burdens on taxpayers, for example, by requiring them to spend multiple hours reading instructions and filing returns. It also may impose indirect compliance burdens—which are typically more costly—by creating incentives to structure transactions in ways that are economically identical but taxed more lightly.

The proposal could slightly increase direct compliance costs because more tax units will have to file returns, especially on an informational basis. There would be about twice as many taxable returns under the


\textsuperscript{248} See Laitner & Ohlsson, note 137, at 212-19.
WHAT SHOULD SOCIETY EXPECT FROM HEIRS?

proposal. While this is a substantial increase in percentage terms, both taxes only burden a tiny fraction of the population. About 3 in 1000 estates bear some estate tax burden annually, and about 3 in 1000 heirs would bear any inheritance tax burden.249

The more important source of new filing burdens would be the requirement that heirs and donors report (but not pay tax on) gifts and bequests falling above the annual exclusions. As noted, however, more than two-thirds of heirs receive bequests smaller than the $65,000 exemption.250 Those who receive a larger bequest would simply have to report its receipt.

Turning to the more costly indirect types of compliance burdens, the proposal should reduce compliance burdens on net. Admittedly part of the way it would do so is by reducing tax planning incentives that could be addressed just as well within the current system, but have not been to date.

For example, the proposal would eliminate the need for careful planning of spousal transfers in order to maximize use of the lifetime exemptions. This problem could be addressed under current law by permitting spouses to carryover the lifetime exemption. Under the proposal, however, even carryovers would be unnecessary. Any tax would be based on the amount the heir receives, regardless of whether it was from his mother or father or someone else. As a result, it would not matter which spouse makes the transfers.

In addition, the proposal would significantly narrow the current substantial differences in the taxation of gifts and bequests. Unlike the current estate tax system, the same lifetime exemption would apply, and the tax rate would always apply to the pretax inheritance. Indexing the lifetime exemption and prior inheritances to inflation would also reduce the incentive to transfer (or appear to transfer) wealth earlier in time, when the present value of the exemption is higher.

Again, these problems could be addressed within current law. In some cases, however, the solution would be less intuitive and thus might more difficult to achieve politically. For instance, in order to apply the same tax rate to gifts and bequests in an estate tax system, gifts have to be grossed up by the tax due when applying the tax rate. In an inheritance tax system, where the tax is paid by the heir, this is unnecessary.

The proposal would also reduce tax planning incentives, however, in important ways that an estate tax system never could. In particular, by waiting to see how much is received by whom, it would reduce the

249 See Appendix B, Table A12.
250 See note 234 and accompanying text.
incentive to try to shift value to tax-exempt spouses and charities when the ultimate beneficiary is unclear. This wait-and-see approach would create more valuation points, which potentially could create further opportunities for valuation games if not dealt with correctly. But any new planning costs should be swamped by the fact that the wait-and-see approach eliminates the need for a wide swath of existing valuation rules. These include the rules governing marital trusts, charitable trusts, grantor trusts, and Crummey trusts, which together compose one-fourth of a leading casebook. An estate tax cannot accomplish this simplification because it cannot adopt the wait-and-see approach. Because its tax rate is based on the amount transferred, and not on the amount received, it has to be levied at the time of transfer.

Finally, the administrative costs for the government that typically accompany compliance costs should decline in response to the proposal. At first blush, one might think that the proposal would increase administrative burdens if more information returns were filed, and if taxes on inheritances were not always levied immediately at the time of transfer. But the government's administrative burdens should ultimately be lower as the number of rules and gaming opportunities that it has to police declines.

Moreover, experience in other jurisdictions suggests that an inheritance tax is administratively feasible. Each component has been successfully implemented at a state or federal level in the United States or in other countries as illustrated in Appendix C. Indeed, the United States had an inheritance tax during parts of the late nineteenth and early twentieth centuries. Seven U.S. states and at least twenty-five countries currently impose some kind of inheritance tax.

Thus, overall, the proposal should decrease compliance burdens by reducing a number of necessary and unnecessary sources of complexity within an estate tax system. Together, the reduction in compliance burdens associated with fewer planning opportunities will likely exceed any burdens imposed by any new filing obligations. Furthermore, this reduction should be mirrored at the governmental level. With fewer rules to enforce and fewer tax planning strategies to address, administrative costs should decline as well.

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251 McDaniel et al., note 207.
252 Id. at 3-4.
253 See Appendix C; note 192.
d. **More Politically Transparent**

The final benefit of the proposal is that it would render the tax system more politically transparent. This transparency may be valued in its own right—a government whose workings are more transparent should have more democratic legitimacy. In addition, if one accepts this Article’s argument that the current level of wealth transfer taxation is too low, it should be valued instrumentally.

Few voters currently understand how wealth transfers are taxed, and with what effects.\(^{254}\) This is probably partially due to low levels of knowledge about the tax system in general.\(^{255}\) But it also likely due to the fact that the form of our wealth transfer tax system disguises its effects.

By taxing the donor on her estate, the estate tax system appears to burden the person giving, a person who may have earned all of her wealth and just died. It appears to tax generosity and success. The proposal, by contrast, places the statutory burden of the tax on the recipients of large windfalls, who generally only received the inheritance because of their lucky birth. Its form more clearly embodies its function. It appears to tax affluence and advantage.

One may object that form should have little impact on rates because wealth transfer tax rates differ little cross-nationally and most other countries have an inheritance tax. The form of these inheritance taxes, however, is also important. Only a few countries include gifts in taxable income and none include bequests.\(^{256}\) As a result, the fact that large inheritances are exempt from the income tax remains largely hidden. Thus, the final advantage of the proposal is that it could expose this exclusion and, in the process, potentially reinvigorate public support for taxing inheritances in the first place.

### 3. Potential Questions and Concerns

Despite these advantages, the proposal is likely to generate a number of questions and concerns because it represents such a fundamental change to our current system. This Subsection considers six.

#### a. **Doesn’t the Proposal Give an Unfair Advantage to Bigger Families?**

One common initial reaction to the idea of replacing the estate with an inheritance tax is to point out that it will impose lower tax burdens

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\(^{254}\) See, e.g., Graetz & Shapiro, note 9, at 126-29.
\(^{255}\) Id. at 122.
\(^{256}\) See Appendix C.
on donors with larger families. Whether this is unfair depends on the incidence of a tax on wealth transfers and one’s views of why we should tax gifts and bequests.

As discussed above, heirs bear most of the burden of wealth transfer taxes, not donors. In addition, the view taken in this Article is that wealth transfer tax rates should turn on the amount inherited, both for efficiency reasons and because of their direct and indirect effects on heir well-being and earning potential. In this view, it is eminently fair for gifts and bequests by donors with larger families and the same net worth to bear lower tax burdens.

For example, if one child has nine siblings and they each inherit $1 million from their parents, that child is substantially less well-off than a child who has no siblings and inherits $10 million from his parents. Not only has he received less financially, but he is also likely to have received less time and attention from his parents, and thus less human and social capital. Indeed, studies have found that individuals with few siblings earn, on average, 50% more than individuals with many.257

b. Why Not Tax Inheritances from Relatives at a Lower Rate?

Another common question is to point out that most jurisdictions with inheritance taxes impose lower tax rates on inheritances from relatives and to ask why the proposal does not follow this practice. After all, doesn’t it discourage giving to your children?

It is true that every U.S. state and nineteen of the twenty-three countries with an inheritance tax impose higher taxes on gifts and bequests received from nonrelatives. Often, the tax rate rises or the exempt amount falls as the relationship to the donor becomes more attenuated. Inheritances from parents bear the lowest tax rates. Inheritances from aunts and uncles may bear higher rates, and inheritances from nonrelatives bear the highest rates of all.258 The rationale

257 Anders Bjorklund & Markus Jantti, The Impact of the Number of Siblings on Men’s Adult Earnings: Evidence from Finland, Sweden and the United States 9, 11, 17 tbl.2 (Sept. 22, 1998), available at http://www.ciln.mcmaster.ca/papers/cc98/fiseus.pdf. The Bjorklund and Jantti study finds that individuals with zero to two siblings on average have 50% higher earnings than those with seven or more siblings when controlling for age and age squared. Once other controls are introduced, the effect is about half as small. Arguably the uncontrolled statistic is more instructive because the controls include things like parental education, for which taxes generally cannot be adjusted. For further studies on the subject, see Dalton Conley, The Pecking Order: A Bold New Look at How Family and Society Determine who We Become (2005); Sandra E. Black, Paul J. Devereux & Kjell G. Salvanes, The More the Merrier? The Effect of Family Size and Birth Order on Children's Education, 120 Q.J. Econ. 669, 695, 696 tbl.IX (2005).

258 For example, in Finland, the ratio of the tax rate applied to inheritances from one’s parents, aunts or uncles, and non-relatives is 1:2:3. In Germany, both the rate rises and the
for this practice is unclear. Most likely it stems from concerns about spouses and children being unreasonably disinherited, and the general social approval accorded to giving to one’s family.

While this concern about incentives to give to children is understandable, it misses the point. An inheritance tax does not encourage giving more to nonrelatives than to one’s children: It simply seeks to tax all people on all of their financial capacity and not let the most advantaged off the hook at the expense of regular people who do not receive vast inheritances.

Because the tax rates on inherited income are progressive under the proposed inheritance tax, the practical effect is to encourage broader and more equal giving, including to nonrelatives who have inherited little or nothing from their own families. But this is not a drawback. Such broader and more equal giving breaks up family wealth dynasties, softens inequalities of opportunity, and can help narrow economic disparities. This is one area in which the ordinary practice in other jurisdictions with inheritance taxes should not be followed.

c. Why Include a Generation-Skipping Transfer Tax?

While existing inheritance taxes typically tax transfers to relatives more lightly, the U.S. estate tax system does the reverse and taxes one type of familial wealth transfer more heavily: those from grandparents to grandchildren. This raises a third (and opposite) question: Why not tax inheritances from closer relatives more heavily? After all, doing so should break up hereditary class structures more quickly, and should account for the fact that inheritances received from close relatives probably provide better indirect information about the heir’s endowment than those received from distant relatives and strangers.259

The proposal does not adopt this approach because it seems too politically ambitious given the reverse norm in most jurisdictions with an inheritance tax. Nevertheless, it does follow the U.S. practice of taxing transfers from grandparents to grandchildren more heavily through a generation-skipping transfer (GST) tax.

As explained above, a GST tax effectively imposes two layers of tax on a transfer from a grandparent to a grandchild, treating the transfer as if it passed through the parent (and it imposes more layers of tax if exempt amount declines as the relationship changes in this manner. European Tax Surveys, note 169.

it skips more generations). One could argue that a GST tax is unfair as a theoretical matter. But, on balance, it seems necessary to limit tax planning costs, as well as the associated inequities and inefficiencies that they generate.

Starting with equity concerns, a GST tax is only ideal within the normative framework of the Article if a parent receives as much welfare from a generation-skipping transfer as if she had received the inheritance herself. If she would have received more welfare by being able to spend the funds on traditional market consumption, the transfer should be subject to less than two layers of tax. And if she receives no welfare from a generation-skipping transfer, it should be subject to only one.

Unfortunately, this is once again an area in which there is little or no evidence so we must rely on proxies. In general, about 40% of all wealth is inherited.\textsuperscript{260} This implies that about 40% is passed on from generation to generation. The wealthiest heirs, however, appear to save and pass on a much larger share of their inherited wealth.\textsuperscript{261} As a result, it is reasonable to suppose that parents inheriting extraordinarily large amounts (and thus subject to tax under the proposal) tend to pass on more than 50% of their inheritances to their children. If this is the case, they must, on average, value their children receiving an inheritance at more than 50% of its value.\textsuperscript{262}

Given this admittedly shaky evidence, one option would be to impose something between one and two levels of tax on generation-skipping transfers. This is where tax planning concerns come into play. Generation-skipping transfers appear to be particularly responsive to tax incentives, and a relatively simple planning device.\textsuperscript{263} For example, if a donor believes that her child will end up giving a portion of her bequest to her grandchild, she can ensure a lower tax burden on both by transferring the bequeathed funds through a trust over which the child does not have full control, rather than directly to the child. Then, absent a GST tax, the child would only be taxed on the amount


\textsuperscript{261} See Joulfaian, note 70, at 12-13.

\textsuperscript{262} If they tend to give up more than 50% of the market consumption value of their inheritances to their children, they must value their children receiving the amount they inherit at more than half its full value.

\textsuperscript{263} Specifically, Sitkoff and Schazenbach have found that an increasing number of donors established perpetual trusts funded up to the GST exemption once states began repealing the rule against perpetuities in order to attract such trust assets. See Sitkoff & Schazenbach, Perpetuities or Taxes, note 247; Sitkoff & Schazenbach, Jurisdictional Competition, note 247, at 359.
she actually withdrew, not the entire bequest, and more would be left for the grandchild after tax.

Given the availability of such strategies, failing to impose a full GST tax may therefore induce a large increase in generation-skipping trusts. The winners would be donors and their heirs who reduce their tax burden—and of course tax attorneys. The losers would be the fisc, and donors and heirs who were not savvy enough to employ such tax planning strategies. Such a result is neither equitable nor efficient. Thus, while imposing a GST tax is not ideal in a world of perfect information, on balance, it seems to be the best approach.

d. How Would the Proposal Impact Charitable Giving?

A fourth potential area of concern is how the proposal would impact charitable giving. Each year, Americans give about $200 billion to charity, and roughly 8% of this giving occurs through charitable bequests. The estate tax is an important driver of charitable giving. It tends to increase charitable giving (both during life and at death) by decreasing the price of charitable transfers relative to the price of transfers to taxable heirs. Moreover, most studies suggest that net charitable transfers would fall if the estate tax were repealed even though donors would be wealthier. Thus, this substitution effect appears to dominate the income effect.

Because the proposal is revenue-neutral, it generally should not change the level of charitable giving. Indeed, in some respects, it would expand incentives for charitable transfers. For example, transfers to all nonprofits would be exempt under the proposal because the tax is imposed on the recipient, not the donor. This differs from the

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estate tax under which transfers to many nonprofits, such as 501(c)(4)s, are ineligible for the unlimited deduction.

In other ways, however, the proposal could weaken incentives for charitable giving. Under the estate tax, donors can avoid taxation only by giving to charity (and for certain other uses). Under the proposal, they could also do so by giving to individuals who have not reached the lifetime exemption—for example, siblings or good friends. As discussed above, there is no empirical basis for estimating how much donors would respond to these new incentives, but a reasonable guess is that they would slightly.

Even if donors do give more broadly among individuals in response to the proposal, however, charitable donations should not decrease substantially. Presumably a portion of this giving would come from existing charitable contributions and a portion from transfers to taxable beneficiaries. To the extent that it came from transfers to taxable heirs, the lifetime exemption would have to be lowered in order to maintain revenue-neutrality. This, in turn, should result in even broader giving among individuals (which is, itself, charity in some sense). More importantly for those concerned about charitable organizations, it should drive charitable giving back up to close to its current level. In short, the effects of the proposal on charitable giving should be minor, and even more so when compared to the substantial negative effects on charitable giving that would result from wealth transfer taxes being reduced or repealed.

e. How Would the Proposal Impact State Revenues?

A further potential question that may arise is the impact the proposal would have on the states. Historically, the federal estate tax offered a dollar-for-dollar credit for state wealth transfer taxes up to a limit. This allowed states to receive a share of federal estate tax revenue without actually imposing economic burdens on their residents. Although the credit was in place for more than eighty years (and is scheduled to reappear in 2011),267 it was replaced in 2005 with a deduction for state wealth transfer taxes.268 The effect was to cut back on federal revenue sharing because the credit was worth more than the deduction. Eliminating the credit also created an incentive for elderly residents to move to a state without any wealth transfer tax. As a result, the number of states with wealth transfer taxes declined from all fifty in 2001 to twenty-eight by late 2005, although state

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267 See note 193.
wealth transfer taxes proved more resilient than some observers expected.269

If the proposal was implemented, it should either improve state finances or have no effect. Any desired level of federal revenue sharing could still be achieved. For example, a credit or deduction could just as easily be offered for state wealth transfer taxes within a federal inheritance tax.270 Moreover, the proposal should improve state’s fiscal capacity independent from such revenue sharing. States would likely piggyback on the federal reporting requirements and conform their wealth transfer taxes to an inheritance tax base (as they have under the federal estate tax system, even when imposing an inheritance tax). As they did so, states should find that their wealth transfer tax base becomes more resilient to tax competition. It is generally easier for a retired individual to move to a state without a wealth transfer tax, than it is for all of her heirs to move.

The same argument would apply vis a vis other countries. An inheritance tax should reduce the incentive for wealthy prospective donors to move abroad and, at the extreme, expatriate. If prospective heirs moved abroad in response to the inheritance tax, they could be taxed on inheritances as part of their worldwide income. The only way heirs could avoid the inheritance tax entirely would be to expatriate well before inheriting, a costly tax planning device.

f. Would Transition Costs Eliminate the Benefits of the Proposal?

The final potential concern one might raise is whether any transition costs associated with the proposal would swamp its benefits. In many areas of tax, this is entirely possible.271 However, the transition costs associated with shifting from the estate tax system to the proposal should be relatively small.

Only one critical transition rule would need to be established if a comprehensive inheritance tax were adopted. Namely, (1) inheritances received after a date prior to enactment (such as the date the bill was introduced) should count towards the new lifetime exemption under the inheritance tax, and (2) heirs should be able to claim a credit for any estate or gift taxes paid on inheritances received after that date. If this rule were not established, an heir could effectively claim two lifetime exemptions, rather than one. He could have his donor first transfer an amount equal to the gift tax lifetime exemption

269 Yablon, note 194, at 278.
270 If the state imposed an estate tax, the deduction or credit would be for the heir’s share of the state estate tax imposed.
once enactment seemed likely, and then transfer an amount equal to
the inheritance tax lifetime exemption once the new regime actually went into effect. A transition rule that provided that the new system is effective as of a date prior to enactment minimizes this tax planning incentive and the inequities it would generate.

Beyond this fundamental rule, there are two principal approaches Congress could take. The first would be to count all inheritances an heir had previously received towards his lifetime inheritance tax exemption and simultaneously give him credit for any estate and gift taxes that had been paid on these amounts inherited. Effectively, the transition date would then be the heir's date of birth. The second would be to exclude all inheritances received prior to the introduction date from the lifetime inheritance tax exemption and give heirs no credit for estate and gift taxes paid on those inheritances.\textsuperscript{272} Effectively, the transition date would then be the date the bill was introduced.

While the first approach is more precise, on balance, the second is probably better because it should result in less tax planning and fewer administrative and compliance costs. Under the second approach, there would be no need for the heir, donor, or the Service to track down records regarding wealth transfers that occurred many years in the past. In particular, the heir would not need to know whether any estate tax was paid on the transfer, and the Service would not need to have records of inheritances on which no tax was due. This approach also would prevent heirs who have kept good records from whipsawing the government and reporting prior inheritances on which estate and gift taxes were paid, while failing to report inheritances that were tax-free. Finally, Ireland applied a transition rule similar to this approach when it transitioned from an estate tax to a lifetime accessions tax, and did not encounter any major problems.\textsuperscript{273}

\textsuperscript{272} The only exception would be for split or contingent trusts (or similar interests) that were subject to the estate tax. Distributions from such trusts after the inheritance tax goes into force should also be excluded from the lifetime exemption of the inheritance tax.

\textsuperscript{273} Ireland's inheritance tax, the Capital Acquisitions Tax ("CAT"), was enacted in 1976 after publication of the 1974 White Paper on Capital Taxation. All bequests received prior to April 1, 1975, were subject to the estate tax, and all bequests received on or after this date were subject to an inheritance tax. See Lynda A.M. Carroll, Ireland: Inheritance and Gift Tax, 34 Eur. Tax'n 374, 374 (1974). This date was viewed as providing sufficient time after publication of the White Paper to adjust their wills or other estate plans. Ireland Department of Finance, Capital Taxation, Laid by the Minister for Finance before Each House of the Oireachtas 60 (Feb. 28, 1974). Prior to the CAT, Ireland did not have a gift tax. The CAT subjected all gifts made on or after the date of the White Paper publication date to a new gift tax, although taxes were not collected until after its 1976 enactment. While gifts received between 1969 and the White Paper publication date were not themselves subject to tax, they were aggregated with gifts after that date for the purpose of determining gift tax liability. Capital Acquisitions Tax Act, No. 8 (1976)(Ir.). This final
Nevertheless, both approaches are reasonable and the stakes should be relatively small. Among children who receive a bequest greater than $1.7 million, the bequest on average represents 94% of their lifetime inheritances to date. The comparable figure for nonchild beneficiaries is 99%. Relatively few inequities should therefore result from the first approach, and relatively little evasion from the second.

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Overall, the proposal thus offers a number of benefits. It would more equitably allocate tax burdens among heirs in the short-term. It would simplify the law on net. And it could strengthen the fairness of the tax system more broadly by setting up a dynamic that would generate a fairer distribution of pretax inherited advantage, and tax rates on inheritances closer to the ideal, in the long-term. The proposal appears to be robust to a number of concerns and objections that could be raised. Before concluding, however, this Article considers one final question: whether the proposal should go farther and address a number of tax issues linked to wealth transfers at the same time.

V. RELATED ISSUES

Serious consideration of the proposal might spur lawmakers to revisit a number of issues related to the tax treatment of wealth transfers. The three existing wealth transfer taxes currently contain a number of tax preferences, including for closely held businesses, charitable giving, educational expenses and health expenses. In addition, the income tax treatment of charitable contributions, retirement savings, life insurance, and accrued gains on inherited wealth all have important implications for the magnitude of wealth transfers and the effective tax rate imposed on them.

This final Part provides suggestions for how to address these issues, again taking into account administrative and political constraints. While the following suggestions are not part of the core proposal and have not been incorporated into its revenue and distributional estimates, these issues are likely to arise in any reform debate.

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feature was attacked as inequitable because it was a retrospective tax. See 83 Seanad Deb. Col.1046 (Mar. 18, 1976).

274 This calculation is based on combined data from the 2001 and 2004 Survey of Consumer Finances used in Batchelder & Khitatrakun, note 23, and on file with author.

275 Id. This pattern probably occurs because about 60% of married decedents give their entire estate to their spouse or charities and leave nothing for their children. This figure is from IRS 1992 Collation Study data on file with author.
A. Accrued Gains

From a fiscal perspective, the most important issue that will probably arise is whether to alter the tax treatment of accrued gains on inherited wealth. While the income tax realization requirement creates incentives to hold on to all appreciated assets, these lock-in incentives are particularly acute in the case of property transferred as a gift or bequest. Gifts of appreciated property receive a carryover basis. If the assets continue to appreciate after transfer, this results in the heir's accrued tax liability—and lock-in incentive—becoming larger and larger over time. Bequests receive a stepped-up basis, which results in even larger lock-in incentives at least for donors, because any accrued tax liability will be forgiven entirely if the donor holds on to the property until death.

The ideal approach to taxing appreciated property would be to eliminate lock-in incentives through an accrual tax or, if this is not possible, reduce them by treating gifts and bequests as a realization event—assuming that the optimal underlying tax is an income tax (a large caveat). All accrued gains would then be taxed at the time of transfer.

This repeal of stepped-up and carryover basis would render the income tax more equitable, efficient, and transparent. It would be more equitable because these provisions disproportionately benefit wealthier individuals. For example, untaxed appreciation represents 36% of the value of all bequests but 56% of the value bequests exceeding $10 million. It would entail less inefficient transactional complexity because these provisions unfairly privilege sophisticated taxpayers. It would be more transparent because few members of the public are aware of how important and costly these provisions are. In addition, contrary to public perception, repeal would be administrable. Five countries successfully treat gifts or bequests as realization events, including Canada. Repeal could raise a significant amount of revenue. Under some estimates, treating gifts and bequests as a realization event would raise one-quarter the revenue raised by the estate tax system.

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276 Poterba & Weisbenner, note 198, at 439-40.
277 For example, less well-advised donors may realize accrued gains prior to death to the detriment of their heirs, and less well-advised heirs may realize accrued gains upon receipt of a gift to their own financial detriment.
278 Canada and Estonia treat both gifts and bequests as realization events, while Australia, Ireland, and the United Kingdom treat inter vivos gifts as realization events. Ault & Arnold, note 169, at 184; Int'l Bureau of Fiscal Documentation, Asia-Pacific Tax Surveys, note 169; Int'l Bureau of Fiscal Documentation, European Tax Surveys, note 169.
Nevertheless, this Article does not advocate for repeal of stepped-up and carryover basis because the political opportunity costs would likely exceed its substantial benefits. In particular, discussions with U.S. experts and the experience of Canada both suggest that wealth transfer taxation is unlikely to survive if coupled with realization at the time of transfer. The reason is that any wealth transfer tax would then be even more likely (although unfairly) to be seen as a “double tax.”

Taxing inherited income is more important than taxing accrued gains at transfer for several reasons. First, repeal of stepped-up and carryover basis would likely raise less revenue than the proposal. Indeed, if tax rates on capital income continue to decline, it would raise less and less over time. Treating gifts and bequests as a realization event also would not target heirs with high economic income as effectively. For example, the highest rate an heir who inherits $100 million could face would be 15% under current capital gains rates. And if his inherited assets contained no accrued gains, he would owe no tax on his inheritance whatsoever. Meanwhile, heirs receiving small inheritances could face significant new burdens because estates of all sizes frequently include appreciated assets. Replacing the estate tax system with realization also would make it far more difficult for Congress to subsequently apply a positive tax rate to inherited income. For all these reasons, if we must choose between the two as a political matter, retaining wealth transfer taxes is the better option.

Nevertheless, this Article does recommend an alternative approach: replacing stepped-up basis with carryover basis. Assuming that the most heated objection politically would be to taxing accrued gains on inherited wealth at the same time that inheritances are taxed, it may still be possible politically to tax such accrued gains at a later point in time. This could be accomplished by applying carryover basis to all wealth transfers.

gov/ftpdocs/18xx/doc1845/wholereport.pdf (citing JCT revenue estimate). This percentage is based on a revenue estimate after the policy change is in effect for three years.

Shortly after Canada began taxing all gains on wealth transfers at the time of the transfer, its estate tax was repealed. Observers believe this occurred because the public began to view the estate tax as a double tax once it was levied at the same time as the tax on capital gains. See Bird, note 224, at 133.

Another possibility is to treat receipt of gifts and bequests above the lifetime exemption as a realization event for the heir. If part of an inheritance fell below the threshold and part above, the accrued gains on the inheritance could be allocated pro rata. This option also would probably face formidable political obstacles, although conceivably it might not if realization replaced the 15% surtax. Doing so, however, would likely reduce the amount of revenue raised and the effective tax rate on heirs with the highest economic income unless a large share of the accrued gains on large inheritances are ordinary.
Applying carryover basis to bequests would reduce the inefficiency and inequity that arises from treating bequests of appreciated assets more favorably than bequests of other assets. It would ensure that all capital income is taxed once, regardless of how sophisticated the donor. It would reduce incentives for investors to hold on to underperforming assets purely for tax reasons as they near the end of life. In addition, it would likely raise a significant amount of revenue—the equivalent of roughly 12% of that raised by the estate tax system.

U.S. tax attorneys frequently object that carryover basis is in administrable. But this view is unduly influenced by the unique history of carryover basis in the United States. The United States enacted carryover basis in 1976 and then repealed it due to concerns about implementation before it went into effect. Those concerns, however, appear to have stemmed from features of that specific bill and not any fundamental administrative barriers. Indeed, at least five countries currently provide for carryover basis for bequests, including such large economies as Germany, Australia, and Japan.

To avoid actual double taxation, one technical adjustment is necessary. If an heir inherits an appreciated asset exceeding the lifetime exemption and counts the fair market value as the amount inherited, he is essentially paying inheritance tax on the capital gains tax that he must subsequently pay on the asset. This issue could be addressed by following current law for ordinary income that has not been taxed to the donor. The heir would treat the fair market value of the appreciated asset as an inheritance at the time of receipt and would also be taxed on the accrued gain when he subsequently sells the asset. He could deduct against his capital gain income an amount equal to the share of his inheritance that the accrued gain represented at the time of receipt, multiplied by his inheritance tax rate at that time. This is identical to the current treatment of 401(k)s and other deductible retirement savings, IRC § 691, and has been a reasonably successful “rough justice” solution to the problem. I am grateful to Joseph Kartiganer for this suggestion.

See Office of Management and Budget, note 279, tbl.2.5; Cong. Budget Office, note 279, at 311-12 (citing JCT revenue estimate). This percentage is based on a revenue estimate after the policy change is in effect for three years.


For example, the legislation included an amnesty provision that required taxpayers to value all of their assets on one day in history in order to claim its benefits. Note 287. The proposal includes no such amnesty provision, and a taxpayer would only need to value appreciated inherited assets if they were subject to tax so that she could claim the deduction for inheritance taxes paid. Such valuation already would have occurred because she would necessarily have exceeded the annual exclusion. See Ira H. Lustgarten, Carryover Basis Under the 1976 Tax Reform Act, 18 Colum. L. Rev. 679 (1978) (reviewing Thomas J. McGrath & Jonathan G. Blattmachr, Carryover Basis Under the 1976 Tax Reform Act (1977).

Appendix C.
WHAT SHOULD SOCIETY EXPECT FROM HEIRS?

Our own system is scheduled to apply carryover basis to bequests for the strange year of 2010.291

In order to ensure that carryover basis entails minimal administrative and compliance costs, donors or their estates should be required to supply the heir with basis information if it is commonly available, and relief provisions should be available if it is not. One possibility would be to permit stepped-up basis for appreciated assets that were not held for the production of income—such as personal jewelry and furniture—and are worth less than, for example, $10,000.292

In short, if designed correctly, replacing stepped-up basis with carryover basis would further enhance the equity, efficiency, and transparency benefits of the proposal, without substantial compliance costs.

B. Illiquid Assets

A great deal of money is at stake in deciding how to treat accrued gains. Nevertheless, the more important issue from a political perspective is whether the tax treatment of illiquid assets—especially family businesses and family farms—should be changed. Michael Graetz and Ian Shapiro argue in their book on the 2001 bill that the failure of estate tax supporters to adequately address this issue was a prime reason for the success of those who advocated estate tax repeal.293 Indeed, when the author testified about a variant of this Article's proposal before the Senate Committee on Finance, ten of the thirty questions that Senators submitted for the record concerned this topic.

The problems the estate tax creates for family businesses have been greatly exaggerated in the public debate. Neither the American Farm Bureau nor the New York Times has been able to identify a single instance of a family farm being sold to pay estate taxes.294 More generally, business assets can create liquidity problems only if they constitute a large portion of a wealth transfer and this is rarely the case. The Tax Policy Center has estimated that less than 3% of taxable estates are composed of more than 50% business assets.295 The propo-

291 See IRC § 1022.
292 The test for whether an asset was held for the production of income could be whether the donor took any deductions on the asset, such as depreciation or brokerage fees.
293 Graetz & Shapiro, note 7, at 32-40.
294 Id. at 126.
sal is estimated to apply to fewer than 3 in 1,000 heirs. A back-of-the-envelope calculation therefore suggests that far fewer than 400 heirs\textsuperscript{296} could conceivably need to sell part of an inherited business in order to pay the proposed tax—even if all of the existing relief provisions governing illiquid assets were repealed.

Nonetheless, the mere possibility that the estate tax could precipitate such sales has been a principal argument against the estate tax. To the extent that Congress considers it necessary to address this theoretical possibility, this Article recommends replacing the existing relief provisions with one that permits indefinite deferral at a market interest rate to the extent that an heir’s tax liability exceeds the value of the liquid assets that he inherits (subject to some reasonable cushion). Doing so should address the concern that taxing inheritances may force the sale of family businesses, while minimizing incentives or disincentives to hold assets in illiquid forms.

The twin goals of any relief provision should be to prevent forced sales of illiquid assets and to treat such assets neutrally. Politics aside, preventing forced sales of inherited assets is efficient to the extent that such assets are most productively held in the heir’s hands. However, treating illiquid assets neutrally by not subsidizing them is also necessary from an efficiency, fairness, and simplification perspective. Preferences for closely-held businesses and illiquid assets tend to distort investment decisions and favor heirs inheriting business assets over others. They tend to benefit heirs receiving the largest inheritances the most because the portion of estates composed of business assets tends to rise with the estate size.\textsuperscript{297} There is also no hard evidence that inherited businesses are more beneficial to the economy than other businesses; in fact, there is fairly strong evidence that businesses

\textsuperscript{296} Three percent of 12,972 (the number of heirs we estimate will be burdened by the proposal) is about 400. The number of heirs eligible should be much fewer than 400 because only heirs inheriting assets worth over $190 million (fewer than seventy annually) would be subject to a 50% effective tax rate under the proposal.

\textsuperscript{297} See note 295.
owned or managed by heirs tend to perform worse.\textsuperscript{298} Thus, liquidity relief should only be offered if it does not involve subsidies.

Current law does a relatively poor job of achieving these objectives. It heavily subsidizes closely-held businesses. For example, certain business assets can be valued at much less than their normal market value.\textsuperscript{299} Payment of any estate taxes attributable to a closely-held business can be deferred for five years and then spread out over ten more years at a below-market interest rate.\textsuperscript{300} There is also a special deduction, for certain qualified family-owned business interests, which sunset in 2004 but is scheduled to return in 2011.\textsuperscript{301} At the same time, current law fails to set a clear policy that no closely-held business that is reasonably well-run will have to be sold in order to pay wealth transfer taxes. While this objective appears to be met in practice,\textsuperscript{302} it depends on a number of factors, including whether the family continues to manage the business and how soon they plan to sell the business after the donor's death.

The relief provision offered here would avoid these pitfalls. If an heir inherited liquid assets sufficient to pay the tax (with an appropriate cushion), he would pay the tax with these assets and inherit any closely-held business or other illiquid assets tax-free.\textsuperscript{303} If not, he


\textsuperscript{299} IRC § 2032A.

\textsuperscript{300} IRC § 6166. The interest rate is 2% on the tax attributable to roughly the first $1 million transferred and 45% of the federal tax underpayment rate thereafter, IRC §§ 6601(j), 6166. The Treasury Secretary may also permit deferral of wealth transfer tax liabilities at his discretion. IRC § 6161.

\textsuperscript{301} IRC § 2057.

\textsuperscript{302} See note 294 and accompanying text.

\textsuperscript{303} The rationale for limiting the deferral election to the portion of the heir's inheritance tax liability that exceeds his readily marketable inherited assets is threefold. First, this feature may be necessary to minimize behavioral distortions and maintain revenue neutrality within the budget window if heirs irrationally perceive the deferral election as advantageous. Second, the limit avoids creating a cliff effect and the associated planning costs. Under current law, if closely held business interests exceed 35% of the value of the estate, taxes on all such assets can be deferred; if they constitute 34%, no deferral is available. IRC § 6166. In response to this all-or-nothing approach, taxpayers frequently spend significant time and funds on tax planning in order to ensure that a trivial valuation difference
would be required to use the liquid assets that he did inherit (again subject to some reasonable cushion) to pay a portion of the associated tax liability.\(^{304}\) He then could elect for the remainder to accrue at a market interest rate until he sold part or all of the business, received distributions from it, or inherited other liquid assets. If none of these possibilities arose, the tax liability and interest would accrue indefinitely.\(^{305}\) The same election could apply to trusts. Example 3 illustrates how the election would work.

Example 3: Inheriting a Closely-Held Business. Heir C is in the highest income tax bracket, receives a bequest of $10 million (above the annual exemption), and has received no prior inheritances. Three quarters of the bequest is a closely-held business and one quarter is liquid assets, such as publicly traded stock. C's total tax liability would be $4.05 million. He could choose to defer $1.55 million of the taxes due (plus a reasonable cushion) until the business was sold. Thus he would face no pressure to sell the business if he operated it profitably, but he also would face no incentive to hold on to it.

The net result of the provision would be that heirs would never have to sell an inherited business in order to pay the associated tax liability and interest. In addition, the provision would not create liquidity constraints for inherited businesses because the tax due would be a liability solely of the heir and thus does not need to be reported on the business’ books. At the same time, tax subsidies for illiquid assets would be avoided.

This recommended approach should reduce transactional complexity relative to current law because far fewer heirs would be eligible for the election. They also would not face any net tax benefit or penalty that does not result in their falling below the threshold. See Dennis L. Belcher & Mary Louise Fellows, Report on Reform of Federal Wealth Transfer Taxes: ABA Task Force on Federal Wealth Transfer Taxes, 58 Tax Law. 93, 244-45 (2004). While the current law provision admittedly differs in offering a lucrative below-market loan, such gaming might continue for less rational reasons. Third, the limit is fair. Any heir who has inherited enough liquid assets to pay any inheritance tax due can freely choose whether to continue investing in the family business. If he chooses to do so, there are no inequities created by requiring him to use his other inherited assets to pay the tax due upfront.

\(^{304}\) Illiquid assets could be defined fairly broadly so long as a market interest rate was applied. For example, the category could include closely held businesses, real property held for investment purposes, and collectibles. Illiquid assets, however, should not be defined to include property used in part for personal consumption because its value will tend to decline as it is consumed. See Dodge, note 39, at 1199.

\(^{305}\) Theoretically, if the heir held on to an illiquid asset for life and ultimately bequeathed it to someone else, the associated tax could carry over to the new heir.
for making it. The decision whether to sell an inherited business could therefore be made purely based on business and personal considerations—not for tax reasons.

This provision would require ongoing monitoring by the Service. In order to minimize evasion, the IRS could require each heir making the election to submit a form annually stating whether he had received any distributions from the business or sold all or a portion of it, perhaps with confirmation from the business. The definition of distributions and sales could parallel those under the current law deferral provision.306 It is critical, however, that unlike current law, interest accrue at a market rate, and the taxpayer be required to use all distributions and proceeds from sales first to satisfy the accrued tax liability and interest.

These annual filing requirements should not be a large burden on the heir or business. Few would be eligible for the election and the filing requirement would simply require confirmation of whether the heir has sold or received cash from the business—a fact of which both should be well aware.

Annual appraisal of the business after it was inherited also should be unnecessary. If the heir did not report distributions and sales proceeds sufficient to satisfy the tax liability and interest for a number of years, however, the question would arise as to whether he was evading the tax by withdrawing cash for personal consumption in other ways. For example, an heir controlling an inherited business could be forcing it to sell assets at a nominal price to another business he controlled, and then forcing that second business to distribute the assets to him. Alternatively, he could be causing an inherited business he controls to pay him an extraordinarily high salary, without performing commensurate services in exchange. One way to address these potential tax shelters would be to grant to the Service a lien or right to foreclose upon the business in such circumstances. Another option, which would never entail forced sales, would be to treat compensation above a certain level and sales to other businesses controlled by the heir, as de facto distributions to the heir after a period of years.307

In summary, unlike current law, this deferral provision should fully address the concern that taxing inheritances can force the sale of family businesses. At the same time, it should reduce the tax planning, compliance, and efficiency costs associated with the current set of provisions, which subsidize wealth transfers composed of illiquid assets and closely held businesses.

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306 See IRC § 6166(g).
307 I am grateful to Noël Cunningham for raising these issues.
The final issue that may arise in conjunction with the proposal is whether tax incentives associated with wealth transfers should be changed. Currently the estate tax system provides unlimited deductions for transfers to charity, and gifts used for health or educational expenses. In addition, the income tax includes deductions and exclusions for charitable contributions, retirement savings, and life insurance, all which strongly affect the magnitude of wealth transfers and the tax rate imposed on them.

The current set of tax incentives in the tax system as a whole is far from ideal. Most operate through deductions, exclusions, and occasionally nonrefundable credits. As Fred Goldberg, Peter Orszag, and I have argued elsewhere, ideally tax incentives should be calibrated to the size of the positive externality (if any), and the default should be a uniform refundable credit—unless there is evidence that the externality of elasticity of the activity varies across the economic distribution. This raises the question of whether tax incentives that relate to wealth transfers should be reformed. In an ideal world, they would be.

Starting with charitable contributions, the ideal tax incentive probably would be a flat refundable credit. To date, there is no evidence that the price elasticity of charitable giving varies systematically across the economic distribution. Charitable bequests, however, do appear to be more tax sensitive than charitable contributions made during life so some additional subsidy may be merited for them.

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308 IRC § 2522; IRC § 2503(e)(2). The estate tax system also provides an unlimited deduction for spousal transfers, IRC § 2056, but I consider this to be less a tax incentive than a provision designed to avoid administrative issues in measuring the tax base. Arguably all household earnings are due to the efforts of both spouses even if one is the primary market worker. If so, it is unclear whether and when wealth left to a spouse should be considered a transfer versus a return to his or her labor.

309 IRC § 170.

310 IRC § 401-457.

311 IRC § 101.


313 This assumes that the provision is intended to induce a behavioral change, and not to more accurately measure income (for example, deductions for business expenses) or ability to pay (for example, the standard deduction).


315 Id.
Ideally, policymakers would also reconsider whether the social benefits of giving to some charities are greater than others—an issue that was raised by Leona Helmsley’s charitable bequest of $8 billion for the care of dogs.\footnote{See, e.g., Posting of Gary Becker to the Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2008/07/cats_and_dogs_a.html (July 13, 2008, 7:09 pm); posting of Richard Posner to the Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2008/07/should_dogs_get.html (July 13, 2008, 7:30 pm). Indeed, the question of how to tax charitable contributions in some respects is identical to the question of how to tax gifts and bequests. If we knew the ultimate beneficiaries of each charitable organization, ideally we might tax each transfer to charity as if it was a transfer to its beneficiaries.}

For spending on health and education, the ideal tax incentive would probably be a progressive refundable credit.\footnote{An additional benefit of an inheritance tax is that it permits tax incentives for these purposes for gifts and bequests. Under current law, the exclusions for amounts paid for support for minors and education and medical expenses do not apply to bequests because doing so would create the same valuation issues that arise for other tax-exempt transfers. An inheritance tax, with its wait-and-see approach, could eliminate these valuation issues.} In this case, there is evidence that elasticities do vary by income: Lower-income households appear to respond more strongly.\footnote{See, e.g., Leonard E. Burman, Elaine Maag, Jeffrey Rohaly & John O’Hare, The Distributional Consequences of Federal Assistance for Higher Education: The Intersection of Tax and Spending Programs (Urban-Brookings Tax Pol’y Ctr., 2005), available at www.urban.org/publications/311210.html.} This greater responsiveness presumably stems in large part from the fact that they spend less on health and education currently, and thus less of any subsidy must be devoted to subsidizing existing behavior.

Turning finally to tax incentives for retirement savings and life insurance, it is unclear whether they currently produce any social benefits and, if so, what they are. The principal potential social benefits associated with retirement savings appear to be the possibility of ensuring that individuals have adequate income in retirement, so that they do not become a burden on government or experience sharp declines in their standard of living in old age. If so, any subsidy should be limited to savings for retirement spending—not transfers to the next generation. Meanwhile, the primary potential social benefit associated with life insurance appears to be supplementing Social Security payments for dependents who cannot support themselves. If so, any subsidy should be limited to life insurance covering such beneficiaries. Lower-income households appear to respond more strongly to tax subsidies for both forms of saving.\footnote{See, e.g., Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag & Emmanuel Saez, Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block, 121 Q.J. Econ. 1311 (2006).} Thus, the ideal tax incentives for these activities, if any, would probably be progressive refundable credits limited to funds used to purchase life annuities, retiree health insurance, and life insurance policies covering those unable to work.
Clearly the ideal structure of these tax incentives stands far from reality. It is unlikely that policymakers would want to reconsider their fundamental structure at the same time they reconsider the fundamental structure of wealth transfer taxes. As a result, despite the advantages of reform, this Article recommends saving these issues for a separate debate. In the meantime, the current structure of tax incentives in the estate tax system could be maintained.

VI. Conclusion

Based on the evidence to date, this Article has argued that the ideal wealth transfer tax should be much higher than current law and take the form of a comprehensive inheritance tax. The current political moment presents a unique opportunity for the United States to move in this direction. We should seize this moment to replace the estate tax system with such a tax, instead of moving further down the road to repeal of wealth transfer taxation.

This Article's proposal would strengthen the ability of our tax system to achieve its underlying goals. By basing tax burdens on the economic status of the person who bears the tax—the heir—it would better account for the direct and indirect information that inheritances provide about an heir’s economic status. By creating incentives to give to those outside of the inner circle of the extraordinary wealthy, it could result in a broader pretax distribution of inherited advantage and income. It should also simplify the law. And ultimately, because its form more transparently embodies its function, it could reinvigorate public support for taxing inheritances. In doing so, we could begin to rectify the undertaxation of inherited income relative to income and wealth that is self-made, and expect from heirs a fairer share of what they have been given.
WHAT SHOULD SOCIETY EXPECT FROM HEIRS?

APPENDIX

A. Methodology

The revenue and distributional estimates in this Article are based on the Urban-Brookings Tax Policy Center Estate Tax Microsimulation Model (ETMM).\textsuperscript{320} The ETMM was constructed by imputing wealth onto micro data of individual income tax returns. It then assigns a probability of death and imputes the amounts of charitable and spousal deductions in order to create a dataset of taxable estates in the current year that matches published IRS data on taxable estates.

The ETMM was modified to estimate the revenue and distributional effects of an inheritance tax in the following ways. First, we imputed the amount of spousal transfers. Spousal deductions in the ETMM database may not be equivalent to the amount transferred. For example, suppose the estate tax exemption is $3.5 million and there are two $4 million estates. If one donor left the entire estate to the surviving spouse while the other left only $500,000 to the surviving spouse (with the remainder going to the children), both would claim a $500,000 spousal deduction even though their spousal transfers vary widely. To address this issue, we imputed spousal transfers below the exemption amount\textsuperscript{321} based on tabulations of the restricted 1992 IRS Collation Study that the Statistics of Income division generously prepared for us.

Next, we imputed the number of beneficiaries in each relationship group (children and other beneficiaries) based on Collation Study tabulations by the decedent’s marital status and estate size.\textsuperscript{322} The number of beneficiaries was classified as zero, one, two, three, four, or greater than four, in which case an average value was used. The Collation Study has quite good information on the identity of estate beneficiaries, including when all or part of the estate is left in trust, because it examines probate records when the beneficiary is unclear. It is able to categorize the beneficiaries of credit shelter trusts, QTIP trusts, and generation-skipping trusts fairly reliably. Where a trust does not fit into one of these categories and provides an income interest to one beneficiary with a remainder to others, the Collation Study assigns all the trust assets to the individual with the income interest. The net effect is probably to attribute some transfers ultimately received by


\textsuperscript{321} The differences between the estimates in this Article and those in Batchelder, Taxing Privilege, note 15, arise from this refinement and use of an updated income tax calculator.

\textsuperscript{322} Estates were grouped in the following categories: (1) up to $600,000, (2) $600,000 - $1 million, (3) $1 million up to $2.5 million, (4) $2.5 million up to $5 million, (5) $5 million up to $10 million, and (6) $10 million and above.
the grandchildren of a donor to the donor’s children instead. Given that the GST applies to generation-skipping transfers through trusts left to the third generation or beyond, however, these errors should not be substantial.

Once the number of beneficiaries in each relationship group was imputed, the share of the estate allocated to each relationship group was then imputed based on the decedent’s marital status, the estate size, and the number of beneficiaries, again using tabulations of Collation Study data. This was necessary because if an estate has, for example, two child beneficiaries and one other beneficiary, it is necessary to determine what share goes to the children.

Once these variables were imputed, the inheritance size for each beneficiary in a given relationship group was calculated by assuming that the portion of the estate going to that relationship group was bequeathed pro rata. This seemed reasonable given that the vast majority of bequests to children are bequeathed pro rata. Specifically, the inheritance size for each beneficiary was calculated as the product of the taxable estate (the estate after expenses and transfers to spouses and charities) and the portion assigned to the beneficiary’s relationship group, divided by the number of beneficiaries in that relationship group.

Based on each beneficiary’s inheritance size, a ratio between the beneficiary’s prior and current inheritance size was then imputed. These imputed ratios were derived from combined 2001 and 2004 Survey of Consumer Finance (SCF) data. For each current inheritance group, the imputed ratio was randomly assigned as the middle percentile of one of the following four groups: 0-40th percentile, 40th-60th percentile, 60th-90th percentile, and 90th-100th percentile. Prior inheritances were then calculated as the product of the imputed ratio and the beneficiary’s current inheritance.

Next, each individual beneficiary was assigned a marital status and income group. Both were based on Collation Study tabulations by the decedent’s marital status, the estate size, and the beneficiary’s relationship to the decedent. The tabulations for the income group assignment were also based on the beneficiary’s marital status. The

323 See note 49.

324 Current inheritances were classified into the following groups: (1) $10,000 or less, (2) more than $10,000 to $50,000, (3) more than $50,000 to $100,000, (4) more than $100,000 to $500,000, (5) more than $500,000 to $1 million, and (6) more than $1 million.

325 Beneficiary income was grouped in the following categories: (1) $10,000 or less, (2) more than $10,000 to $25,000, (3) more than $25,000 to $50,000, (4) more than $50,000 to $100,000, (5) more than $100,000 to $200,000, and (6) more than $200,000, in 1992 dollars. Income growth rates were based on CBO data, Table 1C: Number of Households. Average Pretax and After-Tax Income, Shares of Pretax and After-Tax Income, and Income Cate-
measure of income in the Collation Study generally tracks adjusted gross income (AGI) but with some adjustments.\textsuperscript{326}

Then, conditional on marital status, income group, and relationship to the decedent, each beneficiary was assigned an age group.\textsuperscript{327} The assignment targets the average difference between the decedent's and the beneficiary's ages so that the resulting differences are consistent with the average age gaps reported in the Collation Study.

At this point the heir's AGI, income, taxable income, capital gains, and other tax information were imputed by randomly assigning a micro record from the TPC data on individual income tax returns that matched the income group, marital status, and age group of the heir. All income data was inflated to 2009.\textsuperscript{328} The heir's income, payroll, and inheritance tax liability was then calculated based on this tax information and his or her current and prior inheritance. In particular, we account for child tax credits, and earned income tax credits when calculating tax liability on noninherited income. In the current version, only earned income tax credits are affected by the presence of inheritances in the inheritance tax calculation. Earned income tax credits of beneficiaries with some inheritances subject to the inheritance tax (that is, above the lifetime exemption) are reduced pro rata by the amount of the inheritances subject to tax divided by five until this amount reaches $3,000 at which point all earned income tax credits become zero. The $3,000 threshold reflects the amount of investment income that disqualifies tax units from receiving the earned income tax credit in 2009.

Estate tax burdens were calculated as under the ETMM, which includes an imputed value for inter vivos gifts previously transferred by the donor. For purposes of comparing the tax burdens if they are assumed to fall on heirs, the tax liability of estates was assigned to individual heirs in the same manner as inheritances were assigned to them. That is, any estate tax due was assumed to be borne by an heir

\textsuperscript{326} Specifically, it includes wages, tax-exempt interest, taxable dividends, alimony received, pension, taxable IRA distribution, unemployment compensation, Social Security, rents received, royalties received, partnership and subchapter S income, and estate and trust income. When positive, it also includes Schedule C gross profit/loss (from the first three schedules), Schedule F profit/loss (from the first two schedules), supplemental gains/losses, other income, farm/rent income/loss, taxable interest income, net short-term gain/loss, and net long-term gain/loss.

\textsuperscript{327} The age groups were zero to eighteen, nineteen to twenty-six, twenty-seven to thirty-four, thirty-five to forty-two, forty-three to fifty, fifty-one to fifty-eight, fifty-nine to sixty-five, sixty-six to seventy-two, seventy-three to seventy-nine, and eighty and older.

\textsuperscript{328} Again, income growth rates were based on CBO data. See note 325.
in the same proportion as his inheritance bore to the inheritances of all other nonspousal heirs of the estate.

We examine the distribution of wealth transfer tax burdens based on three measures of income. The first measure is the decedent’s cash income, which we also refer to as earned income and is a more comprehensive measure of income frequently employed and defined by the Tax Policy Center.\textsuperscript{329} In addition to AGI, it includes a variety of forms of tax-exempt income, such as tax-exempt interest, the employer’s share of payroll tax liability, and deductible or excludable contributions to tax-preferred retirement savings plans. It does not include inheritances received.

In order to account for the effect of inheritances on heirs’ economic status, we employ an alternate measure for tax units that receive inheritances. It is the heir’s cash income plus the annuitized value of his current inheritance, which is referred to as economic income. In particular, we assume that the current inheritance is used to buy a fair life annuity that guarantees a constant nominal payment every year until the beneficiary dies. In order to calculate the annual annuity payment, we assume a constant nominal interest rate of 6\% annually and life expectancies based on the Social Security Administration’s 2010 life table.\textsuperscript{330}

Two assumptions underlying the microsimulation model should be noted. First, the estimates of both estate tax and inheritance tax liabilities assume no state wealth transfer tax liability. Second, the estimates importantly assume no behavioral response and thus no deadweight loss. That is, the model assumes no change in the magnitude of wealth transfers or their allocation on a pretax basis in response to the wealth transfer tax.

Both of these assumptions are very strong, and it is implausible that wealth transfer taxes generate no excess burden whatsoever. However, these assumptions are probably the least misleading one can make in light of the very limited information available to study the issue. The assumption of no behavioral response is common in distributional analysis and less troubling where, as here, revenue-neutral alternatives are compared.

As should be clear, the following estimates should be treated with a high degree of caution. They are derived from a model that is based in part on data from 1992 and involves multiple layers of imputation.


This is necessary due to the fact that there is no publicly available micro data linking tax information on decedents and their estates to heirs' income tax returns and the amount heirs inherit. As a result, the estimates could change substantially in response to new information. Nevertheless, they begin to paint a picture of who benefits from wealth transfers, which heirs are burdened by wealth transfer taxes, and how their burdens vary by the type of tax.

### B. Data Underlying Graphs

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<td>62,044,933,370</td>
<td>15.1</td>
</tr>
<tr>
<td>$500K-$1M</td>
<td>90,693</td>
<td>1.9</td>
<td>62,638,606,905</td>
<td>15.2</td>
</tr>
<tr>
<td>$1-$2.5M</td>
<td>39,328</td>
<td>0.8</td>
<td>55,763,085,425</td>
<td>13.5</td>
</tr>
<tr>
<td>$2.5-$5M</td>
<td>5,049</td>
<td>0.1</td>
<td>16,652,820,416</td>
<td>4.0</td>
</tr>
<tr>
<td>$5-$10M</td>
<td>1,660</td>
<td>0.0</td>
<td>11,137,022,099</td>
<td>2.7</td>
</tr>
<tr>
<td>$10-$20M</td>
<td>511</td>
<td>0.0</td>
<td>6,811,015,905</td>
<td>1.7</td>
</tr>
<tr>
<td>$20-$50M</td>
<td>172</td>
<td>0.0</td>
<td>5,139,014,788</td>
<td>1.2</td>
</tr>
<tr>
<td>$50M or more</td>
<td>67</td>
<td>0.0</td>
<td>7,474,189,991</td>
<td>1.8</td>
</tr>
<tr>
<td>Total</td>
<td>4,748,291</td>
<td>100.0</td>
<td>411,882,172,803</td>
<td>100.0</td>
</tr>
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</table>
### Table A2
Rough Distribution of Average Lifetime Inheritance by Earned Income

<table>
<thead>
<tr>
<th>Earned Income</th>
<th>Average Lifetime Inheritance ($) of All</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+$10K</td>
<td>41,939</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>45,840</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>50,985</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>44,069</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>49,932</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>53,042</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>50,882</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>57,531</td>
</tr>
<tr>
<td>$200-$500K</td>
<td>103,129</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>185,203</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>204,064</td>
</tr>
<tr>
<td>$5M+</td>
<td>128,423</td>
</tr>
<tr>
<td>All</td>
<td>52,046</td>
</tr>
</tbody>
</table>

### Table A3
Rough Distribution of Average Lifetime Inheritance ($) by Economic Income

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>Average Lifetime Inheritance ($) of All</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+$10K</td>
<td>14,222</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>23,128</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>30,015</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>43,228</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>41,845</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>50,816</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>64,719</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>89,035</td>
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<td>$200-$500K</td>
<td>170,144</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>359,838</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>638,299</td>
</tr>
<tr>
<td>$5M+</td>
<td>708,164</td>
</tr>
<tr>
<td>All</td>
<td>52,046</td>
</tr>
</tbody>
</table>

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WHAT SHOULD SOCIETY EXPECT FROM HEIRS?

**Table A4**
Rough Share of Economic Income Derived from Annuitized Inheritances

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>Percentage of Economic Income Derived from Annuitized Inheritances</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+-$10K</td>
<td>15.9</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>10.1</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>8.1</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>8.6</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>6.2</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>5.8</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>5.4</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>4.7</td>
</tr>
<tr>
<td>$200-$500K</td>
<td>4.4</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>3.8</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>2.4</td>
</tr>
<tr>
<td>$5M+</td>
<td>0.4</td>
</tr>
<tr>
<td>All</td>
<td>4.4</td>
</tr>
</tbody>
</table>

**Table A5**
Share of Revenue Raised from Wealth Transfer Taxes and Recurrent Wealth Taxes

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of Revenue Raised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>5.6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.9</td>
</tr>
<tr>
<td>Iceland</td>
<td>2.5</td>
</tr>
<tr>
<td>Japan</td>
<td>1.7</td>
</tr>
<tr>
<td>France</td>
<td>1.6</td>
</tr>
<tr>
<td>Norway</td>
<td>1.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.2</td>
</tr>
<tr>
<td>Korea</td>
<td>1.2</td>
</tr>
<tr>
<td>United States</td>
<td>1.1</td>
</tr>
<tr>
<td>Canada</td>
<td>1.1</td>
</tr>
<tr>
<td>Spain</td>
<td>1.0</td>
</tr>
<tr>
<td>Italy</td>
<td>0.9</td>
</tr>
<tr>
<td>Germany</td>
<td>0.9</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.8</td>
</tr>
<tr>
<td>Greece</td>
<td>0.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.8</td>
</tr>
<tr>
<td>Finland</td>
<td>0.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.5</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.4</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.2</td>
</tr>
<tr>
<td>Austria</td>
<td>0.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>0.1</td>
</tr>
<tr>
<td>Poland</td>
<td>0.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>0.0</td>
</tr>
<tr>
<td>New Zealand</td>
<td>0.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.0</td>
</tr>
<tr>
<td>Australia</td>
<td>0.0</td>
</tr>
<tr>
<td>Average</td>
<td>1.1</td>
</tr>
</tbody>
</table>
### Table A6

Number and Percentage of Heirs Burdened by the 2009 Estate Tax by Economic Income

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>All Heirs</th>
<th>Amount Inherited Before Tax</th>
<th>Heirs Burdened by Estate Tax</th>
<th>Percentage of Heirs Burdened</th>
<th>Revenue Derived from Heirs</th>
<th>Percentage of Revenue Derived</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+$10K</td>
<td>593,947</td>
<td>$14,086,690,972</td>
<td>38</td>
<td>0.0</td>
<td>$812,709</td>
<td>0.0</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>694,455</td>
<td>27,702,119,320</td>
<td>153</td>
<td>0.0</td>
<td>2,310,147</td>
<td>0.0</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>598,801</td>
<td>30,261,474,291</td>
<td>252</td>
<td>0.0</td>
<td>13,429,174</td>
<td>0.1</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>529,999</td>
<td>35,957,110,503</td>
<td>449</td>
<td>0.1</td>
<td>25,257,976</td>
<td>0.1</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>404,967</td>
<td>27,519,667,060</td>
<td>717</td>
<td>0.2</td>
<td>23,559,675</td>
<td>0.1</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>712,258</td>
<td>58,150,867,096</td>
<td>1,591</td>
<td>0.2</td>
<td>130,038,623</td>
<td>0.7</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>417,796</td>
<td>45,325,820,865</td>
<td>1,047</td>
<td>0.3</td>
<td>130,758,665</td>
<td>0.7</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>573,723</td>
<td>86,377,336,397</td>
<td>6,867</td>
<td>1.2</td>
<td>1,481,191,540</td>
<td>8.5</td>
</tr>
<tr>
<td>$200-$500K</td>
<td>173,066</td>
<td>48,710,955,703</td>
<td>6,694</td>
<td>3.9</td>
<td>3,834,727,177</td>
<td>21.9</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>21,934</td>
<td>14,178,789,942</td>
<td>2,240</td>
<td>10.2</td>
<td>3,347,913,220</td>
<td>19.1</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>17,452</td>
<td>16,169,305,418</td>
<td>1,365</td>
<td>7.8</td>
<td>5,597,926,205</td>
<td>32.0</td>
</tr>
<tr>
<td>$5M+</td>
<td>9,895</td>
<td>7,442,035,235</td>
<td>104</td>
<td>1.1</td>
<td>2,919,904,290</td>
<td>16.7</td>
</tr>
<tr>
<td>All</td>
<td>4,748,291</td>
<td>411,882,172,803</td>
<td>21,519</td>
<td>0.5</td>
<td>17,507,829,402</td>
<td>100.0</td>
</tr>
<tr>
<td>Inheritance Size</td>
<td>All Heirs</td>
<td>Amount Inherited Before Tax</td>
<td>Heirs Burdened by Estate Tax</td>
<td>Percentage of Heirs Burdened</td>
<td>Revenue Derived from Heirs</td>
<td>Percentage of Revenue Derived</td>
</tr>
<tr>
<td>------------------</td>
<td>-----------</td>
<td>----------------------------</td>
<td>-----------------------------</td>
<td>-----------------------------</td>
<td>---------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>$0-$50K</td>
<td>3,199,899</td>
<td>$53,112,039,792</td>
<td>51</td>
<td>0.0</td>
<td>600,451</td>
<td>0.0</td>
</tr>
<tr>
<td>$50-$100K</td>
<td>699,071</td>
<td>49,231,899,495</td>
<td>370</td>
<td>0.1</td>
<td>6,908,429</td>
<td>0.0</td>
</tr>
<tr>
<td>$100-$250K</td>
<td>532,391</td>
<td>81,877,544,619</td>
<td>961</td>
<td>0.2</td>
<td>28,711,776</td>
<td>0.2</td>
</tr>
<tr>
<td>$250-$500K</td>
<td>179,450</td>
<td>62,044,933,370</td>
<td>3,408</td>
<td>1.9</td>
<td>166,443,206</td>
<td>1.0</td>
</tr>
<tr>
<td>$500-$675K</td>
<td>42,837</td>
<td>62,638,606,905</td>
<td>1,599</td>
<td>3.7</td>
<td>159,654,252</td>
<td>0.9</td>
</tr>
<tr>
<td>$675K-$1M</td>
<td>47,856</td>
<td>55,763,085,425</td>
<td>1,647</td>
<td>3.4</td>
<td>251,947,906</td>
<td>1.4</td>
</tr>
<tr>
<td>$1-$2.5M</td>
<td>39,328</td>
<td>16,652,820,416</td>
<td>7,578</td>
<td>19.3</td>
<td>2,172,261,487</td>
<td>12.4</td>
</tr>
<tr>
<td>$2.5-$5M</td>
<td>5,049</td>
<td>11,137,022,099</td>
<td>3,495</td>
<td>69.2</td>
<td>2,779,965,150</td>
<td>15.9</td>
</tr>
<tr>
<td>$5-$10M</td>
<td>1,660</td>
<td>6,811,015,905</td>
<td>1,660</td>
<td>100.0</td>
<td>3,592,328,575</td>
<td>20.5</td>
</tr>
<tr>
<td>$10-$20M</td>
<td>511</td>
<td>5,139,014,788</td>
<td>511</td>
<td>100.0</td>
<td>2,745,700,478</td>
<td>15.7</td>
</tr>
<tr>
<td>$20-$50M</td>
<td>172</td>
<td>7,474,189,991</td>
<td>172</td>
<td>100.0</td>
<td>2,264,003,122</td>
<td>12.9</td>
</tr>
<tr>
<td>$50M or more</td>
<td>67</td>
<td>411,882,172,803</td>
<td>67</td>
<td>100.0</td>
<td>3,339,304,571</td>
<td>19.1</td>
</tr>
<tr>
<td>All</td>
<td>4,748,291</td>
<td>53,112,039,792</td>
<td>21,519</td>
<td>0.5</td>
<td>17,507,829,402</td>
<td>100.0</td>
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</tbody>
</table>
### Table A8
Average Tax Rate on Earned Income and Inheritances of 2009 Heirs

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>Income Tax Rate on Earned Income</th>
<th>Estate Tax Rate on Inherited Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0++-$10K</td>
<td>11.3</td>
<td>0.0%</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>8.1</td>
<td>0.0%</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>10.2</td>
<td>0.0%</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>13.3</td>
<td>0.1%</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>16.1</td>
<td>0.1%</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>18.5</td>
<td>0.2%</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>19.8</td>
<td>0.3%</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>20.6</td>
<td>1.7%</td>
</tr>
<tr>
<td>$200-$500K</td>
<td>20.2</td>
<td>7.9%</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>18.6</td>
<td>23.6%</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>17.6</td>
<td>34.6%</td>
</tr>
<tr>
<td>$5M+</td>
<td>26.3</td>
<td>39.2%</td>
</tr>
<tr>
<td>All</td>
<td>20.4</td>
<td>0.0%</td>
</tr>
</tbody>
</table>
### Table A9

Inheritance Flows (\$) by Number of Estate's Child and Non-Child Beneficiaries

<table>
<thead>
<tr>
<th>Number of Child Beneficiaries</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5+</th>
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</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
<td>33,433,507,761</td>
<td>28,323,891,263</td>
<td>13,801,777,233</td>
<td>8,062,832,383</td>
<td>45,661,124,369</td>
</tr>
<tr>
<td>1</td>
<td>91,189,377,817</td>
<td>6,182,879,711</td>
<td>2,620,496,748</td>
<td>4,656,131,230</td>
<td>2,479,385,885</td>
<td>3,789,954,895</td>
</tr>
<tr>
<td>2</td>
<td>69,664,543,695</td>
<td>3,884,623,282</td>
<td>8,603,100,484</td>
<td>1,079,607,665</td>
<td>4,126,778,097</td>
<td>3,105,798,767</td>
</tr>
<tr>
<td>3</td>
<td>33,809,972,377</td>
<td>3,042,906,129</td>
<td>4,297,964,958</td>
<td>1,926,162,056</td>
<td>66,245,753</td>
<td>6,872,198,650</td>
</tr>
<tr>
<td>4</td>
<td>18,477,882,758</td>
<td>15,019,540</td>
<td>41,662,919</td>
<td>53,007,308</td>
<td>0</td>
<td>3,047,225,989</td>
</tr>
<tr>
<td>5+</td>
<td>9,288,568,831</td>
<td>124,891</td>
<td>81,743,812</td>
<td>31,653,291</td>
<td>27,981,089</td>
<td>136,041,165</td>
</tr>
</tbody>
</table>
**Table A10**
Average Tax Rate on All Inheritances by Heir Economic Income

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>Prop. Inheritance Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+-$10K</td>
<td>0.0</td>
</tr>
<tr>
<td>$10-$20K</td>
<td>0.0</td>
</tr>
<tr>
<td>$20-$30K</td>
<td>0.0</td>
</tr>
<tr>
<td>$30-$40K</td>
<td>0.1</td>
</tr>
<tr>
<td>$40-$50K</td>
<td>0.1</td>
</tr>
<tr>
<td>$50-$75K</td>
<td>0.2</td>
</tr>
<tr>
<td>$75-$100K</td>
<td>0.3</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>1.7</td>
</tr>
<tr>
<td>$200-$500K</td>
<td>7.9</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>23.6</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>34.6</td>
</tr>
<tr>
<td>$5M+</td>
<td>39.2</td>
</tr>
<tr>
<td>All</td>
<td>4.3</td>
</tr>
</tbody>
</table>

**Table A11**
Average Tax Rate on All Inheritances by Inheritance Size

<table>
<thead>
<tr>
<th>Inheritance Size</th>
<th>Prop. Inheritance Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0+-$50K</td>
<td>0.0</td>
</tr>
<tr>
<td>$50-$100K</td>
<td>0.0</td>
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<tr>
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**Table A12**
Number of 2009 Heirs and Donors Burdened by Estate Tax and Proposal

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<th></th>
<th>Burdened by Estate Tax</th>
<th>Percent Burdened by Estate Tax</th>
<th>Burdened by Proposal</th>
<th>Percent Burdened by Proposal</th>
<th>Burdened by Both</th>
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<td>Heirs</td>
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<td>Estates</td>
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<td>9,399</td>
<td>0.35</td>
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Imaged with the Permission of N.Y.U. Tax Law Review
Table A13
Average Change in After-Tax Income of Winners and Losers by Economic Income

<table>
<thead>
<tr>
<th>Economic Income</th>
<th>Number of Winners (Less Liability Under Proposal)</th>
<th>Number of Losers (More Liability Under Proposal)</th>
<th>Average Change for Winners</th>
<th>Average Change for Losers</th>
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<tbody>
<tr>
<td>$0-$10K</td>
<td>38</td>
<td>0</td>
<td>21,161</td>
<td>-</td>
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<td>$10-$20K</td>
<td>153</td>
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<td>15,081</td>
<td>-</td>
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<td>$20-$30K</td>
<td>252</td>
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<tr>
<td>$30-$40K</td>
<td>449</td>
<td>0</td>
<td>56,248</td>
<td>-</td>
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<tr>
<td>$40-$50K</td>
<td>717</td>
<td>0</td>
<td>32,843</td>
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<tr>
<td>$50-$75K</td>
<td>1,591</td>
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<td>81,668</td>
<td>-</td>
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<tr>
<td>$75-$100K</td>
<td>1,047</td>
<td>0</td>
<td>124,603</td>
<td>(38,082)</td>
</tr>
<tr>
<td>$100-$200K</td>
<td>6,816</td>
<td>1,622</td>
<td>192,057</td>
<td>(141,002)</td>
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<tr>
<td>$200-$500K</td>
<td>5,094</td>
<td>4,513</td>
<td>266,825</td>
<td>(397,056)</td>
</tr>
<tr>
<td>$0.5-$1M</td>
<td>1,425</td>
<td>1,215</td>
<td>293,572</td>
<td>(578,976)</td>
</tr>
<tr>
<td>$1-$5M</td>
<td>733</td>
<td>741</td>
<td>294,709</td>
<td>(826,066)</td>
</tr>
<tr>
<td>$5M+</td>
<td>43</td>
<td>68</td>
<td>445,300</td>
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<td>Total</td>
<td>18,359</td>
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Table A14
Average Change in After-Tax Income of Winners and Losers by Inheritance Size

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<th>Inheritance Size</th>
<th>Number of Winners (Less Liability Under Proposal)</th>
<th>Number of Losers (More Liability Under Proposal)</th>
<th>Average Change for Winners</th>
<th>Average Change for Losers</th>
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<tbody>
<tr>
<td>$0+-$50K</td>
<td>51</td>
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<td>-</td>
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<td>370</td>
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<td>$100-$250K</td>
<td>961</td>
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<td>29,867</td>
<td>-</td>
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<tr>
<td>$250-$500K</td>
<td>3,408</td>
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<td>48,838</td>
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<td>7,455</td>
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<td>-</td>
<td>-5,310,693</td>
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<td>Total</td>
<td>18,359</td>
<td>8,160</td>
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C. Wealth Transfer Taxes Cross-Nationally

<table>
<thead>
<tr>
<th>Country</th>
<th>Donor Pays from After-Tax Income</th>
<th>Other Tax on Donor or Donee</th>
<th>Inclusion Tax</th>
<th>Accessions Tax</th>
<th>Estate and Gift Tax</th>
<th>Rate Varies by Relationship</th>
<th>Aggregation Period &amp; Unit</th>
<th>Treatment of Accrued Gains</th>
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<td>Australia</td>
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<td>N</td>
<td>Y</td>
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<td>Over 10 years by donor</td>
</tr>
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<td>Y</td>
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<td>Over life by relationship</td>
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<td>Y</td>
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<td>Annually from all for gifts, relationship for bequests</td>
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<td>Annually from all</td>
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### Table: Tax Treatment for Inheritance and Gift Taxes

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<th>Country</th>
<th>Donor Pays from After-Tax Income</th>
<th>Other Tax on Donor or Donee</th>
<th>Inclusion Tax</th>
<th>Accessions Tax</th>
<th>Estate and Gift Tax</th>
<th>Rate Varies by Relationship</th>
<th>Aggregation Period &amp; Unit</th>
<th>Treatment of Accrued Gains</th>
</tr>
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<td>N</td>
<td>Y</td>
<td>N</td>
<td>Over Life from All</td>
</tr>
</tbody>
</table>

* Denmark has an inclusion tax for gifts from relatives and requires income inclusion for gifts from non-relatives. It applies a hybrid estate/inheritance tax bequests, where the estate is taxed and there is an additional tax on bequests to heirs who are not lineal relatives or children-in-law. Japan provides exemption per estate and per statutory (not actual) heir, making it a hybrid estate/inheritance tax. Portugal does not tax gifts and bequests to lineal relatives. All others are subject to a flat wealth transfer tax, which is simultaneously an inheritance and an estate tax. Russia requires inclusion only for gifts to nonrelatives. Spain also imposes a progressive surtax based on the wealth of the donee. In Switzerland, it varies by canton whether the wealth transfer tax is an estate or inheritance tax.