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**Study on
Reform of the
Estate and Gift Tax System**

February 2001

AICPA Tax Division

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Reform of the Estate and Gift Tax System**

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Preface

Although historically the transfer tax system (encompassing the estate, gift and generation-skipping transfer taxes) has been targeted at the very wealthy, and currently affects a small percent of all estates, increasing numbers of taxpayers with moderate wealth are likely to be subject to the tax in the future. In addition, many are concerned over the impact of the transfer tax on estates consisting primarily of small businesses, family farms, and illiquid or inaccessible assets. These escalating concerns have caused most observers to agree that some form of reform to the current system is appropriate. The debate centers on how, not if, the system should be changed.

The American Institute of Certified Public Accountants (AICPA) has undertaken an analysis of a number of changes to the transfer tax system including substantial modifications and outright repeal. With respect to each modification or alternative, the AICPA analyzed its probable impact on taxpayer behavior, complexity and compliance, liquidity, redistribution of wealth, tax and succession planning, revenue, and transition issues.

This study, whose purpose is to educate and enlighten, confirms that significant reform of the U.S. transfer tax system is appropriate and should be undertaken as quickly as possible. In our year-long study, the AICPA has identified a number of significant issues, and the study makes substantive suggestions that the AICPA hopes will be considered in crafting any legislative proposal. We offer our suggestions on each of the alternatives not as a matter of ideology or social policy, but as a result of our collective judgment as to the best way to achieve simplicity, reduce taxpayer compliance burdens, improve ease of administration, and address revenue considerations with respect to the overall tax system.

Acknowledgments

This study was developed as a volunteer effort by the Estate Tax Repeal Task Force of the Trust, Estate, and Gift Tax Technical Resource Panel (TRP) and approved by the Tax Executive Committee of the Tax Division of the American Institute of Certified Public Accountants.

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Special acknowledgment is given to Jimmy Wilkins of North Carolina State University, Stephen Goldfarb of the AICPA Marketing Services Team, and Elly Filippi of PricewaterhouseCoopers LLP, for their hours and efforts in analyzing and presenting the survey information.

Study on Reform of the Estate and Gift Tax System

EXECUTIVE SUMMARY

Background

Significant reform of the U.S. transfer tax system has become the topic of much discussion and debate to the point that it is now an important political, social, and economic issue. The current transfer tax system consists of a set of complex laws that apply to estates, gifts, and generation-skipping transfers. These laws are separate and distinct from our income tax system. However, the transfer tax and income tax systems interact with each other in an attempt to achieve overall fairness and congruity in a system of taxation designed both to raise revenue and to achieve various policy goals. Therefore, significant reform of the transfer tax system necessitates an examination of the impact of such transfer tax changes on the income tax system, and how both systems affect complexity, taxpayer compliance burdens, ease of administration, and revenue.

Although historically the transfer tax has been targeted at the very wealthy and currently is paid by less than two percent of all estates, without significant change increasing numbers of taxpayers with moderate wealth will be subject to the tax in the future. Furthermore, huge increases in the value of retirement assets, personal residences, real estate, stock options, and other forms of illiquid or inaccessible wealth have exacerbated the liquidity and tax payment problems, which traditionally, have primarily affected small businesses and farmers.

These factors and others have caused most observers to agree that some form of modification to the current system is appropriate. The debate centers on how, not if, the system should be changed. Congress has considered a variety of approaches to estate tax reform over the last few years. For example, a recent legislative proposal would have reduced transfer tax rates over a ten-year period, followed by a repeal of the transfer tax combined with a new carryover basis regime applied to inherited assets. Although this proposal would have repealed the transfer tax, it would also have increased the complexity and amount of income taxes paid by many heirs. Other proposals would have made relatively minor changes to the transfer tax system, focusing instead on providing targeted relief to farmers and small businesses.

The American Institute of Certified Public Accountants (AICPA) is the national professional association of Certified Public Accountants (CPAs), with more than 350,000 members. Its members practice in public accounting, industry, government, and academia, and represent the full spectrum of political persuasions. As business and financial advisers, and as major participants in the administration of both the income and transfer tax systems, CPAs are uniquely well positioned to contribute to this dialogue from an objective, nonpartisan perspective. Accordingly, the AICPA offers its study and suggestions from the perspectives of simplification, taxpayer compliance burdens, ease of administration, and revenue considerations with respect to the overall tax system, rather than from a particular ideology.

The study first summarizes the current transfer tax system, next gives an overview of the arguments others have made both for and against the transfer tax, and finally describes a variety of possible modifications and alternatives. With respect to each modification or alternative, the

AICPA analyzes the probable impacts on taxpayer behavior, complexity and compliance, liquidity, redistribution of wealth, tax and succession planning, revenue, and transition issues, and discusses advantages, concerns, suggestions, and conclusions.

Modifications to the current transfer tax system that are analyzed in the study include:

- Increasing the applicable exclusion amount and changing its structure;
- Altering tax rates and the tax rate structure;
- Increasing targeted relief aimed at small businesses and farms; and
- Extending and modifying liquidity relief provisions.

In addition, the study evaluates four possible alternatives to the current transfer tax system including:

- An immediate or phased-in repeal of the transfer tax, with or without a step-up in income tax basis to fair market value at the date of death;
- A tax on appreciation at death;
- A comprehensive income tax; and
- An accessions tax.

Modifications to the Current Transfer Tax System

Some in Congress have proposed a combination of modifications that include increasing and recharacterizing the applicable exclusion amount, altering the transfer tax rate structure and brackets, expanding payment deferral relief, and modifying the GST tax. Under such an approach, compliance and administrative burdens would be substantially reduced, as most taxpayers would immediately be eliminated from tax filing and payment responsibilities. The overall tax system would be simplified without significant changes to the income tax system (such as a carryover basis regime), and the complexities associated with a gradual transition from one system to another would be avoided. Liquidity problems would be eased through substantial increases in the exclusion amount, significant reductions in tax rates, and the broad application of tax payment deferral options to all estates. Although both Federal and state revenue would be reduced, the estate tax revenue impact would be much less than that resulting from outright repeal.

If the current transfer tax system were modified, the AICPA suggests the following:

- Although the appropriate increase in the applicable exclusion amount depends on Congress' specific goals, increasing the amount to \$5 million per taxpayer would eliminate estate tax concerns for 90 to 95 percent of previously taxable estates. Also, the applicable exclusion amount should be indexed annually for inflation.
- The applicable exclusion amount should be made portable (i.e., \$10 million per couple), so that any portion unused by the first spouse to die could be utilized by the surviving spouse. Although this can be accomplished under current law through effective tax planning, portability should be made an explicit part of the law.

- Increasing the applicable exclusion amount would necessitate corresponding increases in the \$1,060,000 GST tax exemption. In addition, the GST tax should be immediately modified and simplified by including the GST tax modifications passed in several bills by the 106th Congress in any subsequent tax legislation.
- The applicable exclusion amount should be modified so that it becomes a true exemption. Under the present rate structure, this would result in the first dollar of taxable estate facing a marginal tax rate of 18 percent instead of the current 37 percent.
- If the estate tax rate structure is altered, across the board reductions and fewer brackets are preferable to simply reducing the highest marginal rate. In addition to reducing the rates affecting smaller estates, the top marginal rate should be reduced to a rate that is no higher than the maximum individual income tax rate (currently 39.6 percent).
- The AICPA does not support increasing targeted relief under I.R.C. sections 2031(c), 2032A, or 2057, or trying to extend the current liquidity relief measures under I.R.C. section 6166. Targeted relief has not been successful in the past; it treats similarly situated taxpayers differently. The AICPA believes it would be difficult to structure targeted relief in a way that will be useful for taxpayers. In addition, the complexities of section 6166 make it unworkable for many taxpayers. Therefore, the AICPA favors implementing a new regime of broadened liquidity/payment relief measures by eliminating current I.R.C. sections 2031(c), 2032A, 2057, and 6166 and replacing them with broader, simpler provisions available to all taxpayers. If concerned about overuse, the government could limit the attractiveness of such a tax payment deferral regime by adjusting interest rates and the deferral period.
- The full step-up in income tax basis to fair market value for inherited assets should be retained as under current law.
- The state death tax credit should be retained in its current framework, as a credit instead of a deduction, and any revenue losses to the states should be minimized.

These modifications to the existing transfer tax system are directed at solving identified problems and criticisms. A significant concern with this alternative is that modification might not be undertaken in a comprehensive manner or at the suggested levels, thus allowing some or many of the problems to persist and the criticisms to remain. Although comprehensive adoption of the recommended modifications would alleviate taxpayer compliance burdens and administration costs by excluding roughly 95 percent of the taxpayers affected today (leaving only 3,000 or so taxpayers affected by the estate tax), and would not require complex changes to the income tax system, the transfer tax infrastructure would nonetheless remain in place. The existence of that infrastructure could make it easier for future Congresses to expand the impact of the transfer tax system should, for example, revenue pressures demand such a course of action.

Repeal of the Transfer Tax

The new Administration and some members of Congress have proposed complete repeal of the transfer tax. Most proposals would accomplish the repeal through a reduction of top estate tax rates over eight to ten years, with full repeal at the end of the phase-out period. Some proposals

would retain the full step-up in income tax basis to fair market value, while others would implement a partial carryover basis regime for inherited assets, effectively increasing income taxes for many taxpayers.

Complete repeal of the estate, gift, and generation-skipping transfer taxes would provide significant estate tax savings for over 48,000 taxpayers who would otherwise pay estate tax, and would reduce compliance burdens for over 100,000 taxpayers who would otherwise file estate and gift tax returns. In addition, estate planning expenses would be reduced for far greater numbers of taxpayers. Liquidity concerns affecting farmers, small businesses, and estates containing other illiquid or inaccessible assets would be eliminated as the incidence of tax would be shifted to the sale or receipt of those assets. The administrative burden and costs incurred by the IRS would also be reduced after the tax is eliminated.

The effect of either immediate repeal or a long-term phase out of the transfer tax on state revenues, Federal revenue, and income tax erosion raises concerns that should be considered and addressed. To simplify a phase-out and immediately remove most taxpayers from filing and payment burdens, the AICPA urges that any phase-out be accomplished by increasing the applicable exclusion amount along with reducing tax rates throughout the rate structure during the phase-out period. Although there are problems in determining and dealing with carryover basis, some of these problems can be avoided by providing a substantial allowance for step-up in income tax basis. Regardless of the method or length of phase-out, it is imperative that the GST tax be modified immediately as was contemplated in previous tax bills.

The AICPA also urges that greater attention be given during the transition period to identifying and implementing those changes necessary to the income tax system before final repeal takes effect.

If the current transfer tax system were repealed, the AICPA suggests the following:

- Although lowering estate tax rates during a phase-out will reduce tax burdens somewhat, it will not reduce the administrative costs of the IRS during the phase-out period. A phase-out of top tax rates also will not appreciably reduce the burden on holders of illiquid assets – such as IRAs and other pension assets, stock options, personal residences, small businesses and farms – during the phase-out period. If a phase-out is appropriate, an increase in the applicable exclusion amount is preferable to phasing in reduced rates because it would reduce the administrative burden to both taxpayers and to the IRS by reducing the number of returns filed.
- The phase-out should be accomplished as expeditiously as possible.
- If a carryover basis regime is implemented, the AICPA suggests that an allowance for step-up in income tax basis also be adopted. This allowance should be substantial in order to avoid the problems inherent in determining carryover basis for the vast majority of estates. In addition, the step-up allowance should be indexed annually for inflation.

- In addition to any general basis step-up, the AICPA suggests that a limited basis step-up for a decedent's principal residence, up to the amount of gain that would have been excluded if the residence were sold immediately before death, be included.
- If a carryover basis regime is implemented, it should include a statutory safe-harbor as an alternative method for determining the basis of lifetime gifts and transfers at death. In some cases, an executor or beneficiary will not have adequate records to calculate carryover basis of assets held at death. A safe-harbor could be tied to inflation rates or other measures of price appreciation, based on historical published prices, or based on a statutorily allowed percentage of fair market value.
- Tax professionals, preparers, beneficiaries, and executors who use a "reasonable" method to determine carryover basis when adequate records do not exist should not be penalized under a carryover basis regime.
- If allowances for basis step-ups are included in a carryover basis regime, an elective safe-harbor procedure should be included for allocating the allowable basis step-up pro rata to all assets and all beneficiaries in a taxable estate.
- After repeal, uniform procedures for how basis information should be communicated to heirs and to the IRS must be established. The AICPA suggests requiring a new information return for reporting the basis of gifts. As under current law, \$10,000 annual gifts (\$20,000 if gift-splitting is elected) should not require reporting. It is also likely that an information return of some sort would still be required in order to report basis information to heirs. The filing of the information return should also start the running of the statute of limitations.
- Any repeal of the transfer tax presents problems and new issues for the income tax. These issues should be addressed prior to repeal in order to prevent widespread erosion of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens after final repeal.
- Donees who have received previously taxed gifts should be allowed to increase their basis in the gifted asset by the entire amount of gift tax paid.
- An automatic, long-term holding period for all inherited assets should be continued as under current law.
- Immediate modifications to the GST tax similar to those included in previous tax bills should be included in any legislation that does not provide for outright and immediate repeal of the estate tax.

Although revenue concerns may necessitate a phase-out of the estate tax rather than immediate repeal, phase-outs result in a great deal of uncertainty, significant transition issues, and additional and costly planning by taxpayers. The AICPA is particularly concerned that the estate tax may not ultimately be fully phased out if Congress is later faced with revenue constraints or increased spending needs. This concern is exacerbated by the possibility that — by the end of a long-term phase-out period — a future Congress may be composed of new members, have changed

leadership, and face markedly different challenges than the Congress that approved repeal. In addition, a phase-out of rates provides very little relief during the phase-out period for smaller estates including those containing small businesses, farms, and illiquid assets.

A Tax on Appreciation at Death

The idea of taxing constructive realization of income at death was first proposed in the 1930s and has been resurrected in various forms as recently as 1987. Conceptually, there is no reason why the appreciation on property transferred at death should not be subject to both an income tax on the appreciation and an estate tax on the gratuitous transfer. Practically, if a taxpayer sells appreciated property during his or her lifetime, the gain is subject to income tax, and if the taxpayer transfers the proceeds of the sale (less the income tax paid) at death to his or her heirs, the estate tax will apply also. Therefore, the current step-up in income tax basis at death produces inequities between taxpayers who realize income (appreciation) during life and those who transfer unrealized appreciation at death. Although a tax on appreciation at death has often been referred to by the popular press as a capital gains tax, there is no reason that the appreciation of non-capital assets should escape tax under such a regime. In fact, early proposals suggested taxing the appreciation of all assets.

A tax on appreciation at death is conceptually sound and has the advantage of eliminating the lock-in effect by removing the advantage of holding property until death in order to receive a step-up in income tax basis. A tax on appreciation at death could also raise significant amounts of revenue, particularly if structured with no exemptions and exclusions.

However, an appreciation tax does not address criticisms of the current estate tax related to whether death should be a taxable event. More importantly, an appreciation tax probably would not be feasible without numerous exclusions, exemptions, and targeted relief to address the inherent liquidity problems facing owners of IRAs and other pension assets, real estate, stock options, small businesses, and farms. Even then, it would be difficult to write those exclusions, exemptions and other necessary liquidity relief provisions in a way that would be simple and useful for taxpayers. Consequently, replacing the current estate tax with a tax on appreciation at death does not appear to reduce complexity or taxpayer compliance burdens or ease administration. Although an appreciation tax would reduce the tax burden on many estates by taxing only appreciation and at significantly lower rates than the current estate tax, the distribution of that burden would fall most heavily on small estates.

A Comprehensive Income Tax or an Accessions Tax

In contrast to the current transfer tax or a tax on appreciation at death, which are both assessed on the decedent's estate (the transferor), both a comprehensive income tax and an accessions tax would tax the recipient (transferee) on gifts and bequests received. However, the comprehensive income tax and the accessions tax are separate and distinct modes of taxation. Under a comprehensive income tax, gifts and bequests are included in the recipient's income tax base just as any other item of annual income. By contrast, the accessions tax is essentially an excise tax on the transfer of property by gift or at death. Like the transfer tax, the accessions tax would be assessed on cumulative lifetime gifts and bequests using a graduated tax rate structure. Under most accessions tax proposals, there would be a dual tax rate schedule based on the closeness or

remoteness of the transferor to the taxable recipient – with lower rates applying to gifts and bequests from immediate family members and higher rates applying to gifts and bequests from more distant family and unrelated individuals.

Although an accessions tax would completely eliminate the current transfer tax system, the benefit of its elimination would only be received at the cost of developing a new and complex system to replace it. On the other hand, a comprehensive income tax could be integrated with our present income tax system. This could simplify the overall income tax system if the plethora of exclusions and exemptions allowed in our current income tax system were repealed. A comprehensive income tax could also generate significant increases in revenue.

Neither the comprehensive income tax nor the accessions tax have been recently proposed as a viable alternative to our current transfer tax system. Most commentators conclude that their problems outweigh their benefits. Both are completely new systems that would require significant investments of time and money by taxpayers, tax advisers, and the government. Although a comprehensive income tax could simplify the overall income tax system if structured appropriately, it would only be feasible with a number of exclusions and exemptions that would increase its complexity. These taxes do little to alleviate liquidity problems caused by the current transfer tax regime and would be politically difficult to implement due to the change in imposition of the tax from transferor to transferee.

A more elaborate analysis of the transfer tax system and the AICPA's suggestions regarding reform follows.

Study on Reform of the Estate and Gift Tax System

I. INTRODUCTION

A. Overview

For most of the last half of the 20th Century, policy makers, practitioners, and academicians have debated the need for a change in the Federal transfer tax system. In the last several years, significant reform or modification of the transfer tax system has become an increasingly important political, social, and economic issue. Both Houses of Congress, several Administrations, taxpayers, and their advisers have debated the need to repeal or modify the tax on the grounds that it (1) creates a hardship for those with small businesses, farms, and other illiquid assets; (2) results in excessive taxation; (3) raises little revenue; (4) is highly complex; and (5) is simply inefficient.

The transfer tax system consists of a set of complex laws that apply to estates, gifts and generation-skipping transfers. These laws are separate and distinct from our income tax system. However, the transfer tax and income tax systems interact in an attempt to achieve overall fairness and congruity in a system of taxation designed both to raise revenue and achieve social goals. Therefore, significant reform of the transfer tax system necessitates an examination of the impact of any proposed changes on the income tax system, as well as an examination of the overall affect on both systems in terms of complexity, taxpayer compliance burdens, ease of administration, and revenue.

While the transfer tax applies to relatively few estates (42,901 taxable estate tax returns were filed in 1997, representing less than 2 percent of the total estimated deaths), and while the tax is primarily paid by the wealthy (almost half of all estate tax payments in 1997 were made by 2,335 estates with a gross value of over \$5 million; Johnson and Mikow 1999, 107), evidence suggests that the tax may encompass a much larger number and percentage of taxpayers in the future. Without changes in the current transfer tax system, the combination of an aging population and increases in household net worth, fueled by unprecedented growth in the stock market and in the value of real estate, likely will result in significant increases in the number of taxpayers required to file estate tax returns and pay estate taxes. Furthermore, huge increases in the value of retirement assets, personal residences, real estate, stock options, and other forms of illiquid or inaccessible wealth have exacerbated the liquidity problems traditionally considered to affect only small businesses and farmers.

These factors and others have caused most observers to agree that some sort of modification to the current system is appropriate. The debate centers on how the system should be changed.

The American Institute of Certified Public Accountants (AICPA) is the national professional association of Certified Public Accountants (CPAs), with more than 350,000 members. Its members practice in public accounting, industry, government, and academia, and represent the full spectrum of political persuasions. Many of these members have practical experience assisting clients with the many nuances and complexities of planning for the transfer

tax, and in preparing estate and gift tax returns for clients. As business and financial advisers and as major participants in the administration of both the income and transfer tax systems, CPAs are uniquely well positioned to contribute to this dialogue from an objective, nonpartisan perspective.

In this study, the AICPA provides an overview of the arguments others have made both for and against the current transfer tax, followed by a summary of the current system of taxing wealth transfers. Following the summary of the current system, the AICPA discusses a variety of modifications and alternatives to the current transfer tax. Modifications include: (1) increasing the applicable exclusion amount and changing its structure; (2) altering tax rates and the tax rate structure; (3) increasing targeted relief aimed at small businesses and farms; and (4) extending and modifying liquidity relief provisions currently provided in the law. Alternatives include: (1) the immediate or phased-in repeal of the tax, with and without a step-up in income tax basis; (2) a tax on appreciation at death; (3) a comprehensive income tax; and (4) an accessions tax.¹

For each modification or alternative, the AICPA provides a description of how it would work, and analyzes its impact on taxpayer behavior, complexity and compliance, liquidity, redistribution of wealth, tax and succession planning, revenue, and transition issues. The study then includes a discussion of concerns, suggestions, and conclusions for each modification and alternative.

The AICPA study does not debate or take a position with respect to the ideologies underlying the current transfer tax system. Rather, the AICPA offers its analysis and suggestions from the perspectives of simplification, taxpayer compliance burdens, ease of administration, and revenue considerations of the overall tax system.

B. Arguments for Keeping the Current Transfer Tax System

Supporters of the current system of taxing wealth at death argue that the estate tax is an important and growing source of revenue for the government. Between 1983 and 1998, transfer tax revenue increased 282 percent to an estimated \$27.7 billion in 1999 (Repetti 2000).² The Joint Committee on Taxation (1999, 247) estimates that receipts from transfer taxes will exceed \$330 billion over the ten years from 1999 to 2008.

Supporters also argue that the transfer tax makes a significant contribution to the overall progressivity of the nation's tax system. Graetz (1983) concluded that about one-third of the progressivity in our tax system is due to the estate tax. However, his comments are now almost 20 years old. The observable trend suggests that the very wealthy pay less estate tax (as a percentage of the net estate) than those of moderate wealth (see Table 1). For returns filed in 1997, the estate tax as a percentage of the net estate averaged only 3.5 percent for gross estates of

¹ While other options, including consumption taxes, periodic wealth taxes, and intangible taxes have been mentioned as possible alternatives to the current system of taxing wealth transfers, these options are not discussed in this paper.

² To put the dollars in perspective, Repetti notes that the estimated \$27.7 billion in 1999 equals the entire 1997 individual income tax liability of taxpayers with an adjusted gross income under \$15,000 and all the corporate income tax collected in 1996 from corporations with assets under \$100 million.

less than \$1 million, increasing to 24.3 percent for estates between \$10 and \$20 million. However, for gross estates in excess of \$20 million, the tax as a percentage of the net estate drops to 16.9 percent (Gravelle and Maguire 2000). This likely is a result of effective planning and large charitable gifts.

Table 1
Estate Tax Deductions and Burdens, 1997
 (Adapted from Gravelle and Maguire 2000)

Size of Gross Estate (\$ millions)	Tax as a Percent of the Net Estate after the Unified Credit	Charitable Deduction as a Percent of the Estate
0.6 - 1.0	3.5%	3.1%
1.0 - 2.5	11.8%	3.2%
2.5 - 5.0	19.2%	5.7%
5.0 - 10.0	23.2%	6.7%
10.0 - 20.0	24.3%	9.0%
Over 20.0	16.9%	28.4%

Related to the progressivity argument is the argument that the transfer tax serves as a backstop to the income tax. Wealthy individuals generally realize more income from capital appreciation than individuals with more moderate wealth. Much of the income of wealthy individuals is accrued, but unrealized capital gains. Thus, the transfer tax serves as a “backstop” to the income tax system by taxing these unrealized capital gains.³

Supporters also argue that the transfer tax provides an important tool for redistributing wealth in society and prevents unlimited wealth from being passed down from generation to generation. In 1891, Andrew Carnegie speculated that “the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would” (Kirkland 1962). In fact, there seems to be some truth to the “Carnegie conjecture.” In a research study, Holtz-Eakin et al. (1993, 432) found that “the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received.”

Proponents of the transfer tax also suggest that the tax provides a powerful incentive to make charitable contributions at death.⁴ However, due to the difficulty of separating wealth and price effects, the impact on charitable giving is not as clear as one might think. As tax rates increase, the cost or price of charitable giving goes down, increasing the incentive to make charitable contributions. For example, assuming a marginal estate tax rate of 40 percent, an individual with a taxable estate of \$1,000,000 faces a tax liability of \$400,000. If this individual donates \$500,000 to charity, the tax decreases by \$200,000 (\$500,000 x 40 percent). Every \$1 given to charity costs only 60 cents because 40 cents are saved in taxes. However, as tax rates

³ If the estate tax is to serve as a backstop to the income tax, one must question the rationale of replacing a capital gains tax that has a maximum rate of 20 percent with an estate tax that has a maximum rate of 55 percent. Of course, the estate tax also does not allow a deduction for basis in determining the amount of asset value to be taxed.

⁴ Some criticize the use of tax incentives for charitable giving in the first place, arguing that the electorate as a whole, not individual donors, should make decisions about which activities deserve taxpayer support.

increase, wealth decreases (due to the increased amount of taxes paid), reducing the incentive to make charitable contributions.

These conflicting forces can be seen in a recent study of the very wealthy conducted for Bankers Trust Private Banking by the Boston College Social Welfare Research Institute and the University of Massachusetts Boston Center for Survey Research (2000).⁵ While 74 percent of respondents indicated that increased tax benefits likely would increase their charitable giving, 88 percent indicated that increasing their net worth would increase their giving. The impact of transfer tax rates on charitable giving is also confounded by the income tax and income tax rates. The income tax deduction for charitable contributions encourages making lifetime gifts rather than testamentary gifts.⁶

Most academic studies have concluded that the transfer tax does promote charitable giving. However, the strength of the relationship is questionable. Some studies indicate that tax rates are an important motivating force (Clotfelter 1985; Auten and Joulfaian 1996). Joulfaian (2000) estimates that charitable giving through bequests would decrease 12 percent if the estate tax were eliminated. Other research indicates that tax rates play little, if any, role in encouraging giving (Barthold and Plotnick 1984).

While the total amount donated to charity at death is impressive, charitable bequests amount to only a small portion of total charitable giving. For returns filed in 1997, charitable deductions of over \$14 billion were taken on 15,575 estate tax returns, compared to over \$105 billion of charitable deductions on individual income tax returns in 1998 (IRS 2000). As is shown in Table 1, the percentage of the estate donated to charity ranged from 3.1 percent for gross estates under \$1 million to 28.4 percent for estates with assets exceeding \$20 million (Johnson and Mikow 1999, 105). However, the \$9.3 billion of charitable bequests on 1994 returns represented less than 1.5 percent of the total revenue of charitable groups and less than 8 percent of total charitable giving by individuals (Joint Committee on Taxation 1997, 40; Joint Economic Committee 1998, 10).

C. Arguments Against the Current Transfer Tax System

The current system of taxing wealth at death has been criticized for a number of reasons. One study argues that repeal of the estate tax would result in sizable economic gains, including larger Gross Domestic Product (GDP), more jobs, and lower interest rates that would increase Federal tax revenues above the current baseline and thus offset the transfer tax revenue losses (Robbins and Robbins 1999).

The wealth transfer tax system has traditionally been seen as a particular burden to farmers and small business owners. However, this burden also extends to taxpayers with a

⁵ The average level of wealth in the study was \$38 million, with almost 16 percent of respondents reporting family net worth of \$100 million or more.

⁶ A number of extremely wealthy individuals, including Bill Gates, have publicly announced their intentions to leave a significant amount of their wealth to charity. However, as noted by Abbin (2000), much of this giving appears to be directed towards private foundations established by the donors to benefit special needs of their choosing rather than to public charities.

substantial portion of their wealth tied up in retirement assets, real estate, personal residences and other forms of illiquid or otherwise inaccessible assets.⁷ The need to pay estate taxes may force heirs to liquidate family businesses and farms, sell the family home, or take other drastic steps in order to pay the estate tax.⁸ In a recent survey conducted by the AICPA, over 80 percent of respondents said that the transfer of a closely held business or farm was a major issue faced by their clients (second only to providing for a spouse). In addition, almost 13 percent of respondents said that one or more of their clients had been forced to sell a closely held business or family farm to pay estate tax.⁹ Davenport and Soled (1999) point out that liquidity problems are often the result of the need to pay off multiple heirs rather than to pay the estate tax. While the transfer tax makes liquidity problems worse, its overall impact may be exaggerated.

The transfer tax is also criticized as having a negative impact on the investment and savings activities of taxpayers by encouraging greater consumption of wealth during lifetime. However, due to offsetting income and substitution effects, most economists would argue that the impact of the transfer tax is not clear. The Joint Committee on Taxation (1999, 251) concludes that “it is an open question whether the estate and gift taxes encourage or discourage saving.”

Additionally, the transfer tax is often criticized as being highly complex. The vast majority of gift and estate tax returns require professional assistance. Taxpayers spend billions of dollars annually on complex planning to reduce or avoid the tax. A number of provisions and components, including the generation-skipping transfer (GST) tax, are so complex that even experienced tax professionals often have difficulty interpreting the law. The complexity of the system results in significant problems for taxpayers.

Finally, the transfer tax is criticized as being “inefficient,” resulting in excessive administrative, planning, and compliance costs. However, the estimates of the total costs vary greatly. Munnell (1988) estimates that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised. On the other hand, Davenport and Soled (1999) estimate total annual compliance costs of between \$1.6 and \$2 billion, about 6 to 9 percent of expected tax revenue. This consists of over \$150 million per year incurred by the Internal Revenue Service (IRS) in processing and examining transfer tax returns, over \$1 billion in taxpayer planning costs, and another \$550 to \$800 million in administration costs. Practitioners have indicated that the costs are significantly more than estimated above.

⁷ In this study, illiquid assets are considered to include assets like retirement plans that might require liquidation during unfavorable market conditions and that often cannot be accessed without incurring substantial income tax costs that otherwise would not be necessary.

⁸ While farm assets were reported on “only” 5.7 percent of taxable estate tax returns filed in 1997, this amounts to almost 2,500 individual farms (Johnson and Mikow 1999).

⁹ The survey was conducted by the AICPA to better understand the opinions and concerns of practicing CPAs with regard to the estate tax system and its various alternatives. The survey was administered to 3,826 members of the AICPA Tax Section (all Tax Section members in public accounting with both email addresses on file with the AICPA and with membership records indicating an interest in estate and gift tax issues). At the time of the survey, there were 23,007 Tax Section members with 13,187 indicating an interest in estate tax issues. Of these, 4,973 had email addresses on file and 3,826 worked in public accounting. A total of 806 individuals responded to the survey, resulting in a 21 percent response rate. More information concerning the demographic make-up of the respondents can be found in the Appendix.

In this study, the AICPA does not debate the ideological merits of the arguments either supporting or opposing the transfer tax. Rather, the AICPA's objective is to examine a variety of alternatives and modifications to the current system from the perspective of simplification, taxpayer compliance burdens, ease of administration, and revenue considerations with respect to the overall tax system. In the current debate surrounding the transfer tax, Congress and the Administration must determine (1) their policy goals in maintaining, modifying or repealing the transfer tax; (2) the relationship of the transfer tax to the income tax; (3) the need for the transfer tax as a revenue source; and (4) whether the transfer tax is the appropriate mechanism for reaching these goals.

II. THE CURRENT SYSTEM OF TAXING WEALTH TRANSFERS

A. Background

The modern estate tax was enacted in 1916 to help finance the "war-readiness" campaign (Joulfaian 1998).¹⁰ The gift tax was first enacted in 1924, repealed in 1926, and reenacted in 1932 as government revenues shrank during the Great Depression and in an attempt to reduce estate and income tax avoidance. In 1977, the estate tax and the gift tax were integrated as a unified transfer tax and complemented with a GST tax. The GST tax was substantially revised in 1986.

The current system is unified in that the estate and gift taxes share a common tax rate schedule and a common unified credit (applicable exclusion amount). The system is cumulative, requiring the addition of previous taxable gifts in computing current taxable gifts and requiring the addition of post-1976 lifetime taxable gifts in computing the estate tax at death (both adjusted for the payment of previous gift taxes). This cumulative feature has the impact of taxing cumulative transfers of wealth at the highest possible progressive tax rates.

B. The Tax Base

In general, the gift tax applies to lifetime transfers of wealth for less than full and adequate consideration and is applied to the fair market value (less consideration paid) of those transferred assets. The gift tax is cumulative in nature, requiring the addition of previous taxable gifts to calculate the current tax liability. As a general rule, the estate tax base includes the fair market value of all assets owned by the decedent at death, including cash, stocks, bonds, real estate, pension assets, business assets and farms, personal property, and life insurance. As discussed previously, the estate tax base also includes cumulative post-1976 lifetime taxable gifts.

¹⁰ In order to finance wars, the Federal government enacted a variety of temporary transfer taxes as early as 1797.

C. Valuation

Assets generally are valued at fair market value at date of gift or at date of death. Estates may elect to value their assets six months after the date of death (the alternate valuation date) if the election reduces both the value of the gross estate and the estate tax due. Under certain circumstances, alternative special use valuation is allowed for certain real property used in farms or businesses. If a number of special requirements are met under I.R.C. section 2032A, estates may value the real property as it is currently used rather than at its highest and best use.¹¹ However, the maximum reduction from fair market value is limited to \$800,000 in 2001. Minority discounts, “blockage” discounts, and other factors may be reflected in determining fair market value.¹²

D. Exemptions, Exclusions and the Unified Credit

Historically, Congress has allowed an exemption or exclusion from estate or gift tax for a certain dollar amount of taxable estate or gift. The role of this exemption is to exclude small gifts and small estates from the payment of gift and estate taxes. When first enacted, the gift tax provided an annual exclusion of \$500 and a lifetime exemption of \$40,000. The lifetime exemption was replaced with a unified credit in 1977, and the annual exclusion was increased to its current level of \$10,000 per year per donee in 1982 (see Table 2).

Table 2
Historical Features of the Gift Tax
(Adapted from Joulfaian 1998)

Year*	Annual Exclusion per Donee	Exemption or Equivalent Amount	Tax Rate Range
1924	\$ 500	\$ 40,000	1-25%
1926	N.A.	N.A.	N.A.
1932	5,000	50,000	0.75-33.5
1934	5,000	50,000	0.75-45
1936	5,000	40,000	1.5-52.5
1942	4,000	40,000	2.25-57.75
1943 - 1976	3,000	30,000	2.25-57.75
1977	3,000	120,667	18-70
1978	3,000	134,000	18-70
1979	3,000	147,333	18-70
1980	3,000	161,563	18-70
1981	3,000	175,625	18-70
1982	10,000	225,000	18-65

¹¹ These special requirements include: (1) passing the real estate to a qualified heir; (2) use of the realty for farming or in a business; (3) material participation by the decedent or a family member; and (4) percentage tests. As a practical matter, section 2032A is rarely used. Only 463 estates utilized section 2032A in 1998 (Eller et al. 2000).

¹² While valuation might appear simple, over 50 percent of estate tax court cases deal with valuation issues.

Year*	Annual Exclusion per Donee	Exemption or Equivalent Amount	Tax Rate Range
1983	10,000	275,000	18-60
1984	10,000	325,000	18-55
1985	10,000	400,000	18-55
1986	10,000	500,000	18-55
1987	10,000	600,000	18-55
1996	10,000	600,000	18-55
1998	Indexed	625,000	18-55
1999	Indexed	650,000	18-55
2000	Indexed	675,000	18-55
2001	Indexed	675,000	18-55
2002	Indexed	700,000	18-55
2003	Indexed	700,000	18-55
2004	Indexed	850,000	18-55
2005	Indexed	950,000	18-55
2006	Indexed	1,000,000	18-55

*Note: Year reflects period when feature took effect.

From the inception of the estate tax in 1916 until 1976, the estate tax exemption ranged from \$40,000 to \$100,000. In the Tax Reform Act of 1976 (effective in 1977), Congress substantially revised the estate and gift tax regime by providing for a single unified rate structure for estate and gift taxes and a unified credit in place of the earlier exemptions.¹³ After a period of phase-in, the unified credit reached \$47,000 in 1981, effectively exempting an estate or gift of \$175,625 from transfer tax.

In 1981, the unified credit was increased. After a phase-in period of several years, the credit stood at \$192,800 (equivalent to an exemption amount of \$600,000) from 1987 through 1997. In 1997, the credit was increased again, providing for an exemption equivalent of \$625,000 in 1998, increasing to \$1,000,000 in 2006. The amount of the exemption equivalent (called the applicable exclusion amount) is \$675,000 in 2001 (see Table 3).

As currently structured, the law does not explicitly allow for portability of the applicable exclusion amount between spouses. That is, if one spouse dies with assets of less than the current applicable exclusion amount (e.g., \$500,000), the surviving spouse is not allowed to use any remaining applicable exclusion amount (\$175,000 in 2001). Of course, the surviving spouse still gets to use their own applicable exclusion amount in full (\$675,000 in 2001). While portability is not explicitly provided by statute, it can be accomplished through proper planning. However, this often entails changing the legal title of assets held by each spouse and other costly planning techniques.

¹³ The unified credit works differently from an exemption. A credit provides the same benefit to small estates and large estates, while an exemption provides a greater benefit to smaller estates by taxing the first dollar of taxable estate at 18 percent instead of the current 37 percent.

Table 3
Historical Features of the Estate Tax
 (Adapted from Joulfaian 1998)

Year*	Unified Credit	Exemption or Equivalent Amount	Tax Rate Range
1916	N.A.	\$ 50,000	1-10%
1917	N.A.	50,000	1-15
1918	N.A.	50,000	2-25
1919	N.A.	50,000	1-25
1926	N.A.	100,000	1-20
1932	N.A.	50,000	1-45
1934	N.A.	50,000	1-60
1935	N.A.	40,000	2-70
1941	N.A.	40,000	3-77
1942 - 1976	N.A.	60,000	3-77
1977	\$ 30,000	120,667	18-70
1978	34,000	134,000	18-70
1979	38,000	147,333	18-70
1980	42,000	161,563	18-70
1981	47,000	175,625	18-70
1982	62,800	225,000	18-65
1983	79,300	275,000	18-60
1984	96,300	325,000	18-55
1985	121,800	400,000	18-55
1986	155,800	500,000	18-55
1987	192,800	600,000	18-55
1996	192,800	600,000	18-55
1998	202,050	625,000	18-55
1999	211,300	650,000	18-55
2000	220,550	675,000	18-55
2001	220,550	675,000	18-55
2002	229,800	700,000	18-55
2003	229,800	700,000	18-55
2004	287,300	850,000	18-55
2005	326,300	950,000	18-55
2006	345,800	1,000,000	18-55

*Note: Year reflects period when feature took effect.

E. Rate Structure

Estate and gift tax rates have been modified frequently since inception (see Tables 2 and 3). When the estate tax was initiated in 1916, the rates ranged from 1 percent to 10 percent. The top rate increased to 25 percent in 1917, 70 percent in 1935, and 77 percent in 1941. The top rate was reduced back to 70 percent in 1977 and to 55 percent in 1984. Gift tax rates ranged from 1 percent to 25 percent in 1924, increasing to a range of 2.25 percent to 57.75 percent between 1942 and 1955. From 1977 to the present, gift tax rates have mirrored estate tax rates as part of the unified transfer tax.

Under current law, the unified transfer tax rate schedule includes 17 brackets ranging from 18 percent on taxable estates not exceeding \$10,000 to 55 percent on estates over \$3,000,000. The current applicable exclusion amount of \$675,000 exempts smaller estates from the payment of estate tax. However, once the taxable estate exceeds the applicable exclusion amount, the marginal tax bracket is applied to the net taxable estate. For example, in 2001 when the applicable exclusion amount is \$675,000, the tax bracket of the smallest taxable estate is 37 percent (see Table 4).¹⁴

Table 4
Estate Tax Rate Schedule
 (Adapted from Joulfaian 1998)

If the amount of Taxable Estate (\$1,000's)		Then for the Tentative Tax	
Is over:	But not over:	Enter:	Of the amount over:
0	10	\$ 0 + 18.0%	\$ 0
10	20	1,800 + 20.0%	10
20	40	3,800 + 22.0%	20
40	60	8,200 + 24.0%	40
60	80	13,000 + 26.0%	60
80	100	18,200 + 28.0%	80
100	150	23,800 + 30.0%	100
150	250	38,800 + 32.0%	150
250	500	70,800 + 34.0%	250
500	750	155,800 + 37.0%	500
750	1,000	248,300 + 39.0%	750
1,000	1,250	345,800 + 41.0%	1,000
1,250	1,500	448,300 + 43.0%	1,250
1,500	2,000	555,800 + 45.0%	1,500
2,000	2,500	780,800 + 49.0%	2,000
2,500	3,000	1,025,800 + 53.0%	2,500
3,000		1,290,800 + 55.0%	3,000

¹⁴ The benefit of the lower rates is phased out for large estates.

F. Deductions and Exclusions

A variety of deductions and exclusions are allowed in computing taxable gifts and the taxable estate including a marital deduction and a deduction for charitable bequests. In addition, payments of tuition and medical expenses made directly to a third party provider are excluded from taxable gifts. Deductions for debts and expenses of an estate also are allowed in computing the taxable estate. The current marital deduction allows unlimited transfers between spouses with no gift or estate tax consequences. Amounts donated to qualifying charities and to Federal, state and local governments are deductible in computing the amount of taxable gifts and the taxable estate. I.R.C. section 2031(c) provides an exclusion from the gross estate for estates with land subject to a qualified conservation easement. The exclusion is limited to \$400,000 for estates of decedents dying in 2001.

G. Credits

Credits are allowed for state death taxes, previously paid gift taxes, and in some cases, previously paid Federal estate taxes. The state death tax credit was originally enacted in 1924 in response to states' concerns that the Federal government was encroaching upon their right to tax transfers at death. The credit ranges from zero to 16 percent of the adjusted taxable estate (the Federal taxable estate less \$60,000). Thirty-five states have estate taxes (often referred to as a "pick-up" or "soak-up" tax) that are exactly equal to the amount of the Federal state death tax credit. The other fifteen states have other forms of estate and/or inheritance taxes.¹⁵ However, if the state tax is less than the credit allowed against Federal taxes, the state tax is increased to the amount of the credit. Thus, the Federal credit for state death taxes effectively offsets most estate taxes levied by states, minimizing the interstate competition for the wealthy.

To avoid double taxation resulting from the cumulative nature of the estate tax, the estate tax provides a credit for previously paid gift taxes. In order to prevent excessive reduction of an estate by successive taxes on the same property within a brief period of time, the estate tax also provides a credit for previous Federal estate taxes paid on inherited wealth. The credit is phased out over ten years from the death of the original decedent.

H. Liquidity Relief Provisions

Under current law, the entire estate tax is generally due nine months after the date of death, regardless of the degree of liquidity of the estate. This often necessitates the sale of assets to raise cash. Because buyers may be aware of the time constraints on the executors and trustees, the estate may be not be able to realize the full value of its assets on sale.

Congress has tried to provide some relief to estates of business owners since 1958. Initially, I.R.C. section 6166 provided for payments of tax over ten years. In 1976, Congress extended this period to 14 years, but, at the same time, made the qualification provisions under section 6166 more stringent. An estate with a closely held business interest could only get relief if the business exceeded 65 percent of the adjusted gross estate. The Economic Recovery Tax Act

¹⁵ Inheritance taxes differ from estate taxes with respect to the incidence of the tax. While estate taxes are assessed on the decedent's estate, inheritance taxes are assessed on the heir or heirs receiving estate assets.

of 1981 introduced a 15-year payment provision and reduced the qualification threshold to 35 percent of the adjusted gross estate. The Tax Reform Act of 1984 added restrictions for a business that is either a holding company or holds a significant portion of passive assets not used in the operation of the business. As a practical matter, the number of estates electing to defer taxes under section 6166 is small. In 1998, only 565 estates (1.2 percent of taxable estates) took advantage of the provisions of section 6166, deferring only \$47 million of estate taxes (Eller et al. 2000).¹⁶

In 1997, Congress provided limited relief for qualified family-owned business interests in the form of a special deduction. Under I.R.C. section 2057, if an interest in a qualified family owned business represents more than 50 percent of the value of a decedent's estate, the executor may elect to deduct the value of the interest in computing the taxable estate.¹⁷ The maximum deduction cannot exceed \$675,000 and the combined deduction and the applicable exclusion amount cannot exceed \$1,300,000. However, evidence suggests that due to the extreme complexity and narrowness of the restrictions in section 2057, the provision is not frequently used by taxpayers.¹⁸

I. The Generation-Skipping Transfer (GST) Tax

The fundamental purpose of the GST tax is to ensure that a form of transfer tax is imposed at every generation. Without the GST tax, wealthy individuals could avoid estate or gift tax on one or more generations simply by transferring assets directly to grandchildren (or even great-grandchildren), thus avoiding estate tax at the level of the skipped generations. This technique would be particularly attractive to the super-wealthy.

The GST tax was first introduced in the Tax Reform Act of 1976. Under the 1976 Act, property that was transferred in trust was included in the gross estate of the deemed transferor for GST tax purposes. However, outright skips were not taxable. The 1976 provision was considered too complex, and talk of repeal began soon after its enactment. In 1986, the 1976 provision was repealed retroactive to its inception and was replaced by a "simplified" GST tax. Instead of computing GST tax as if the property had been included in the deemed transferor's estate, it applied a transfer tax at the highest estate and gift tax rate in effect. Importantly, it also taxed outright transfers. The Technical and Miscellaneous Revenue Act of 1988 contained various technical corrections that were effective as of the date of enactment of the 1986 Act.

¹⁶ One reason that I.R.C. section 6166 is not used more frequently is that many executors do not want to keep estates open for an extended number of years in order to receive its benefits.

¹⁷ In addition, a laundry list of special rules must be met, including ownership requirements and passing the business to a qualified heir. Finally, any tax savings attributable to the deduction must be recaptured and paid by the heirs if the business is disposed of, or if other criteria are not met, for up to ten years following the decedent's death.

¹⁸ Preliminary data indicates that about 900 returns utilizing section 2057 were filed in 1999 (unpublished IRS estimates, conversation in January 2001 with Barry Johnson, IRS Statistics of Income). Interestingly, H.R. 5315 of the 106th Congress, The Death Tax Relief Now Act of 2000, introduced by Representative John Tanner (D-TN) in September 2000, would have repealed I.R.C. section 2057.

Under the current GST tax regime, tax is imposed when property is transferred to a person in a generation that is two or more generations below the transferor. Such transfers include distributions of income or principal from a trust to a “skip” person. The tax rate is the maximum estate and gift tax rate in effect at the time of the transfer. Just as under the gift tax, the tax imposed on direct skips is tax exclusive and is imposed only on the amount transferred. However, tax on transfers resulting from distributions from trusts and terminations of trusts are tax inclusive as under the estate tax, meaning that the taxable amount includes the GST tax itself. Since 1986, each transferor has been allowed a GST tax exemption of \$1,000,000 that can be allocated to transfers during life or at death. Beginning in 1999, the exemption has been indexed for inflation. The indexed exemption is \$1,060,000 in 2001.

The current GST tax has been criticized as a trap for the unwary (Gardner 1998).¹⁹ To shield the average taxpayer from having to deal with the complex GST tax rules and pay the GST tax, Congress provided an automatic allocation of the exemption to direct transfers (outright gifts). However, in connection with most transfers to trusts, taxpayers have to elect to allocate the GST tax exemption. As a result, serious compliance problems have arisen.

Experience has shown that for ease of compliance and administration, the automatic allocation rules should also apply to transfers to trusts. In cases of missed allocations, even when it can be shown (and the IRS agrees) that the taxpayers and their advisers intended to make an allocation of GST tax exemption to a transfer, no relief is currently available. The IRS would like to be given the statutory authority to grant such relief. Innocent taxpayers, many of whom would not be considered wealthy and who are trying to follow the law, are failing to correctly allocate the GST exemption. Professional tax practitioners are facing serious liability problems arising from the GST. Some practitioners consider the preparation of gift tax returns to be too risky for the fees involved and are declining to prepare such returns.

Specifically, the problem occurs if there is a transfer to a trust and the GST tax exemption allocation is not made correctly on a timely filed gift tax return. In such a case, the portion of the trust protected by the GST tax exemption is based on the value of the property at the time of the late allocation, rather than the value at the time of the original transfer. The problem is intensified because of the compounding factor and the impact of inflation over time, which allow the GST tax liability to grow exponentially over the decades that property may be in a trust. The planning and drafting necessitated by the current allocation rules are complex and do not accommodate the average taxpayer, the person for whom the original GST tax exemption legislation was intended.

The AICPA has supported, and continues to support, legislation that would reform the GST tax provisions and provide relief for taxpayers by:

- Extending the automatic GST tax exemption allocation rule that currently applies to direct skips to generation-skipping transfer trusts (trusts to which most people would want the GST tax exemption allocated). Taxpayers who do not want the automatic allocation to apply could elect out.

¹⁹ The following discussion of GST tax traps was taken from “GST Compliance: Preparing the 706 and 709; Allocating the Exemption,” Chapter 21, pages 51-55, prepared by John H. Gardner for the 24th Annual Notre Dame Tax and Estate Planning Institute.

- Giving the IRS the statutory authority to grant section 9100 relief to taxpayers for late allocations. The IRS should also have full discretion in granting section 9100 relief for inadvertent mistakes made in prior years.
- Confirming that substantial compliance provisions cover intended allocations evident from returns and other documents.
- Extending the predeceased parent exception to provide for retroactive allocation of the GST tax exemption for unnatural order of death when the transferor is still alive.
- Creating a trust severance rule to cover various situations, including unexpected order of death and trusts with an inclusion ratio between zero and one.²⁰

These modifications would: (1) eliminate a trap for the unwary; (2) provide the intended GST tax exemption benefit that Congress originally intended; (3) bring fairness and equity to this area of the law by providing equivalent tax treatment to transfers to trusts and direct transfers; (4) simplify an extremely complex area that affects all taxpayers who might potentially give money to a grandchild; (5) make the GST tax rules more user friendly and fairer by ensuring that the benefits of the GST tax exemption are more accessible to taxpayers who do not have sophisticated advisers; (6) reduce the costs and complexities of compliance, drafting, and administering multiple trusts; and (7) reduce the incidence of liability due to a missed allocation.

In addition to the problems discussed above, the GST tax has recently come under attack as several states have repealed their longstanding “Rules Against Perpetuities,” allowing the creation of dynastic trusts designed to last as long as there are descendants of the trust creator.²¹ When formed to take advantage of the current \$1,060,000 GST tax exemption, these dynastic trusts can result in huge accumulations of wealth passing through several generations with no estate or gift tax paid by succeeding generations.

J. Basis Considerations

A key ancillary of the unified transfer tax structure is the calculation of basis resulting from gifts and bequests and the resulting income tax considerations. In general, if a taxpayer makes a gift of appreciated property, the donee takes the property with the donor’s basis (called a carryover basis), so the appreciation will be subject to income tax when the property is sold by the donee (I.R.C. section 1015). However, if a taxpayer dies owning appreciated property, the basis of the property becomes its fair market value (a stepped-up income tax basis) (I.R.C. section 1014).²² While the property is subject to estate tax, the pre-death appreciation in the property escapes income taxation entirely.

²⁰ These provisions were included in H.R. 8 of the 106th Congress, which was passed by both Houses of Congress and subsequently vetoed by President Clinton in September 2000.

²¹ Eleven states currently allow the creation of perpetual trusts. A discussion of the Rule Against Perpetuities and its repeal can be found in Bloom (2000).

²² An exception is provided for income in respect of a decedent (IRD) that retains a carryover basis.

III. POSSIBLE MODIFICATIONS TO THE CURRENT WEALTH TRANSFER SYSTEM

In the remainder of this study, alternatives and possible modifications to the current wealth transfer system are discussed. Modifications include: (1) increasing the applicable exclusion amount and changing its structure; (2) altering tax rates and the tax rate structure; (3) increasing targeted relief aimed at small businesses and farms; and (4) extending and modifying liquidity relief provisions currently provided in the law. Alternatives include (1) the immediate or phased-in repeal of the estate, gift and generation-skipping transfer taxes, with and without a step-up in income tax basis; (2) a tax on appreciation at death; (3) a comprehensive income tax; and (4) an accessions tax.

A. Increase the Applicable Exclusion Amount and Change its Structure

Increasing the applicable exclusion amount has been proposed as a way to alleviate many of the perceived problems with the current transfer tax system with minimal impact on the overall system of taxing wealth transfers. Proposals have included an immediate phase-in of the \$1,000,000 applicable exclusion amount (currently scheduled to gradually phase-in by 2006) to more generous increases of up to \$10,000,000.²³ Proponents of increasing the applicable exclusion amount argue that increases in the amount have not kept pace with increases in the value of real estate, stocks and other assets over the last 85 years. Adjusted for economic growth, Robbins and Robbins (1999) state that in 1916, estates under \$9 million (in today's dollars) would not have been taxed. An inflation-adjusted exclusion based on a baseline amount of \$600,000 in 1987 would exceed \$900,000 in 2000 (Joint Committee on Taxation 1997, adjusted for post-1997 years by the AICPA).

Making the exclusion portable would benefit taxpayers by allowing any exclusion unused at the death of a taxpayer to be used by a surviving spouse.

B. Alter Tax Rates and the Tax Rate Structure

The current transfer tax system has been criticized for its high tax rates and numerous brackets, starting at an effective rate of 37 percent and increasing to a top rate of 55 percent (see Table 4). After adding the impact of income taxes, opponents of the current estate and gift tax argue that the total tax burden is excessive. Although the estate and gift tax rates and brackets have generally fluctuated over time, they have not changed since 1981. For example, when top income tax rates were reduced from 70 percent to 50 percent by the Economic Recovery Tax Act of 1981, estate and gift tax rates were also reduced from 70 percent to 50 percent.²⁴ However, when top income tax rates were reduced from 50 percent to 33 percent (28

²³ For example, H.R. 5058 of the 106th Congress, introduced by Rep. James A. Leach (R-IA), would increase the applicable exclusion amount to \$10,000,000 and reduce top rates to 30 percent.

²⁴ The Tax Reform Act of 1984 deferred the scheduled rate decreases, effectively maintaining a top rate of 55 percent.

percent plus a 5 percent surtax) and brackets were indexed for inflation by the Tax Reform Act of 1986, no further reductions were made in the top estate tax rates.²⁵

Decreasing marginal rates within the current transfer tax system has been offered by some as a cure for many of its problems. Alternatives for reducing rates include: (1) decreasing transfer tax rates to reflect the current income tax rates on ordinary income (currently ranging from 15 percent to approximately 40 percent); (2) decreasing the top transfer tax rate to the highest income tax rate applied to capital gains (currently 20 percent); (3) decreasing the top transfer tax rate to 30 percent (see footnote 23); and (4) changing the way the applicable exclusion works to make the first dollar of taxable estate subject to the lowest 18 percent rate rather than the 37 percent rate.

C. Increase Targeted Relief Aimed at Family Farms and Small Businesses

Expanding targeted relief for small businesses and family farms has been proposed as a way to alleviate the liquidity problems and forced sales alluded to by estate tax opponents. In the 106th Congress, House Democrats proposed increasing the small business exclusion from a maximum of \$1.3 million to \$2 million and would have permitted the portion of the exclusion not used in the estate of the first spouse to die to be used by the estate of the surviving spouse. House Ways and Means Committee ranking Democrat, Charles Rangel (D-NY) said this alternative would have provided relief to 99 percent of farmers and small businesses currently impacted by the estate tax (BNA, Inc. 2000a). The Senate version of this proposed legislation would have increased the exclusion to \$8 million per couple by 2010. Senate Minority Leader Thomas Daschle (D-SD) said that this would have ultimately allowed estate tax relief for all but about 0.7 percent of those estates that remain taxable (BNA, Inc. 2000b).²⁶

However, relief aimed solely at farmers and small business owners does not provide any benefit to holders of other illiquid and inaccessible assets, including retirement accounts, personal residences and other real estate, installment obligations, stock options, etc. In today's economy, liquidity relief must be much broader than in the past.

D. Extend and Modify Liquidity Relief Provisions

Under current law, I.R.C. sections 2031(c), 2032A, 2057 and 6166 provide limited relief to a small number of business owners, land owners, and farmers by allowing

²⁵ The Revenue Reconciliation Act of 1993 increased the top individual income tax rate to 39.6 percent and made permanent the top estate tax rate of 55 percent. It also phased out the benefit of the lower transfer tax brackets and the unified credit for large estates.

²⁶ Other targeted relief bills of the 106th Congress included: H.R. 4562 introduced by Rep. Bob Etheridge (D-NC) and S. 3111 introduced by Senator Daniel K. Inouye (D-HI). H.R. 4562 would have increased the maximum estate tax deduction for family owned business interests from \$1.3 million to \$4 million by 2005. S. 3111 would have provided an extension of time for the payment of estate tax under section 6166 to more estates with closely held businesses by increasing the number of allowable partners and shareholders from 15 to 75.

exclusions, special valuations, deductions, and deferral of estate tax payments if a number of restrictions are met.²⁷ Some have suggested extending these liquidity relief provisions to all taxpayers regardless of the composition of the gross estate, arguing that this would decrease the burden caused by the need to quickly liquidate assets and pay estate tax liabilities within nine months of death. However, rather than extending these little-utilized provisions with their inherent restrictions and complexities, a new regime for deferring the payment of estate tax for all estates, regardless of asset makeup, is needed.²⁸

E. Analysis of Possible Modifications to the Current Wealth Transfer Tax System

1. The Impact on Behavior

Modifying the current wealth transfer tax system may alter taxpayer behavior in a number of ways. Decreasing the number of taxable estates and the estate tax burden may limit some of the more aggressive efforts to minimize the estate tax. For example, one might expect a reduction in highly complex and expensive strategies like tiered family partnerships and corporations intended to create multiple layers of valuation discounts.

Taxpayers with smaller estates may be less willing to make lifetime gifts or to make charitable contributions at death. The use of charities in testamentary planning and charitable remainder trusts could become less attractive. Although the empirical evidence regarding the impact of estate taxes on charitable giving is mixed (see previous discussion), CPA survey respondents indicated that only 31 percent of their clients would have made charitable contributions at death if there were no transfer tax.

In addition, the purchase of life insurance as a liquidity tool could be significantly affected. In general, the enhanced liquidity provided by these modification proposals should reduce the effect of transfer tax considerations on personal and dispositive aspects of all financial and investment decisions.

2. The Impact on Complexity and Compliance

Increasing the applicable exclusion amount would decrease the number of estate and gift tax returns filed, reducing the compliance burden faced by taxpayers and reducing administration costs incurred by the IRS. It also would make dispositive planning simpler and easier for most taxpayers. Increasing the applicable exclusion amount and/or altering tax rates and their structure would require no additional training for IRS personnel, require little change in current forms and instructions, and would require little change in the Internal Revenue Code. On the other hand, altering tax rates and structure without increasing the applicable exclusion amount would have little impact on the compliance burden of taxpayers.

²⁷ As noted earlier, in 1998, only 565 estates took advantage of the provisions of I.R.C. section 6166, deferring only \$47 million of estate tax, while 463 estates utilized the provisions of section 2032A (Eller et al. 2000). Likewise, preliminary evidence suggests that I.R.C. sections 2057 and 2031(c) are not being frequently used by taxpayers (unpublished IRS estimates, conversation in January 2001 with Barry Johnson, IRS Statistics of Income).

²⁸ If the government is concerned about the overuse of such an estate tax deferral mechanism, its attractiveness could be limited by adjusting the interest rate and deferral period.

Although the compliance costs of the current estate tax may be high, a substantial part of an estate's administrative costs has little or nothing to do with the estate tax. "Even without the estate tax, assets must be marshaled, debts must be paid, heirs must be pacified, property must be valued, special orders must be sought, asset schedules must be prepared, claims and debts must be listed, income and expenses must be tracked." (Davenport and Soled 1999).

Complexity could be minimized if liquidity relief provisions, including deferral mechanisms, were available to all estates with no phase-ins and no acceleration. However, to the extent that limitations and requirements are either retained or added in subsequent years, the complexity level would increase dramatically. For example, few executors and trustees can deal with the complexities of current I.R.C. sections 2031(c), 2032A, 2057 and 6166 (e.g., eligibility, valuation issues, acceleration rules, etc.) without sophisticated professional help. Targeted relief provisions are by their nature very complex and are little utilized. Attempting to make sure that an estate qualifies for special valuation, deductions and tax deferral under current law has been a difficult task for both taxpayers and their advisers. In addition, regardless of the complexity, executors and trustees may be reluctant to take advantage of the deferral provisions since they require holding an estate open for many years.²⁹

3. The Impact on Liquidity

To the extent the tax burden is eliminated or reduced by increasing the applicable exclusion amount, increasing targeted relief, or decreasing tax rates, liquidity problems will be reduced. Liquidity concerns would also be minimized by adopting simple payment options available to all taxpayers. There would be no need for additional targeted relief provisions aimed at solving liquidity problems facing small business owners, farmers, taxpayers with large retirement accounts, and others with large amounts of illiquid assets. By making payment relief measures available to all taxpayers, estate tax could be paid from a combination of future income and the proceeds of an orderly, deliberate sale of assets.

4. The Impact on the Redistribution of Wealth

Proposals to modify the current transfer tax system through increased exclusions and reduced rates may affect the distribution of wealth in a variety of ways. If it is necessary to replace the revenue lost or deferred with other tax revenues, these new tax sources may result in a reduction in the overall progressivity of the tax system.³⁰ If the lost revenues are not replaced, the governmental services provided to lower economic strata might be diminished,

²⁹ Broad payment relief measures would extend by years the involvement of families, executors, trustees, advisers, and the government in the tax collection process. More estates might remain open to take advantage of tax payment deferral. This likely would result in greater administration fees and possibly result in frustration on the part of beneficiaries whose distributions might be delayed. Likewise, government costs to administer an installment payment regime would be increased, although such costs might be mitigated by a reduction in the administration costs of other aspects of estate taxation (e.g., reduced need for audits of more aggressive tax reduction techniques).

³⁰ The impact on progressivity is difficult to judge and depends on overall budget considerations, the need to replace revenue, other spending needs, etc.

effectively reducing wealth redistribution. If charitable bequests are diminished, the lack of wealth redistribution may be exacerbated since many charities provide benefits to lower economic strata.

On the other hand, if the proposals reduce the tax burden of the wealthy, greater wealth would be passed to succeeding generations. This might increase the capital available to invest in businesses, possibly resulting in more jobs created for all economic strata (the “trickle down” argument for reduction in taxes on the wealthy).³¹

5. The Impact on Tax and Succession Planning

A decrease in the number of taxable estates and a reduction in their tax burden should reduce the planning required to address estate tax costs and that may be motivated primarily by estate tax savings. Likewise, the need for particular estate planning techniques is likely to be reduced. For example, costs could outweigh the benefits for estate tax savings techniques such as family limited partnerships, qualified personal residence trusts, certain life insurance products (such as second-to-die policies), irrevocable life insurance trusts, charitable remainder trusts, generation-skipping transfer and dynasty trusts, etc. Making the exclusion amount portable would reduce costs associated with changing the legal title of assets held by each spouse in order to equalize estates. Of course, non-tax planning related to succession and administration of estates and trusts would still be required.

6. The Impact on Revenue

Increasing the applicable exclusion amount and/or altering tax rates and the tax rate structure would decrease the potential amount of estate and gift tax revenue collected. However, this decrease in revenue may be offset in part by a decrease in administration costs incurred by the IRS and increases in income and other taxes. In addition, the decreased use of certain estate planning techniques could lead to a proportionate increase in revenue. On the other hand, the amount of gratuitous transfers to family members and others in lower income tax brackets might increase, resulting in a reduction in income tax revenue.

As estate taxes assessed by individual states are typically based on Federal estate taxes, reductions in Federal estate taxes may force states to restructure estate taxes or find other sources of revenue. Recent estimates suggest that, in the aggregate, states would lose almost \$9 billion of revenue annually by the time the Federal estate tax was fully repealed under a long-term phase-out like that of H.R. 8 of the 106th Congress (McNichol et al. 2000). Interestingly, changing the current applicable exclusion amount to a true exemption, without changes in the underlying credit for state estate taxes, would reduce the overall tax on estates (both Federal and state) almost entirely at the cost of state revenue (see Table 5). If states counter these changes at the Federal level with increases in their own estate and inheritance taxes, the overall tax burden at death could conceivably increase.

³¹ It should be noted that scholars and economists disagree with respect to the “trickle down” argument.

Table 5

Comparison of Federal & State Estate Taxes under Current Law & with a True Exemption

(adapted from Gravelle and Maguire 2000)

	Current Law	True Exemption
Gross Estate	\$2,000,000	\$2,000,000
Less: Marital Deduction	800,000	800,000
Less: Charitable Deduction	300,000	300,000
Less: Exemption	N/A	675,000
Taxable Estate	\$ 900,000	\$ 225,000
Tentative Estate Tax	\$ 306,800	\$ 62,800
Less: Applicable Credit Amount	220,550	N/A
Estate Tax Due Before State Estate Tax Credit	\$ 86,250	\$ 62,800
Less: State Estate Tax Credit	\$ 27,600	\$ 1,800
Net Federal Estate Tax Due	\$ 58,650	\$ 61,000

The revenue effect of an expansion of payment options for all taxable estates could be significant, especially in the short term. For example, if estate taxes were payable over ten years, it would take ten years before estate tax revenues in a given year stabilized to an amount comparable to collections under current law. That is, at the conclusion of the tenth year, ten percent of the tax from each of the previous ten years would be collected. The effect of this deferral would be mitigated by the collection of interest on the deferred amount, and possibly by a reduction in planning by taxpayers attempting to reduce the amount of tax immediately payable. There would be a similar effect on state revenue to the extent that states piggyback Federal law. The short-term revenue effect to both Federal and state governments would probably be worsened by the additional administrative costs of monitoring and collecting the tax over an extended period of time.

7. Transition Issues

One of the advantages of modifying the current estate and gift tax system is that transition problems are minimized and very few taxpayers are adversely affected.³²

8. Advantages

Substantial modifications to the current wealth transfer tax system would provide significant reductions in tax payment and tax compliance burdens, reduce administration costs, and simplify the transfer tax system with little impact on the income tax system. In addition, modifying the current system as described above offers a reasonable and practical solution to the long-range revenue implications of outright repeal, while effectively providing immediate repeal for the vast majority of taxpayers currently affected by the estate tax.

³² There still might be a perception of unfairness on the part of those executors, trustees and heirs of estates faced with paying estate taxes just before the effective date of any changes. Even those individuals whose estates may benefit from these proposals might feel frustrated because they arranged their affairs (e.g., purchased life insurance, made lifetime gifts, etc.) in a manner inconsistent with any changes in the law.

Specific advantages of modifying the current transfer tax system include the following:

- The compliance burden would be substantially reduced because the number of taxpayers subject to the transfer tax would be greatly decreased. Importantly, elimination of taxpayers would start with smaller estates because of the increased exemption, leaving only the largest estates subject to a transfer tax. In 1997, of 90,006 estate tax returns filed, only 3,399 reported gross estates over \$5 million. Of 42,901 returns actually paying estate tax that year, only 2,335 had gross estates exceeding \$5 million. Said another way, over 96 percent of the 90,006 estate tax returns filed in 1997 would be exempt from filing requirements and over 94 percent of the 42,901 taxable returns would be removed from the tax payment rolls if the applicable exclusion amount and corresponding filing threshold were increased to \$5 million. In addition, estate planning expenses would be reduced for substantial numbers of taxpayers.
- The administrative burden and costs incurred by the IRS would be reduced as large numbers of taxpayers would immediately be eliminated from tax filing responsibilities.
- The complexities associated with a gradual transition from one system to another would be avoided. Transition rules are typically among the most complicated rules in the tax system.
- Transfer tax simplification would be achieved by replacing multiple targeted relief provisions with broad-based liquidity relief available to all taxpayers. Targeted relief has proven to be complex and largely unused.
- Overall simplification would be achieved by avoiding significant changes to the income tax system, for example, by avoiding conversion to a carryover basis regime for assets passing to heirs at death, and avoiding special complex rules that would otherwise be needed to prevent the erosion of the income tax system.
- The re-education of taxpayers, tax professionals and tax administrators would be minimized. Other alternatives, including carryover basis, a tax on appreciation at death, a comprehensive income tax, and an accessions tax, would require significant investments of both time and money by taxpayers, their advisers, and the government.
- It is less likely that the Federal government would need alternative sources of revenue in the future. While the exact revenue impact of these modifications is not known, in 1997, 2,335 taxable estates with gross estates exceeding \$5 million paid almost half of the total estate tax collected from 42,901 taxable estates.
- States would not be forced to establish their own systems of estate and inheritance taxes which many states have previously repealed. This would avoid significant changes in the states' revenue collection infrastructure that would be complex and costly for taxpayers and their advisers to learn and for the states to implement and administer.

9. Concerns

The recommended modifications to the existing transfer tax system are directed at solving identified problems and criticisms. A significant concern with this alternative is that modification might not be undertaken in a comprehensive manner or at the suggested levels, thus allowing some or many of the problems to persist and the criticisms to remain. Although comprehensive adoption of the recommended modifications would alleviate taxpayer compliance burdens and administration costs by excluding roughly 95 percent of the taxpayers affected today (leaving only 3,000 or so taxpayers affected by the estate tax), and would not require complex changes to the income tax system, the transfer tax infrastructure would nonetheless remain in place. The existence of that infrastructure could make it easier for future Congresses to expand the impact of the transfer tax system should, for example, revenue pressures demand such a course of action. Finally, to the extent utilized, phase-ins of changes generally cause problems for taxpayers who must continually readjust their estate plans to follow the phased-in changes.

A number of other specific concerns also exist should the comprehensive modification approach not be adopted. For example, as long as the first-to-die's applicable exclusion amount is not portable, taxpayers might be compelled to retitle assets, perhaps multiple times to affect their planning objectives during the phase-in period. Also, if the applicable exclusion amount is applied after the estate tax is determined, smaller estates will still be subject to a higher marginal rate of tax. A phased-in reduction in estate tax rates that begins by reducing the top rates may be viewed as benefiting the wealthy without offering immediate relief to smaller estates, including those containing farms and small businesses.

To the extent targeted relief provisions are retained, many estates that do not contain small business or farm assets would still face unresolved liquidity problems. Unless liquidity relief is expanded to allow all estates to opt for installment payment of their estate tax liability, beneficiaries will incur significant income taxes and other costs to enable them to pay the estate tax bill. For example, beneficiaries may have to liquidate assets during unfavorable market conditions. Targeted relief provisions are also economically inefficient in that their requirements may pressure elderly taxpayers to hold assets that they otherwise would (and perhaps should) dispose of and may force heirs to continue holding farms and businesses just to receive tax advantages.

The current GST tax rules contain expensive tax "traps" for taxpayers and malpractice risks for practitioners in preparing gift tax returns. Families may not discover a missed GST tax exemption allocation for many decades, at which time the GST tax liability to the family as a result of the missed allocation may have increased exponentially due to compounding and the impact of inflation. Without default allocation schemes covering both direct skips and transfers to trusts, GST tax-generated problems will persist.

10. Suggestions

If the current transfer tax system were modified, the AICPA suggests the following:

- Although the appropriate increase in the applicable exclusion amount depends on Congress' specific goals, increasing the amount to \$5 million per taxpayer would eliminate estate tax concerns for 90 to 95 percent of previously taxable estates.³³
- The applicable exclusion amount should be made portable (i.e., \$10 million per couple), so that any portion unused by the first spouse to die could be utilized by the surviving spouse. Although it can be accomplished under current law through effective tax planning, portability should be made an explicit part of the law.³⁴
- Increasing the applicable exclusion amount would necessitate corresponding increases in the \$1,060,000 GST tax exemption. To the extent that these increases are made without modifications addressing the erosion of the efficacy of the GST tax due to repeal of the Rule Against Perpetuities at the state level, the ability to use dynastic trusts to create wealth will be exacerbated. In addition, the GST tax should be immediately modified and simplified by including the GST tax modifications passed in several bills by the 106th Congress in any subsequent tax legislation.
- The applicable exclusion amount should be modified so that it becomes a true exemption. Under the current rate structure, this would result in the first dollar of taxable estate facing a marginal tax rate of 18 percent instead of the current 37 percent (see Table 4).
- If the estate tax rate structure is altered, across the board reductions and fewer brackets are preferable to simply reducing the highest marginal rate. In addition to reducing the rates affecting smaller estates, the top marginal rate should be reduced to a rate that is no higher than the maximum individual income tax rate (currently 39.6 percent).
- The AICPA does not support increasing targeted relief under I.R.C. sections 2031(c), 2032A, or 2057, or trying to extend the current liquidity relief measures under I.R.C. section 6166. Targeted relief has not been successful in the past; it treats similarly situated taxpayers differently. The AICPA believes it would be difficult to structure targeted relief in a way that will be useful for taxpayers. In addition, the complexities of section 6166 make it unworkable for many taxpayers. Therefore, we would favor implementing a new regime of broadened liquidity/payment relief measures by eliminating current I.R.C. sections 2031(c), 2032A, 2057, and 6166 and replacing them with broader, simpler provisions available to all taxpayers. If concerned about overuse, the government could limit the attractiveness of such a tax payment deferral regime by adjusting interest rates and the deferral period.

³³ Based on 1997 IRS SOI data, of 90,006 estate tax returns filed in 1997, only 3,399 reported gross estates over \$5 million. Of 42,901 estates actually paying estate tax that year, only 2,335 had gross estates exceeding \$5 million (IRS 1999/2000). When AICPA survey respondents were asked how large the applicable exclusion amount would need to be to eliminate estate tax liability concerns for 90 percent of their clients, the median response was \$4 million and the mean response was \$8.8 million (see Appendix).

³⁴ The AICPA recognizes that portability of the applicable exclusion amount introduces potential problems relating to remarriages and may require taxpayers that would otherwise not be required to file an estate tax return to file some type of information return to claim their deceased spouse's unused exclusion.

- The full step-up in income tax basis to fair market value for inherited assets should be retained as under current law.
- The state death tax credit should be retained in its current framework, as a credit instead of a deduction, and any revenue losses to the states should be minimized.

11. Conclusion

A combination of an increased applicable exclusion amount, alteration of the rate structure and brackets, broad deferral relief for all estates, and modifications to the GST tax would satisfy many of the critics of the current estate tax. Although both Federal and state revenue would be reduced, the long-term revenue impact would be much less than that resulting from outright repeal.

IV. ESTATE TAX REPEAL

A. Analysis of Estate Tax Repeal

Complete repeal of the estate tax has been proposed by the new Administration and some members of Congress. Most proposals would accomplish the repeal through a long-term reduction of tax rates occurring over eight or more years, and delay full repeal to the end of the phase-out period. Some proposals would retain the full step-up in income tax basis to fair market value, while others would implement a partial carryover basis regime for inherited assets, effectively increasing income taxes for many taxpayers.

H.R. 8 of the 106th Congress would have incrementally reduced the Federal transfer tax rates over ten years, followed by full repeal and a partial carryover basis regime in the eleventh year.³⁵ The phase-out would have been accomplished by reducing tax rates. However, most of the reductions would have occurred in the final year, resulting in a maximum tax rate of 42.5 percent in the final year of phase-out. Along with the reduction in rates, H.R. 8 would have replaced the current applicable exclusion amount (exempting estates up to \$675,000 from tax) with a true exemption of the same amount. Following currently scheduled increases in the applicable exclusion amount, the exemption would have increased to \$1,000,000 by 2006. By changing the applicable exclusion amount to a true exemption, the estate tax on smaller estates would be reduced because the first taxable dollar of the estate would be taxed at 18 percent instead of the current 37 percent.

After repeal, H.R. 8 would have replaced the unlimited step-up in income tax basis allowed under current law for assets transferred at death with a limited step-up in income tax basis for up to \$1.3 million of the total assets transferred. In addition, if transferred to a spouse, another \$3 million of assets could have received a step-up in income tax basis. The remaining assets would have received a carryover basis. Essentially, the bill would have provided relief from the estate tax on the transfer of property at the time of death (at the current maximum tax rate of 55 percent on the total fair market value), but would have required the payment of

³⁵ H.R. 8 of the 106th Congress was passed by both the House and Senate but vetoed by President Clinton in September 2000. It also included the desirable modifications to the GST tax rules as discussed earlier.

income tax at a later date when appreciated property was sold by heirs (albeit at a lower rate, often equal to 20 percent of the gain).

The following analysis addresses the general issues raised by repeal of the estate tax along with additional issues raised by each possible approach — i.e., repeal with a carryover basis regime or repeal with a full step-up in income tax basis to fair market value — and the method of repeal — immediate or a long-term phase-out.

1. The Impact on Behavior

The current transfer tax law encourages the transfer of fractional interests in assets, regardless of whether the assets are active operating businesses or passive financial assets. The elimination of the estate tax likely would lead to the creation of fewer entities. In addition, the types of entities (i.e., trusts, partnerships) created to hold financial assets likely would change, with more emphasis being placed on maintaining control of the assets and the income tax characteristics of the entities. The consideration given to types of entities for operating businesses are typically more a function of control or management, legal liability, and income tax than estate tax.

Without an estate tax, families at marginal levels of wealth (i.e., near the current and projected applicable exclusion amounts) would be less likely to transfer wealth during their lifetime. However, families with income producing assets might still transfer assets to family members in lower income tax brackets or family members living in other countries in order to reduce income taxes.

A repeal of the estate tax that is accompanied by carryover basis would eliminate much of the incentive for retaining until death property that has substantially appreciated. The “lock-in” effect is a result of the current step-up in income tax basis accompanying assets passing at death. However, the estate tax elimination accompanied by carryover basis also reduces the incentive to sell property that has lost value before death. Under current law, if loss property is retained, an unrealized loss at death does not generate tax benefits. Carryover basis would allow heirs to use unrealized losses when the property is sold.

The current estate and income tax regimes provide an incentive for investors to hold onto appreciated assets that may escape capital gains taxation due to the stepped-up income tax basis at death. This effect would be exacerbated by transfer tax repeal with a full step-up in income tax basis. On the other hand, a carryover basis regime might result in less incentive for investors to hold onto assets that generate capital gains, and thus, might alter the types of assets taxpayers hold in their portfolios.

Eliminating the estate tax also allows more flexible investment decisions regarding purchases of life insurance products. Under our current tax structure, life insurance is frequently purchased to fund estate tax liabilities and is a tax-favored asset that can be the subject of a gift, usually in trust, that escapes estate tax. Eliminating the estate tax would allow the decision to purchase life insurance to be made based on factors other than estate tax needs.

Eliminating the estate tax may have a negative impact on charitable giving. Wealthy individuals who, under our current regime, transfer a significant portion of their

assets to charity as a method of minimizing estate taxes might reduce their charitable transfers. However, as discussed previously, the impact of the estate tax on charitable giving is not known with certainty.

2. The Impact on Complexity and Compliance

As was discussed earlier with regard to modifications to the current transfer tax system, compliance costs relate to more than estate tax. “Even without the estate tax, assets must be marshaled, debts must be paid, heirs must be pacified, property must be valued, special orders must be sought, asset schedules must be prepared, claims and debts must be listed, income and expenses must be tracked”(Davenport and Soled 1999). Administrative costs would remain significant even if the estate tax were repealed. Elimination of transfer taxes would eventually eliminate the administrative expenditures that the IRS makes in this area. However, a phase-out would do nothing to reduce administrative burdens during the phase-out period.

Those repeal proposals that would retain the full step-up in income tax basis to fair market value would achieve the greatest reduction in complexity. Repeal of the estate tax accompanied by a partial carryover basis regime, as is contemplated under several repeal proposals, may increase complexity for some taxpayers.³⁶ While computerization of records relating to stock and mutual fund purchases and real estate investments has made basis determination easier, determining carryover basis of these and other assets still may cause problems. For example, although some mutual fund companies provide basis information to owners, the practice is not uniform. It can still be difficult and time consuming to determine carryover basis for a stock or mutual fund that has been held for decades with reinvested dividends, stock splits, and perhaps additional purchases and sales.

Although taxpayers must cope with carryover basis in many cases under current law (transfers to trusts, outright gifts, installment sales to grantor trusts, GRATS, the formation of family limited partnerships, etc.), carryover basis issues can be largely ignored if property is held until death.

The \$1.3 million step-up in income tax basis plus the additional \$3 million step-up in income tax basis for assets passing to a surviving spouse proposed under H.R. 8 would have exempted some taxpayers from a carryover regime. Still, as the AICPA pointed out in testimony before the Senate Finance Committee over 20 years ago, a young person, regardless of his or her present circumstances, would be foolish to decide today that over his or her lifetime, he or she will not accumulate enough assets for carryover basis to present a serious problem for his or her family. The duty of maintaining records of purchase dates and prices of all of one’s assets – of every variety – would be imposed upon an enormous segment of the population. In addition, for those taxpayers affected by carryover basis, allocating the step-up exemption among assets would be a new and complex task.

Because current income tax provisions allow taxpayers to exclude up to \$500,000 of gain on the sale of a principal residence, taxpayers may consider keeping adequate

³⁶ What is not clear is how many taxpayers will be required to determine carryover basis. For example, as discussed earlier, H.R. 8 of the 106th Congress proposed a limited basis step-up that would have eliminated some taxpayers from a carryover basis regime.

records of basis for a principal residence to be unimportant. Therefore, determining the carryover basis of a decedent's former principal residence could be particularly problematic. In addition, the imposition of carryover basis might have the unintended consequence of forcing the sale of a principal residence before death (which would avoid all taxes if the gain were below \$500,000) instead of passing it to heirs who would be faced with a carryover basis and income tax on any gain.

The AICPA survey results (see Appendix) suggest that many CPAs are concerned about the impact of carryover basis. Absent any step-up in income tax basis for assets passing to heirs, over half of the respondents indicated that calculating carryover basis would "definitely" or "probably" cause significant problems for their clients for collectibles, other personal property and household goods, mutual funds, and listed securities. Calculating carryover basis for a personal residence or other real estate was viewed to be less problematic, but still viewed as causing significant problems for clients by over 40 percent of respondents.

However, concerns about collectibles and other personal assets should be tempered by the fact that these assets make up a very small percentage of total assets in most estates. As can be seen in Table 6, regardless of the size of the estate, collectibles and other personal property make up an average of less than 4 percent of total assets. Likewise, regardless of estate size, stock and bond mutual funds make up less than 2.2 percent of total assets. The proportions of other asset categories varies greatly with estate size. For example, a personal residence and other real estate (for which determining carryover basis is less problematic) constitute an average of over 30 percent of smaller estates and just over 10 percent of the largest estates. Likewise, closely-held stock and other stock vary from a low of less than 18 percent of total assets in small estates to over 57 percent of total assets in the largest estates.

Table 6
Estate Size (\$ Millions) /Asset Category as a Percent of Total Assets
 (Adapted from IRS SOI Bulletin, Winter 1999/2000, Publication 1136)

Asset Type	\$0.6 to \$1	\$1 to \$2.5	\$2.5 to \$5	\$5 to \$10	\$10 to \$20	Over \$20
Personal Residence	13.94%	10.00%	7.15%	5.62%	3.71%	1.52%
Other Real Estate	17.43	17.53	16.58	14.68	13.64	8.96
Closely Held Stock	4.43	8.70	12.51	16.13	21.56	26.42
Other Stock	13.42	15.30	19.19	21.23	22.99	30.77
Tax Exempt Bonds	5.29	7.70	9.52	10.50	10.17	9.36
Government Bonds	3.33	2.75	2.48	2.63	2.38	2.00
Corporate Bonds	0.64	0.47	0.82	0.47	0.71	0.54
Bond Mutual Funds	0.40	0.37	0.19	0.21	0.24	0.09
Stock Mutual Funds	1.75	1.47	0.96	0.70	0.53	0.17
Cash/Money Market	9.17	6.83	4.46	3.76	2.60	1.56
Mortgage Notes	2.84	2.91	3.35	3.15	2.94	2.63
Equity & Life Insurance	2.52	1.94	1.15	0.86	0.63	0.16
Non-Corporate Business	2.91	2.72	2.75	3.58	4.96	4.25
Limited Partnerships	0.74	1.11	1.70	2.78	2.81	4.91
Retirement Assets	14.09	13.33	10.31	7.09	3.62	1.28
Other (Personal/ collectibles)	3.96	3.58	3.80	3.75	3.89	3.88

The imposition of carryover basis would result in substantial new responsibilities (and potential penalties) for executors, even those of modest estates, which might negatively impact the choice of executors, their agreeing to serve, and the fees they charge. Executors would have to determine how to allocate the limited basis step-up for estate assets. It is likely that additional reporting rules would be needed, requiring the executor to provide basis information to heirs. Executors likely would turn to CPAs, attorneys, and other professionals in order to determine carryover basis. In some cases, a decedent's family may need to retain professionals to review a lifetime's accumulation of bills, checks, insurance policies, and other records to determine the acquisition dates and prices of a multitude of assets and then make detailed time-consuming computations of their bases. This would increase fees paid to administer estates. However, fees related to the preparation of estate and gift tax returns would be eliminated³⁷ so the impact on total fees is difficult to estimate.

Federal repeal of the transfer tax, whether immediate or accomplished through a phase-out, may result in additional complexity for taxpayers if states are forced to change their revenue collection infrastructure to supplant their lost revenue. A number of different transfer tax systems in each state would be complex and costly for taxpayers and their advisers, as well as difficult and costly for the states to implement and administer. Repeal would also add complexity to income tax planning as taxpayers change the focus of their planning from estate tax to income tax avoidance.

3. The Impact on Liquidity

Although liquidity issues created by the need to pay estate taxes would be alleviated with full repeal, significant problems with illiquid assets would still exist during any phase-out period. If the tax is phased out through a gradual top-down reduction of rates, smaller estates receive very little relief from the estate tax during the phase-out period. After repeal, by postponing taxation until property and businesses are sold, the need for complex and expensive administrative remedies targeted at farmers, small business owners, and ranchers, such as special use valuation provisions, deferred payments of death taxes, etc., would be eliminated.

4. The Impact on the Redistribution of Wealth

The distributional impact of a repeal of the current transfer tax regime is not clear. If Congress imposes new taxes to make up the revenue lost from the repeal of the estate tax, the tax burden currently borne by the wealthiest taxpayers may be shifted to those of moderate or lesser wealth. Repeal with a full step-up in income tax basis would particularly benefit taxpayers who would otherwise pay the estate tax.

After repeal (and without the imposition of new taxes), a proposal like H.R. 8 of the 106th Congress would essentially be tax-neutral or provide a net tax advantage for individuals with assets below \$1.3 million by allowing a full step-up in income tax basis for those assets. For the same reason, it would provide a net advantage for those individuals who pass less than \$1.3 million to any heir and an additional \$3 million to a surviving spouse. Likewise, a similar repeal proposal likely would provide a tax benefit for individuals and married couples with larger estates by eliminating an estate tax on property held at death (at a maximum

³⁷ As discussed above, it may still be necessary to prepare basis-reporting information returns.

rate of 55 percent) and replacing it with an income tax on appreciation when (and if) property is sold. If property has not appreciated in value, the taxation is eliminated altogether. Income tax on the sale of appreciated assets could be as high as 39.6 percent of the gain, although a substantial amount of gain would likely be taxed at capital gains rates of 20 percent.

It should be noted that estate planning techniques undertaken under current law might eliminate or reduce a substantial portion of estate tax. Consequently, the tax impact of repeal with carryover basis on high wealth individuals is difficult to judge.

5. The Impact on Tax and Succession Planning

The repeal of the estate tax likely would move wealth transfer planning to the “back burner,” although phase-outs might increase planning costs over the phase-out period.³⁸ While potentially reducing estate planning costs for taxpayers, final repeal of the estate tax likely would shift the emphasis of tax planning for wealthy taxpayers from estate planning to income tax planning. It is likely that the use of techniques to defer the payment of income tax (like-kind exchanges, tax-free reorganizations, borrowing against assets, etc.) will increase.

The ultimate repeal of the estate tax would eliminate the need for bypass trusts, QTIP trusts, and other trust arrangements created solely for estate tax planning purposes. This type of planning is often used by those with moderate wealth. Repeal of the estate tax would also reduce the use of partnerships, LLCs, and other entities created primarily for estate tax planning purposes. Use of these entities would be relegated to mainly non-tax reasons, including the management of assets and control of distributions. Estate tax repeal would eliminate the advantage that very wealthy taxpayers have in using generation-skipping trusts and dynasty trusts to mitigate or eliminate estate taxes and would reduce the use of expatriation activities and offshore entities for estate planning purposes.

Repealing the estate tax may have an adverse effect on taxpayers who have effectively planned their estates under current law to minimize transfer tax payments. For example, taxpayers who have made taxable gifts, purchased substantial life insurance policies to provide liquidity, transferred assets to irrevocable trusts, transferred a personal residence to a qualified personal residence trust, or utilized family limited partnerships to transfer assets might believe they were worse off.

Estate tax repeal accompanied by carryover basis with a limited step-up in income tax basis would make planning difficult for taxpayers with estates close to the current applicable exclusion amount. Those taxpayers would face a great deal of uncertainty caused by not knowing whether only the stepped-up basis or both carryover basis and stepped-up income tax basis rules would apply to assets held in their estates.

³⁸ Davenport and Soled (1999) suggest that wealth transfer planning has many positives including: avoiding family squabbles, protecting assets from creditors, and the orderly management of business assets. “Planning is a positive benefit to society although it may well reduce estate tax receipts, and ... estate taxes may sensitize people to the need for planning the disposition of assets at death.”

The preparation of wills and trusts would remain complicated by non-tax factors such as evolving family structures due to the frequency of divorce and remarriage. Despite the fact that documents may not be significantly different, clients may be less willing to pay for planning services where tax savings are not at issue (Davenport and Soled 1999).

6. The Impact on Revenue

A phase-out of the estate tax would reduce the revenue impact to the government. Due to the large increases in the equity markets over the last several years, and the deaths of many surviving spouses over the next ten years, substantial revenue would be generated over the phase-out period. The cost of the phase-out proposed in H.R. 8, coupled with carryover basis, is estimated to be \$100 billion over ten years.³⁹ However, after a phase-out is complete, the revenue loss over the next ten years has been estimated to be as high as \$750 billion.⁴⁰ Repeal with a full step-up in income tax basis to fair market value likely would result in even greater revenue losses due to the lock-in effect and the subsequent reduction in income tax collections.

The long-term impact of repeal and carryover basis on total tax receipts is difficult to ascertain. Income tax revenues may be accelerated when taxpayers do not have an incentive to hold assets until death for a step-up in income tax basis. However, tax revenues may also be deferred if heirs choose to hold onto property to avoid the income tax. Also, a decrease in transfer tax revenue may be offset in part by a decrease in administration costs incurred by the IRS and increases in income and other taxes.

The lack of a gift tax would increase the incentive for taxpayers to make gifts to family members in lower income tax brackets and family members living outside the country to reduce their income tax liability. Without special rules, taxpayers could simply make gifts of appreciated assets to family members in lower tax brackets (or family members living outside the country) who would then sell the assets and give the after-tax proceeds back to the original donor. If full step-up in income tax basis to fair market value is retained, this increased incentive to make gifts could be offset by the lock-in effect (i.e., the incentive to hold appreciated assets until death to receive a step-up in income tax basis).

Unless state inheritance and estate taxes are abolished or changed, repeal of the Federal estate tax may not reduce such state taxes. Recent estimates suggest that in the aggregate, states would lose almost \$9 billion annually by the time the Federal estate tax would be fully repealed under the provisions of H.R. 8. It is unclear what impact eliminating the Federal transfer tax would have on changing individual states' inheritance and estate tax provisions. At a minimum, the change would create confusion with a number of states due to the interplay of current state and Federal statutes. Changes in the states' revenue collection infrastructure that might be necessary to supplant this revenue would be complex and costly for taxpayers, their advisers, and the states.

7. Transition Issues

³⁹ Carryover basis (with a safe harbor of 50 percent of fair market value) is estimated to raise \$1 to \$4 billion annually in the first few years with a total of almost \$45 billion over 10 years (Congressional Budget Office 1999).

⁴⁰ It should be noted that these are both static estimates that do not consider changes in taxpayer behavior.

While outright repeal would have little transitional impact, phase-outs are likely to result in significant transition issues and complexities for both taxpayers and the IRS. Transition issues may be substantial and include the administrative costs of educating taxpayers each year and planning costs incurred by taxpayers forced to update and revise their estate plans on an annual basis. Other alternatives and options may be less disruptive to taxpayers and may be easier to implement than phased-out repeal.

8. Advantages

Complete repeal of the estate, gift and generation-skipping transfer taxes would provide significant estate tax savings for the 48,000 or so taxpayers currently paying estate tax and reduce compliance burdens for over 100,000 taxpayers currently filing estate and gift tax returns.⁴¹ Complete repeal would reduce administration costs and reduce the tax planning costs incurred by taxpayers, although other estate planning costs related to broader succession issues would remain. Complete repeal, with or without a carryover basis regime, would solve the liquidity problems currently faced by farmers, small businesses and others with illiquid and/or inaccessible assets.

Specific advantages of estate tax repeal include the following:

- The tax return filing burden would be completely eliminated for over 100,000 taxpayers who would otherwise file estate and gift tax returns and over 48,000 taxpayers, who would otherwise pay estate tax, would be removed from tax payment responsibilities. This includes a substantial number of estates with farm assets and/or business assets. In addition, tax planning expenses would be reduced for a great number of taxpayers.
- The administrative burden and costs incurred by the IRS would be significantly reduced as large numbers of taxpayers would immediately be eliminated from tax filing responsibilities.
- The transfer tax system would be simplified through the complete repeal of the estate, gift, and GST taxes.
- Liquidity concerns affecting farmers, small businesses, and other decedents with illiquid or inaccessible assets would be largely eliminated as the incidence of tax would be shifted to the sale or distribution of those assets.
- Complex planning techniques and the creation of entities used solely for estate tax planning would be curtailed.
- Complete repeal of the transfer tax might make it difficult to resurrect other forms of estate and inheritance taxes in the future.

9. Concerns

⁴¹ It is likely that some reporting mechanism will still be required to report the carryover basis of gifts and inherited assets for income tax purposes.

Although revenue concerns may necessitate a phase-out of the estate tax rather than immediate repeal, phase-outs result in a great deal of uncertainty, significant transition issues, and additional and costly planning by taxpayers. The AICPA is particularly concerned that the estate tax may not ultimately be fully phased out if Congress is later faced with revenue constraints or increased spending needs. This concern is exacerbated by the possibility that – by the end of a long-term phase-out period – a future Congress may be composed of new members, have changed leadership, and face markedly different challenges than the Congress that approved repeal. In addition, a phase-out of rates provides very little relief during the phase-out period for smaller estates including those containing small businesses, farms, and illiquid assets.

It is likely that estate tax revenues have been substantially deferred by the impact of the unlimited marital deduction. The wealth of many surviving spouses has grown enormously over the last 20 years. Outright repeal of the estate tax may be viewed as a windfall for wealthy surviving spouses, especially those who may have recently received a full step-up in income tax basis upon the death of their spouse.

Although immediate, outright repeal of the estate and gift tax mitigates many of the concerns raised by a long-term phase-out, concerns remain about repeal accompanied by retention of the full step-up in income tax basis to fair market value at death. Regardless of the arguments concerning the impact of the estate tax on the progressivity of our tax system, charitable giving, and the redistribution of wealth, the AICPA is concerned that future revenue needs may require Congress to impose one or more tax increases in the form of an income tax on appreciation at death, some sort of carryover basis regime, or possibly a national sales tax. The AICPA believes that the complexities inherent in a carryover basis regime (without large allowances for income tax basis step-up) and a tax on appreciation at death are at least as great as that in the current transfer tax system.

One might assume that the traditional distinction between lifetime gifts and transfers made at death would be abolished if the current transfer tax is repealed. However, to avoid the complete erosion of the income tax, gifts would still require carryover basis and the filing of an information return to report that basis to donees and the IRS. Even with reporting of carryover basis, the lack of a gift tax would increase the incentive for taxpayers to make gifts to family members in lower income tax brackets or family members living abroad to reduce their income tax liability. Without special rules, taxpayers could simply make gifts of appreciated assets to family members in lower tax brackets or family members in other countries who would then sell or receive income from the assets and give the proceeds back to the original donor. Finally, it should be noted that manipulating the basis of assets by making “death bed” gifts would be problematic after the estate tax is repealed unless the basis rules in I.R.C. section 1014(e) are expanded.⁴²

The AICPA is also concerned that immediate repeal of the Federal transfer tax system would force states to establish their own systems of estate and inheritance taxes. Immediate elimination of the Federal estate tax would cost states somewhere between \$2 billion

⁴² I.R.C. section 1014(e) disallows a step-up in income tax basis for appreciated property acquired by a decedent by gift within one year of death that passes back to the donor at death.

and \$5 billion of estate tax revenue each year. Most states will also lose income tax revenue if taxpayers make gifts of appreciated assets to family members in other states or in lower tax brackets. Changes in the states' revenue collection infrastructure would be complex and costly for taxpayers and their advisers and difficult for the states to implement and administer.

A carryover holding period for inherited assets may be problematic for heirs seeking to diversify their inherited investment portfolio after the death of a family member. A need to liquidate investments to meet current cash needs is made more difficult by the prospect of paying income taxes at ordinary rates for assets that do not meet a one-year holding requirement.

The AICPA has concerns about how the IRS would deal with carryover basis of assets that have passed through multiple generations, specifically that the IRS would take the view that the basis is zero unless the taxpayer can prove otherwise. The AICPA is also concerned about who will have responsibility for determining the basis of inherited assets. Some type of reporting system will have to be devised. Will the executor or the beneficiaries be responsible for this task? Will some sort of separate informational reporting be required to include carryover basis information? If so, what penalties might an executor or preparer be exposed to if incomplete or inaccurate information is reported? Will a beneficiary of carryover basis property be able to rely on information (or be bound by information) provided by an executor or will the IRS be able to continually challenge "old and cold" information due to the lack of a statute of limitations?

Repeal of the transfer tax that includes a full step-up in income tax basis to fair market value would perpetuate the lock-in effect of current law and result in substantial income tax erosion. The alternative of substituting a carryover basis regime would present many practical problems and increase complexity for many taxpayers. Providing a limited step-up in income tax basis might address carryover basis issues for some taxpayers. However, other taxpayers would have to deal with a new source of complexity caused by the need to allocate the step-up in income tax basis among assets.

Any repeal of the transfer tax presents problems and new issues for the income tax that must be thought through and addressed prior to repeal in order to prevent widespread erosion of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens under the new regime.

10. Suggestions

Should Congress and the Administration agree to repeal the transfer tax in stages over a period of years, the AICPA has several suggestions with respect to how such a phase-out could be accomplished to provide needed relief to the largest number of taxpayers during the transition period. The AICPA also urges that greater attention be given during the transition period to identifying and implementing those changes necessary to the income tax system before final repeal takes effect. The specific suggestions follow.

- Although lowering estate tax rates during a phase-out will reduce tax burdens somewhat, it will not reduce the administrative costs of the IRS during the phase-out period. A phase-out

of top tax rates also will not appreciably reduce the burden on holders of illiquid assets – such as IRAs and other pension assets, stock options, personal residences, small businesses and farms – during the phase-out period. If a phase-out is appropriate, an increase in the applicable exclusion amount is preferable to phasing in reduced rates because it would reduce the administrative burden to both taxpayers and to the IRS by reducing the number of returns filed.

- The phase-out should be accomplished as expeditiously as possible.
- If a carryover basis regime is implemented, the AICPA suggests that an allowance for step-up in income tax basis also be adopted. This allowance should be substantial in order to avoid the problems inherent in determining carryover basis for the vast majority of estates. In addition, the step-up allowance should be indexed annually for inflation.
- In addition to any general basis step-up, the AICPA suggests that a limited basis step-up for a decedent’s principal residence, up to the amount of gain that would have been excluded if the residence were sold immediately before death, be included.
- If a carryover basis regime is implemented, it should include a statutory safe-harbor as an elective method for determining the basis of lifetime gifts and transfers at death. In some cases, an executor or beneficiary will not have adequate records to calculate carryover basis of assets held at death. A safe-harbor could be tied to inflation rates or other measures of price appreciation, based on historical published prices, or based on a statutorily allowed percentage of fair market value.
- Tax professionals, preparers, beneficiaries, and executors who use a “reasonable” method to determine carryover basis when adequate records do not exist should not be penalized under a carryover basis regime.
- If allowances for basis step-ups are included in a carryover basis regime, an elective safe-harbor procedure should be included for allocating the allowable basis step-up pro rata to all assets and all beneficiaries in a taxable estate.
- After repeal, uniform procedures for how basis information should be communicated to heirs and to the IRS must be established. The AICPA suggests requiring a new information return for reporting the basis of gifts. As under current law, \$10,000 annual gifts (\$20,000 if gift-splitting is elected) should not require reporting. It is also likely that an information return of some sort would still be required in order to report basis information to heirs. The filing of the information return should also start the running of the statute of limitations.
- Any repeal of the transfer tax presents problems and new issues for the income tax. These issues should be addressed prior to repeal in order to prevent widespread erosion of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens after final repeal.
- Donees who have received previously taxed gifts should be allowed to increase their basis in the gifted asset by the entire amount of gift tax paid.

- An automatic, long-term holding period for all inherited assets should be continued as under current law.
- Immediate modifications to the GST tax similar to those included in previous tax bills should be included in any legislation that does not provide for outright and immediate repeal of the estate tax.

11. Conclusion

Implementing a repeal of the transfer tax system necessitates consideration of a number of issues including the effect of immediate repeal of the transfer tax on state revenues, Federal revenue and income tax erosion. Likewise, a long-term phase-out of the transfer tax could be problematic. In order to simplify a phase-out and to immediately relieve taxpayers of filing and payment burdens, any phase-out should be accomplished by increasing the applicable exclusion amount along with reducing tax rates throughout the rate structure. Although there are problems in determining and dealing with carryover basis, some of these problems can be avoided by providing a substantial allowance for step-up in income tax basis allowance. Increased computerization of records makes determining basis for stocks and mutual funds much less of a problem than in the past. Regardless of the phase-out period or method of phase-out, it is imperative that the GST tax be modified immediately during the phase-out period.

V. TAX ON APPRECIATION AT DEATH

If carryover basis proves difficult to implement, another option is to expand the income tax by taxing appreciated assets at death. Taxing appreciation at death is not a new idea. Subotnik (1989) notes that the idea of taxing constructive realization of income at death was proposed as early as the 1930s. The Kennedy Administration recommended a tax on appreciation at death in 1963, and Treasury re-introduced the concept in 1969. In 1987, two proposals dealing with the taxation of appreciation at death were included in the Joint Tax Committee's *Overview of Tax Proposals for Consideration in Revenue Reconciliation* (Subotnik 1989).

Proponents of taxing appreciation at death argue that conceptually there is no reason why the appreciation on property transferred at death should not be subject to both an income tax on the gain and estate tax on the gratuitous transfer.⁴³ Practically, if a taxpayer sells appreciated property during his or her lifetime, the gain is subject to income tax, and if the taxpayer transfers the proceeds of the sale (less the income tax paid) at death to his or her heirs, the estate tax would apply also. Therefore, the current treatment of appreciation at death and the subsequent step-up in income tax basis produce inequity between taxpayers who realize income (appreciation) during life and those who transfer unrealized appreciation at death. Either carryover basis at death or a tax on appreciation at death would prevent the permanent avoidance of a tax on gains that occurs under current law.

Conceptually, the argument for carryover basis is that postponing the tax until an actual

⁴³ While this argument would suggest the need for both the estate tax and an income tax on gains at death, most current proponents of a tax on appreciation at death offer it as a substitute to the current estate tax. Likewise, our discussion assumes the tax is imposed instead of the estate tax.

sale of the property avoids the need to determine the property's fair market value and the tax is imposed at the time that the taxpayer realizes cash flow from the property. Taxing appreciation at death would enforce the long-standing concept that income should be taxed to the person who earned it. It also imposes tax at an ideal time in terms of the ability to pay (because the decedent no longer has any need for the funds used to pay the tax) and would limit the maximum deferral possibility to a single lifetime.

On the other hand, opponents argue that income tax should only be paid on realization and that death is not, and should not be, a realization event. They also argue that the tax would cause liquidity problems for many taxpayers and that exceptions (such as for marital transfers) can force unnatural dispositive decisions to avoid the harsh cash drain at the death of the first to die.

A. Structure of a Tax on Appreciation at Death

Although a tax on appreciation at death has often been referred to by the popular press as a capital gains tax, there is no conceptual reason that the appreciation of non-capital assets should escape tax under such a regime. In fact, early proposals suggested a tax on the appreciation of all assets. As described in a 1969 Treasury proposal, "the new rule would be that gain on an asset, the sale or exchange of which would produce ordinary income or capital gain, or a combination of both, will be taxed at death with ordinary income to the required extent and capital gain as to the remainder" (U.S. Treasury Department 1969).

Regardless of the approach taken in taxing all assets or only capital assets, it is likely that such a tax would have to be structured to provide exemptions for assets passing to a spouse or to charity.⁴⁴ Likewise, Congress would need to consider the potential for avoiding such a tax through inter-vivos gifts and generation-skipping transfers.⁴⁵ In addition, the provision of one or more special exclusions might be necessary in order to eliminate "small" estates from the tax and to provide relief for family farms, small businesses and estates with other illiquid assets.⁴⁶

B. Analysis of a Tax on Appreciation at Death

1. The Impact on Behavior

Taxing appreciation at death would solve the "problem" of lock-in by

⁴⁴ The 1963 plan called for an exemption of up to 50 percent of the gain if 50 percent of the estate passed to a spouse, plus a complete exemption for a residence passing to a spouse. The 1969 and 1987 proposals provided for an unlimited marital deduction. All plans allowed an unlimited deduction for transfers of property to charity (Kurtz and Surrey 1970 and Subotnik 1989).

⁴⁵ Both the 1963 and 1969 proposals treated lifetime gifts essentially the same as bequests (Kurtz and Surrey 1970 and Subotnik 1989).

⁴⁶ The 1963 proposal called for an exemption of all household items and a \$15,000 exemption applicable to gain from other assets. The 1969 proposal excluded personal and household effects with a value less than \$1,000 per asset and increased the general exemption (through a minimum basis assumption) to \$60,000 (Kurtz and Surrey 1970 and Subotnik 1989).

removing any advantage of holding property until death for a step-up in income tax basis. An argument against a small-estate exclusion is that property subject to the exclusion would continue to be subject to the lock-in effect. Charitable bequests likely would not be affected if a deduction were allowed for assets passing to charity at death.

Under the current transfer tax and income tax systems, there is a strong incentive to hold assets that generate capital gains rather than ordinary dividends and interest. At a minimum, the income tax on capital gains is now postponed until the asset is sold and gains may escape income taxation entirely if held until death. If unrealized gains are taxed at death, taxpayers may react by reducing investments in assets expected to generate capital gains.

One of the biggest changes in behavior is likely to revolve around the purchase of life insurance. While currently excluded from the income tax, there is no conceptual reason to exclude insurance proceeds from a tax on appreciation at death when viewing life insurance as an investment. Without a special exclusion, the “gain” on life insurance proceeds received at death would be taxed as ordinary income.

Likewise, unless specifically excluded from the tax, the immediate taxation of otherwise tax-deferred retirement plans, IRAs, stock options, etc. at death likely would force a dramatic change in compensation and retirement planning.

2. The Impact on Complexity and Compliance

Replacing the current transfer tax with a tax on appreciation at death with few exceptions and exclusions likely would result in simplification for taxpayers. However, complexity becomes a problem when exceptions, deductions and exclusions are allowed. Although probably necessary, providing for a marital deduction would generate complexity and uncertainty. Until funding of the marital bequest is complete, the income tax liability generated by appreciation of the decedent’s remaining assets could not be computed. Similar problems would exist for charitable bequests of appreciated property.

The most complex aspect of a tax on appreciation at death results from the need to determine the basis of each asset held at death in order to calculate taxable gains. The IRS would also likely incur significant retooling costs if the current transfer tax system were abandoned in favor of an appreciation tax. In other respects, the administration of the appreciation tax would be similar to the current estate tax. As with the estate tax, assets generally receive a fair market value basis following the imposition of the tax at death. However, providing carryover basis for assets passing to a surviving spouse, exempting charitable bequests, and allowing a small-estate exclusion would complicate the job of executors in deciding which assets to distribute to heirs and other beneficiaries.

3. The Impact on Liquidity

A major problem with a tax on appreciation at death is its impact on illiquid estates. In the late 1960s and early 1970s, opponents argued that the tax would cause significant problems for illiquid estates (Abbin 1993). As a result of tremendous growth in

qualified retirement plan benefits, deferred compensation arrangements, Keogh plans and IRAs, the problems today would be even worse. Many of these assets cannot be sold and are payable over long period of time to a taxpayer's beneficiaries. However, a tax on appreciation at death would require payment of tax at ordinary income tax rates at the time of death.

A marital exemption would eliminate a potential liquidity problem for a surviving spouse. However, when assets are passed to other beneficiaries, liquidity remains a problem. The most persuasive argument against the taxation of appreciation at death is that the tax can be imposed on substantially illiquid estates that consist of farms, closely-held businesses, retirement accounts, etc. that could lead to forced sales to raise the cash necessary to pay the tax. One possible solution is to provide targeted relief, special valuation and tax deferral mechanisms for farms and closely held businesses as under the current estate tax.⁴⁷ However, unless expanded beyond the present scheme, targeted relief would provide no benefit to estates with other illiquid assets, including retirement accounts, stock options, and personal residences and other real estate.

4. The Impact on the Redistribution of Wealth

The distribution of tax burdens is likely to be different under a tax on appreciation at death. Poterba and Weisbenner (2000) find that taxing capital gains at death would collect more revenue than the current estate tax for about half of those with estates of \$1 million or less. For those with larger estates, a tax on capital gains at death would result in a substantial reduction in total tax payments.

5. The Impact on Tax and Succession Planning

If a marital exemption is provided, the executor would have an incentive to transfer low basis assets to the surviving spouse and high basis assets to other beneficiaries in order to defer the tax on appreciation. In addition, tax considerations may encourage the funding of the marital bequest with low basis assets when an alternative funding method may make more practical sense. Likewise, the fact that the appreciation attached to property that is the subject of a charitable bequest is not taxed may cause the executor to satisfy the charitable bequest with low basis assets.⁴⁸ If a small-estate exclusion is allowed, planning would be made complicated by the need to pick which assets receive the benefit of the exclusion. Taxpayers likely would continue to emphasize planning techniques for discounting the fair market value of assets.

6. The Impact on Revenue

Taxing unrealized appreciation at death (with no exemptions and exclusions) is estimated to yield about \$25 billion of annual revenue in the near term, somewhat less than current collections under the estate tax. However, taking into account an exemption for gains left to a spouse and to charity, and special exclusions for a family business, personal

⁴⁷ However, one must question the efficacy of crafting targeted relief provisions for a tax on appreciation at death given the problems inherent in the targeted relief provisions of the current estate tax.

⁴⁸ It should be noted that executors are not likely to undertake such planning without clear authority in the will or trust document, placing an additional burden on drafters.

residence and personal property, the CBO (1999) estimated that only \$9 to \$12 billion of annual revenue would result over the next five years. Although providing an unlimited marital deduction would result in some immediate revenue loss, that revenue would only be deferred until the second spouse dies. Allowing unlimited charitable bequests would have more impact on revenue because the tax on the gain is permanently forgiven.

7. Transition Issues

Transition issues and complexities associated with a tax on appreciation at death may be substantial. Other alternatives and options may be less disruptive to taxpayers and may be easier to implement than a tax on appreciation at death.

8. Advantages

A tax on appreciation at death is conceptually sound and could serve as an appropriate backstop to the current income tax system. If a tax on appreciation at death was assessed at a reasonable tax rate and structured in a way to provide exemptions to assets passing to a spouse or charity, and exclusions for family farms, small businesses, and other estates with illiquid and inaccessible assets, such a tax could be feasible. However, it would also be very complex.

Specific advantages of a tax on appreciation at death include the following:

- It eliminates the lock-in effect by removing any advantage of holding property until death in order to receive a step-up in income tax basis.
- It could yield significant revenue, particularly if structured with no exemptions and exclusions.

9. Concerns

The complexities of a tax on appreciation at death are numerous. The exemptions and exclusions that would be needed under such a regime might quickly result in a tax that is as complex as the estate tax it would replace. Special rules would need to be crafted to handle lifetime gifts and generation-skipping transfers as well.

The premise on which the tax on appreciation at death is based is that appreciation on property should be taxed at least once in each generation. However, a tax on appreciation at death can be deferred indefinitely if appreciated property is transferred from one generation to another by gift and the gain is not taxed at the time of the gift. It seems clear that gifts of appreciated property should also trigger the recognition of gain, and hence a tax on that gain. A major dilemma arises with regard to incomplete lifetime gifts, i.e., a gift of property in trust with the donor retaining an interest in the transferred property. At what point is an incomplete transfer deemed sufficient to impose a tax on appreciation, or should the tax be postponed until the retained interest is terminated, i.e., at the death of the transferor? Current law provides several possible answers. From an income tax perspective, one could refer to the rules

that govern whether a grantor will continue to be taxed on the income from incompletely transferred property. However, it would seem to be more appropriate to craft rules for taxing gains on lifetime gifts based on the current transfer tax statutes.

Paying a tax at death (albeit at a lower rate than the current estate tax) would still cause liquidity problems for estates composed of illiquid assets such as farms, closely held businesses, personal residences, and retirement accounts. This likely would result in the need for liquidity relief and tax payment deferral provisions of some sort.

10. Suggestions

If a tax on appreciation at death is enacted, the AICPA has the following suggestions:

- In view of the unlimited marital deduction in our current estate and gift tax system and the non-recognition rule of I.R.C. section 1041 on lifetime transfers between spouses, a tax on appreciation at death likely would be acceptable only with a marital exemption. The assets used to fund the marital bequest should retain a pure carryover basis so that appreciation on assets would eventually be subject to the income tax when sold.⁴⁹
- Gain on property bequeathed to charity should not be taxed at death and similar treatment should be given to lifetime charitable gifts of appreciated property. Under current law, a lifetime gift of appreciated property to charity gives rise to an income tax deduction for the fair market value of the property, but does not require the donor to recognize the gain on the disposition.
- Under current law, the GST tax prevents a taxpayer from avoiding transfer tax at each generation by using a generation-skipping transfer. Similarly, rules would be needed to define what types of generation-skipping events would trigger a tax on appreciation at death.
- At some point, estates are sufficiently small and so little revenue is generated from taxing their appreciation that one cannot justify imposing the complexities of a tax on all appreciated assets. One possible solution is to design an exemption from a tax on appreciation that is similar to the current applicable exclusion amount in the estate tax.⁵⁰ For estates not subject to the tax on appreciation, current law would apply – no recognition of gain at death, and a stepped-up fair market value basis for inherited property.
- Other items of ordinary income, such as inventory appreciation and depreciation recapture, need to be considered. With respect to inventory, taxpayers expect to pay income tax on the gains from the sales of inventory in the ordinary course of business, so there is no reason to allow such gain to escape income taxation through a small-estate exclusion. However, rather

⁴⁹ While a carryover basis on assets subject to a marital deduction is recommended, this may result in added complexity when surviving spouses dispose of these assets.

⁵⁰ The exclusion could be based on value, the amount of the gain, or could take the form of a minimum basis (like that in the 1963 and 1969 proposals). In addition to a general exclusion applying to all assets, some commentators suggest an additional exclusion for non-business tangible personal property.

than tax the gain at death, carryover basis should be applied and the gain recognized in the ordinary course of the business.

- A tax on appreciation at death should logically be imposed on depreciation recapture. Allowing a carryover basis to apply would result in a deferral of an unlimited duration. Similarly, if the small-estate exclusion was applied to depreciation recapture, the opportunity exists that the recapture would never be taxed. The price of taking an artificial depreciation deduction against ordinary income should be the recapture of that depreciation at death.
- Another special circumstance involves a principal residence. Given that the current income tax statute that exempts \$500,000 of gain from the sale of the principal residence for married persons, there should be an exclusion for the principal residence from a tax on appreciation at death. This might be included in the general applicable exclusion amount or allowed as a separate exclusion of up to \$500,000.
- Currently, I.R.C. section 101 excludes life insurance proceeds payable by reason of the death of the insured from gross income for income tax purposes. On the other hand, life insurance proceeds payable to an estate or owned by the decedent are subject to estate tax. If tax is imposed on appreciation at death, the treatment of life insurance proceeds must be considered. There are several options for taxing life insurance proceeds. One of the primary reasons for owning life insurance is to provide liquidity at the death of the insured for the payment of the death taxes. Rules could be designed to limit any exclusion to the excess of the tax on appreciation over the total of other liquid assets in the estate.
- Although this discussion has been concerned with a tax on appreciation, losses should be netted against gains in calculating the tax. A question arises as to the deductibility of a net loss against ordinary income on the decedent's final income tax return. If losses are deductible against ordinary income without limitation, the executor may be inclined to allocate assets with gains to the surviving spouse, and assets with losses to the other beneficiaries, thereby, deferring the gain until the death of the surviving spouse. If the deductibility of the net losses against ordinary income on the decedent's final income tax return is limited, there should be some provision to carryback the net losses to the decedent's prior years' income tax returns, or to carry over the net losses to the income tax returns of the beneficiaries who inherit the property that gave rise to the loss. It also appears that some limitation on the deductibility of net losses should apply to lifetime gifts. Perhaps I.R.C. section 267, which disallows losses on sales between related persons, should apply to gifts between related persons.

11. Conclusion

While a tax on appreciation at death is conceptually sound, it does not address criticisms of the current estate tax related to whether death should be a taxable event. More importantly, due to the complexities of an appreciation tax and the inherent liquidity problems facing owners of IRAs and other pension assets, real estate, stock options, small businesses and farms, the tax likely would not be feasible without numerous exclusions, exemptions and targeted relief. Even then, it would be difficult to write those exclusions, exemptions and other necessary liquidity relief provisions in a way that would be simple and useful for taxpayers. Consequently, replacing the current estate tax with a tax on appreciation at

death does not appear to reduce complexity or taxpayer compliance burdens or ease administration.

Although an appreciation tax would reduce the burden on many estates by taxing only appreciation and at significantly lower rates than the current estate tax, the distribution of the tax burden would fall most heavily on small estates. The benefits of a tax on appreciation at death appear to be outweighed by its complexities and liquidity concerns.

VI. COMPREHENSIVE INCOME TAX AND ACCESSIONS TAX

In contrast to the current estate tax or a tax on appreciation at death, which are both assessed on the decedent’s estate (the transferor), both a comprehensive income tax and an accessions tax would tax the recipient (transferee) on the fair market value of gifts and bequests received. However, the comprehensive income tax and accessions tax are separate and distinct modes of taxation. Under a comprehensive income tax, the fair market value of gifts and bequests are included in the recipient’s tax base just as any other item of income. By contrast, the accessions tax is essentially an excise tax on the transfer of property by gift or at death. Like the transfer tax, the accessions tax would be assessed on cumulative lifetime gifts and bequests using a graduated tax rate structure (see Table 7). Under most proposals, there would be a dual tax rate schedule with lower rates applying to gifts and bequests to immediate family members and higher rates applying to more distant family and unrelated individuals.⁵¹

Table 7

A Comparison of the Comprehensive Income Tax and the Accessions Tax

Comprehensive Income Tax	Accessions Tax
Current AGI plus Receipts from:	Current Gifts and Bequests
Section 101 Insurance Exclusion	
Section 102 Gift and Bequest Exclusion	
= Comprehensive Income Tax Base	
Less:	Less:
Statutory Deductions and Exemptions	Statutory Deductions and Exemptions
= Annual Income Tax Base (ITB)	= Current Annual Accessions
Tax on ITB (using bifurcated rates)	Plus:
	Prior Year’s Cumulative Accessions
	= Accessions Tax Base (ATB)
	Tax on ATB (using bifurcated rates)
	Less:
	Tax on Prior Year’s Accessions
	= Current Year’s Accessions Tax

Proponents of a comprehensive income tax or accessions tax argue that a tax system should be based on the ability to pay and that the recipient of a gift or bequest should be subject to tax. Even though gifts and bequests may not represent new wealth from an economic

⁵¹ The accessions tax was first proposed in 1945 and was seriously considered as an alternative to the integration and unification of the estate and gift tax in 1976. However, little has been written on “the expanded income tax base” since Dodge (1978).

perspective, its proponents contend that any source of receipt should be included in the income tax base.⁵² Two primary non-equity objectives of transfer taxes are raising revenue, and preventing undue accumulations of wealth. Comprehensive income tax proponents note that the present transfer tax system, by focusing on the transferor, uses a delayed penalty on the accumulation of wealth. Undue accumulations are better prevented, they conclude, by curbing the excessive wealth amassment through more timely taxation of the recipient. The double tax that results from not allowing the transferor to deduct gifts and bequests has generally been viewed as no different than our current system of taxation in which income tax and estate tax are applied to the same appreciation on assets.

A. Structure of a Comprehensive Income Tax

Essential to integrating a comprehensive tax base with our present income tax system would be the elimination of the present provisions in I.R.C. section 101 excluding insurance proceeds and I.R.C. section 102 excluding gifts and bequests from the gross income of the recipient. Simply summarized, the intent of the comprehensive income tax is to include gifts and bequests in the income tax base of the donee or heir and to subject gifts and bequests to annual progressive income tax rates. At the same time, the current transfer tax system, including the GST tax, would be eliminated.⁵³ Consistent with present law, gifts and bequests would not be deductible by the donor/transferor or by the estate.

Under a comprehensive income tax, trusts and estates no longer would be taxable entities. Although the grantor trust rules would continue to impose income tax on a trust's grantor in some circumstances, in most cases, both the corpus and accumulated income would be taxable to the beneficiary upon distribution, not as earned. See also Section B.3 on page 52.

1. Special Exclusions

Under most versions of a comprehensive income tax, all gratuitous transfers would be included in the tax base except de minimis exclusions for occasional gifts. Transfers to trusts and transfers of trust interests would not be currently taxed. Rather, tax would be deferred until the receipt of distributions from the fiduciary entity. Likewise, the payment of life insurance premiums by a trust would not be taxed. Rather, tax would be deferred until life insurance proceeds are paid to a beneficiary.

Retirement plans and death benefits would be treated in the same manner as life insurance. Ordinarily taxation would occur only upon actual distribution from

⁵² It should be noted that including gifts in income has been suggested by some as a way to avoid erosion of the income tax base due to outright repeal of the transfer tax.

⁵³ Under some versions of a comprehensive income tax (see Brandford 1984), corporations would not be subject to income tax. Instead, shareholders would be taxed on their pro-rata share of corporate income or able to deduct their pro rata share of corporate loss. Likewise, there would be no distinction between capital gains and ordinary income, and losses would be fully deductible against income from other sources.

compensation and retirement plans to a plan beneficiary or recipient (i.e., a cash receipts method).

The premise of the comprehensive income tax reflects ability to pay. If a husband and wife are viewed as one taxable unit, a gratuitous transfer from one spouse to another does not alter that ability to pay and should not be subject to taxation. Likewise, payments in the nature of support for a spouse would not be subject to tax, in effect providing an unlimited marital deduction.⁵⁴ If a married couple is viewed as a single unit, the commencement and cessation by death of marital status would similarly not give rise to income or loss.⁵⁵ Other than inclusion of life insurance proceeds and employee death benefits or related pension payments, inter-spousal bequests would be entirely tax-free since the surviving spouse is a continuation of the original tax unit. As a result, all such “tax-free” gifts and bequests would result in a carryover basis to the transferee spouse.

Upon divorce, the spousal taxing unit would be bifurcated. Consequently, post-divorce payments to a spouse would be included in the income tax base of the recipient. In contrast with other transfers, divorce-related payments that are taxable to the recipient would be deductible by the payor. As under current law, property settlements would be tax-free to both parties with the transferee receiving a carryover basis.

Costs and expenses associated with transfers at death, such as debts, funeral expenses, expense administration, state death taxes and foreign death taxes would be categorized as reductions in amounts otherwise taxable to the recipient, unless they were charged on property received, in which case the recipient would be allowed an offsetting deduction.

2. Gifts and Bequests in Kind

Gifts and bequests of non-cash property would probably cause liquidity problems in a comprehensive income tax regime. However, most proponents do not recommend deferring tax on personal assets (collectibles, homes, etc.), but would limit relief rules to investment in business type assets that do not have a ready market, primarily encompassing real property and small business interests.

⁵⁴ Although minors might logically be considered a part of the taxable unit, most proposals suggest that minors' income not be included as part of the parents' unit because of problems of disassociation when they become an independent unit. Even though this goes counter to the basic system, at the same time, proponents of a comprehensive income tax argue that the parents' provision of support should be excluded from the tax base of a child.

⁵⁵ All property brought into a marital unit by one spouse is considered a tax-free gift to the unit, and income realized during marriage is taxed to the unit, not to either spouse as an individual.

B. The Structure of an Accessions Tax

With several exceptions, includeable transfers under the unified transfer tax would be treated as taxable accessions under an accessions tax. As with a comprehensive income tax, trusts and estates no longer would be taxable entities under an accessions tax. Although the grantor trust rules would continue to impose income tax on a trust's grantor in some circumstances, in most cases both the corpus and accumulated income would be taxable to the beneficiary upon distribution, not as earned.

1. Exclusions and Deductions

Like the comprehensive income tax, the accessions tax would provide complete exemption for inter-spousal transfers. However, an accessions tax would differ in that an exemption would be allowed for transfers for current consumption. Under the accessions tax, employee benefits would be taxed currently rather than on distribution to a beneficiary.

As with the comprehensive income tax, the formation of, and additional transfers to, trusts would not be a taxable event. Only distributions from estates and trusts would be subject to the accessions tax so that the distribution of trust property (whether income or principal), rather than its contribution would result in a taxable event.

In addition, proposals for an accessions tax typically provide an annual per donee exclusion for outright lifetime gifts that would be comparable to the current annual exclusion for gifts but given to the recipient, not the transferor and an overall lifetime exemption. Although no specific exclusion is included for charitable transfers, the net tax result is the same because recipient charitable organizations are exempt from tax.

2. Calculation of Tax

Although a comprehensive income tax might be incorporated within the current income tax framework, due to the cumulative nature of the accessions tax, an accessions tax return would more likely resemble a current gift tax return. Both taxes are likely to include dual rates, accomplished by applying a higher tax rate for accessions received from "non-immediate" relations while applying a lower rate to accessions received from "immediate relations" (a parent, parent-in-law, sibling, child, or parent of a deceased child).

The accessions tax would allow a credit for tax on prior years' accessions, thus, mirroring the present gift tax regime. Multiple taxation of recipients caused by premature death can be relieved by providing a reduction or refund of accessions tax based on excluding, in whole or part, accessions received during a decedent's last years of life.

3. Additional Trust Tax

Excluding property transferred to a trust from the accessions tax creates significant opportunities for tax deferral for large estates. As a result, a "trust tax" has been proposed for large estates as an addition to the comprehensive income tax or accessions tax. Subsequent distributions from the trust would then receive a credit against the comprehensive

income tax or accessions tax equal to the amount of “trust tax” paid. In addition, an elective provision would give an income beneficiary of a trust the right to pay a hypothetical tax on the actuarial value of the interest, meaning all subsequent distributions would be free of tax.

C. Analysis of a Comprehensive Income Tax and Accessions Tax

1. The Impact on Behavior

Adopting either a comprehensive income tax or accessions tax would have significant impact on taxpayer behavior. With respect to the comprehensive income tax, the major impact would appear to be a significant reduction in outright gifts since the recipient would have to dispose of a significant portion of the gift to pay the tax liability. Under a comprehensive income tax system, consideration would be given to “stringing out,” gifts to mitigate the impact of a progressive income tax system. Because of the deferral potential of trusts, it is likely that trusts would be utilized for tax planning purposes to an even greater extent than under current law. Under either tax, charitable bequests, and the use of charitable lead and remainder trusts during lifetime might be reduced significantly.

Generation-skipping transfers would be curtailed by a dual rate structure that treats accessions to children more favorably than transfers to grandchildren. Depending on rates, this may significantly change the attitude of transferors about making transfers to first generations and transfers established in trust or otherwise for second generations and beyond.

2. The Impact on Complexity and Compliance

As a theoretical scheme, the comprehensive income tax has appeal in eliminating the entire transfer tax system, including the complexities of the GST tax and basis issues to a distributee. Proponents conclude that a comprehensive tax base (CTB) is simpler than other transfer tax schemes that require complicated distinctions in legal form, exclusions, deductions and credits, and that a CTB facilitates compliance and enforcement of taxation on gratuitous transfers by including them in the basic annual income tax return. While enforcement might be easier, the transition costs and overall retooling costs incurred by the IRS would be significant.

Others point out that many more individuals will be subject to tax, that they will need to maintain records of accessions and obtain valuations, and that transferors will need to maintain similar records and report information to the government (Alexander 1967). Overall simplicity of a comprehensive income tax likely would depend on whether other exclusions in current law for scholarship and fellowship grants, prizes, etc. are allowed and on how the plethora of current income tax deductions are handled by Congress.

The accessions tax does little to alleviate many of the complexities inherent in our current dual income and transfer tax system. In fact, it may intensify them. The major difference from the current gift tax regime is that recipients must keep track of gifts and inheritances received during their lifetimes rather than donors.

Both systems are new and as such would require retooling and relearning on the part of tax advisers, taxpayers, and the IRS. Likewise, the complexities of any transition period would be significant. Finally, the dual rate structure applying to accessions from different sources likely would result in significant complexity with respect to planning.

3. The Impact on Liquidity

Significant legislative efforts would be required to provide liquidity relief or tax deferral mechanisms when unmarketable and hard-to-value assets are involved in transfers. Because insurance proceeds would be taxed, the efficacy of using life insurance to provide liquidity would be reduced.

4. The Impact on the Redistribution of Wealth

The greatest impediments to a comprehensive income tax or accessions tax are the complete switch in tax incidence, i.e., from the transferor to the transferee, and how the tax-paying public would react. Without special exemptions or credits, many taxpayers who do not now pay estate or gift taxes would be subject to additional income tax on a broadened income tax base or an accessions tax on cumulative transfers calculated using a graduated tax rate structure. This appears to be a political hurdle of enormous dimensions.

5. The Impact on Tax and Succession Planning

Although the CTB would minimize a great deal of the tax planning and tax basis considerations of the current unified transfer tax system, several administrative and compliance problems would offset any savings to taxpayers resulting from reduced planning costs.

Planners and drafters would have to switch from attitudes reflecting the transferor to the transferee. However, it may not always be possible to fully understand the tax status of the transferee on whom the accessions tax would be imposed. Planning based on projecting a recipient's tax status is much more difficult than when dealing with the transferor.

It is doubtful whether a change in tax scheme from a transferor to a transferee would be easily received by taxpayers or their advisers unless the complexities of the dual tax systems, valuation and liquidity, are alleviated and resistance to changing the taxation of insurance are overcome.

6. The Impact on Revenue

The revenue impact of a comprehensive income tax or accessions tax is not known. However, if structured without large numbers of exclusions and deductions and with a rate structure similar to the current income tax structure, these taxes may increase revenue significantly. More importantly, the taxes likely would be more regressive than the current transfer tax system by including many taxpayers who are not now affected by the imposition of transfer taxes under current law.

7. Transition Issues

Transitional rules to prevent double taxation may be needed for gifts and bequests received by a beneficiary which have already been subject to gift or estate taxes by the donor or estate. Tracing rules may be complex, particularly for partially taxed prior transfers. An alternative would be to double-tax such distributions at the effective date of the comprehensive income tax, but allow a credit to the distributees for estate and gift taxes paid by the transferor, or provide grandfathering provisions that would exempt from tax gifts and bequests received before certain dates.

8. Advantages

An accessions tax would eliminate the current transfer tax system (at a cost of developing a new and complex system).

A comprehensive income tax could be integrated within our present income tax system, eliminating the need for the current estate, gift and generation-skipping transfer taxes. Some proposals would also eliminate the corporate income tax, instead taxing shareholders on their pro-rata share of corporate income.

Specific advantages of a comprehensive income tax include the following:

- A comprehensive income tax facilitates compliance and enforcement of taxation on gratuitous transfers by including them in the basic annual income tax return.
- A comprehensive income tax would simplify the overall income tax system if the plethora of exclusions and exemptions allowed under current law were repealed.
- A comprehensive income tax could result in significant increases in revenue.

9. Concerns

The formulation of detailed rules and implementation requirements for the taxation of trusts and distributions from trusts could prove very difficult. Uncertainty concerning these rules would make planning difficult and could result in trustees not being willing to accept responsibility for the tax implications of distributions. Gifts and bequests of non-cash property likely would cause liquidity problems similar to those of the current transfer tax system. Carve-outs aimed at providing relief for farms and small businesses likely would be complex and difficult to administer and would not provide relief for those receiving other forms of illiquid assets including real estate, retirement plans, installment obligations, etc.

Both the comprehensive income tax and the accessions tax could be complex if they contain numerous exclusions and deductions similar to the current income tax system. The cumulative nature of the accessions tax adds to these complexities. Without special exclusions and credits, many taxpayers who now do not pay estate or gift taxes would be subject to additional taxes under either a comprehensive tax base or an accessions regime.

10. Conclusion

Neither the comprehensive income tax nor the accessions tax have been recently proposed as a viable alternative to our current transfer tax system. Most commentators conclude that their problems outweigh their benefits. Both are completely new systems that would require significant investments of time and money by taxpayers, tax advisers, and the government. Although a comprehensive income tax could simplify the overall income tax system if structured appropriately, it would only be feasible with a number of exclusions and exemptions that would increase its complexity. These taxes do little to alleviate liquidity problems caused by the current transfer tax regime and would be politically difficult to implement due to the change in imposition of the tax from transferor to transferee.

VII. OVERALL CONCLUSION

The AICPA concurs with most observers that the current transfer tax system warrants significant reform. Although the estate tax has historically been targeted at the super-wealthy and currently affects less than two percent of all estates, without significant changes increasing numbers of taxpayers with moderate wealth likely will be affected in the future. In addition, unprecedented increases in the value of retirement assets, personal residences, real estate, stock options, and other forms of illiquid or inaccessible wealth have exacerbated the liquidity problems traditionally considered to affect only small business owners and farmers.

In our year-long study, the AICPA has identified a number of significant issues and made substantive suggestions that the AICPA hopes will be considered in crafting any legislative proposal. The problems inherent in the current transfer tax system could be substantially mitigated through meaningful modifications to the current system, without abandoning its fundamental infrastructure. Alternatively, if the transfer tax is repealed, that repeal should be implemented as quickly as possible so that needed relief can be provided to the largest number of taxpayers. Also, during a transition period, significant attention should be given to identifying and implementing necessary changes to the Federal and state income tax systems before final repeal takes effect.

APPENDIX

**Results of the
AICPA Estate and Gift Tax Survey —**

**An Analysis of Member Views Toward the
Estate and Gift Tax System and Its Alternatives**

Prepared by:

**The Estate Tax Repeal Task Force
of the
Trust, Estate, and Gift Tax Technical Resource Panel
of the
Tax Division**

November 2000

OVERVIEW

- Survey Methodology
- Respondent Demographics
- Planning Techniques Currently Utilized
- Major Issues Faced by Clients
- Attitudes toward Retaining the Current System
- Advantages and Disadvantages of the Current System
- Preferences for Alternatives to the Current System
- Preferences for Modifying the Current System
- Preferable Applicable Exclusion Amount
- Applicable Exclusion
- Applicable Exclusion Amounts by Preferences for Retaining the Current System
- Preferred Maximum Tax Rate
- Attitudes toward Maximum Tax Rate by Preferences for Retaining the Current System
- Carryover Basis
- Implications for Restructuring the Estate and Gift Tax System

SURVEY METHODOLOGY

The Estate Tax Repeal Task Force of the AICPA Tax Division's Estate and Gift Tax Technical Resource Panel developed a survey to gather members' opinions about the transfer tax system. The survey website was provided in an e-mail message on May 19, 2000. As of that date, the AICPA had 23,007 Tax Section members, of whom 13,187 had identified themselves as having an interest in estate and gift tax issues, and of those 4,973 had e-mail addresses. Of those that had e-mail addresses, 3,826 were in public accounting and were, therefore, chosen for the survey e-mail message.

The survey e-mail included a link to the AICPA web site to permit survey completion online. A total of 806 individuals completed the survey, resulting in a 21 percent response rate. Of the 806 people responding, 752 provide estate planning and compliance services to clients and were able to provide their opinions on the current system and preferences for various alternatives.

With a sample of this size, the results have a statistical precision of plus or minus 4 percentage points with 95 percent certainty. There are several other possible sources of error in the survey including non-response bias and problems with question wording and question order. It is impossible to quantify the errors that may result from these factors.

Special acknowledgement is given to members of the Estate Tax Repeal Task Force who developed this survey:

Roby B. Sawyers, Task Force Chair
Byrle M. Abbin, Task Force Vice-Chair
John H. Gardner, TRP Immediate Past Chair
Barbara A. Bond
Robert M. Caplan
Evelyn M. Capassakis, TRP Chair
Ruchika Garga
Brian T. Whitlock
Eileen R. Sherr, Technical Manager

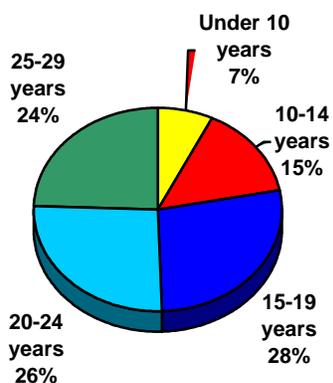
The involvement by the task force members was a volunteer effort. Special acknowledgment is given to: Jimmy Wilkins of North Carolina State University, Elly Filippi of PricewaterhouseCoopers LLP, and Stephen Goldfarb of the AICPA Marketing Services Department for their assistance in developing this report.

RESPONDENT DEMOGRAPHICS

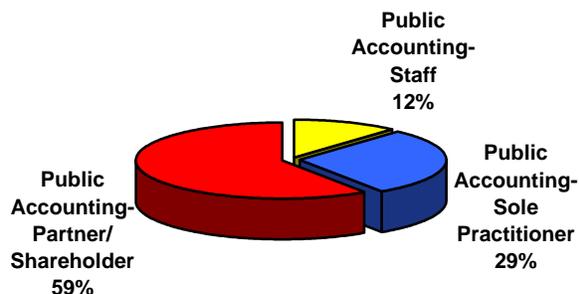
Respondents had an average of 22 years of experience as CPAs. Approximately 59 percent of respondents classified themselves as partners or shareholders in their firms, while another 29 percent were sole practitioners. Most (84 percent) of respondents worked for a local firm, 10 percent were employed by a regional firm, and 5 percent were employed by a national firm. Over one-half worked in the Southeast and Southwest.

Almost all of the respondents (93 percent) provided estate planning and compliance services to clients. A majority (65 percent) of respondents had between 100 and 500 individual tax clients in 1999, with 15 percent having over 500 clients. Additionally, 29 percent of the individual tax clients of the respondents required some sort of wealth transfer (estate and gift tax) planning in 1999.

**Years as a CPA
(N=806)**

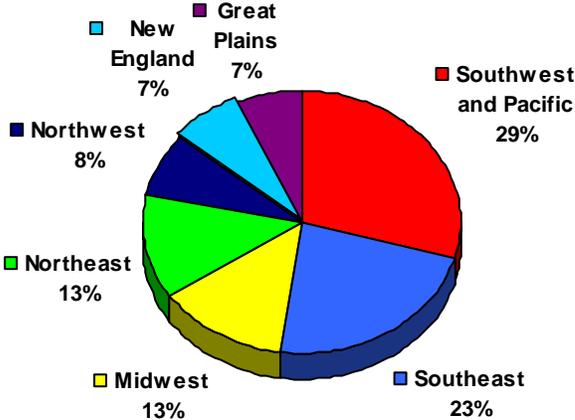


**Area of Employment
(N=806)**



RESPONDENT DEMOGRAPHICS (Continued)

Geographic Region in Which Survey Respondents Practice
(N= 806)

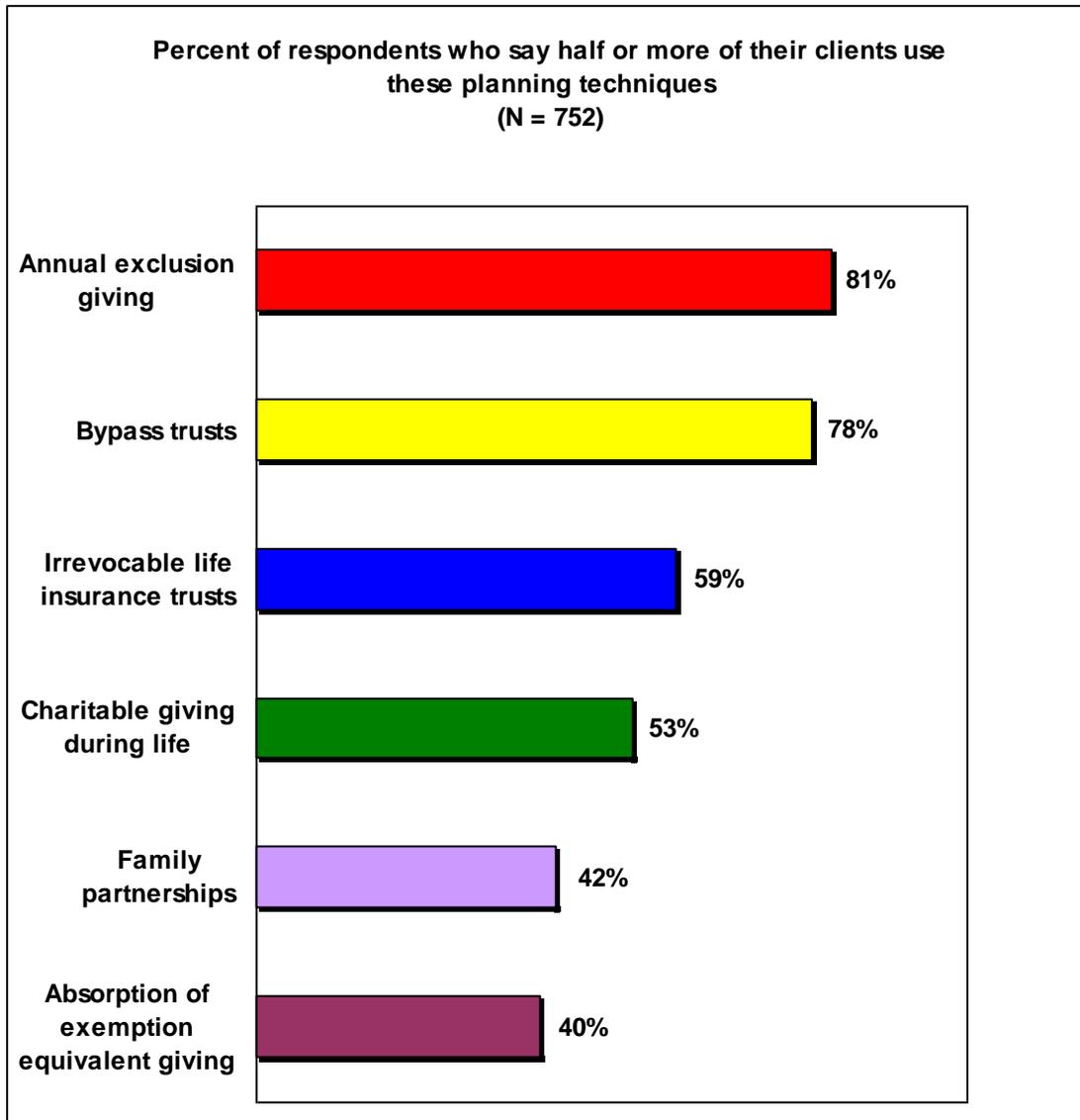


Type of Firm
(N=806)



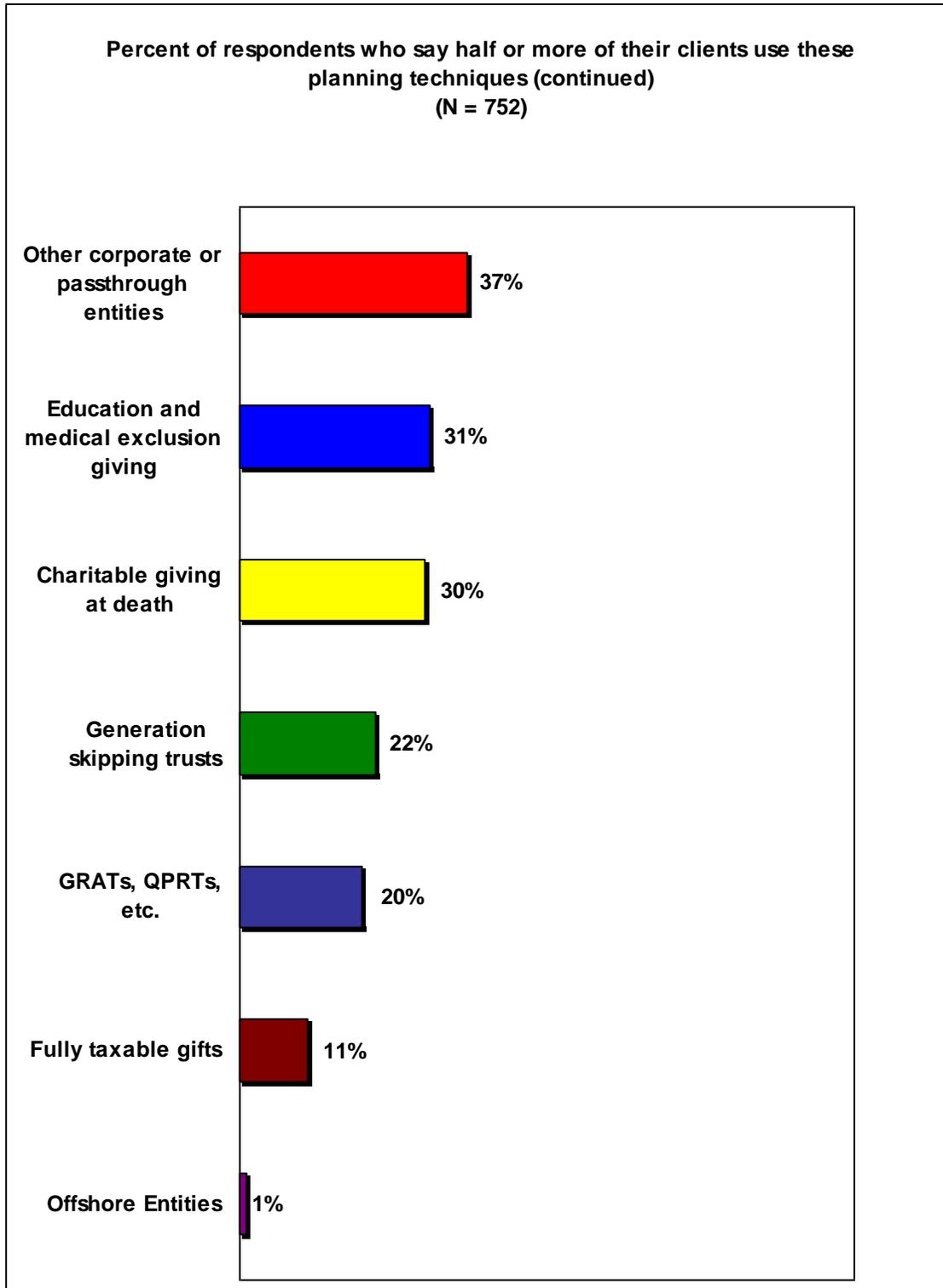
PLANNING TECHNIQUES CURRENTLY UTILIZED

Annual exclusion giving and bypass trusts were the most frequently used planning techniques mentioned by respondents.



PLANNING TECHNIQUES CURRENTLY UTILIZED (continued)

The use of fully taxable gifts and offshore entities were the least frequently used planning techniques.

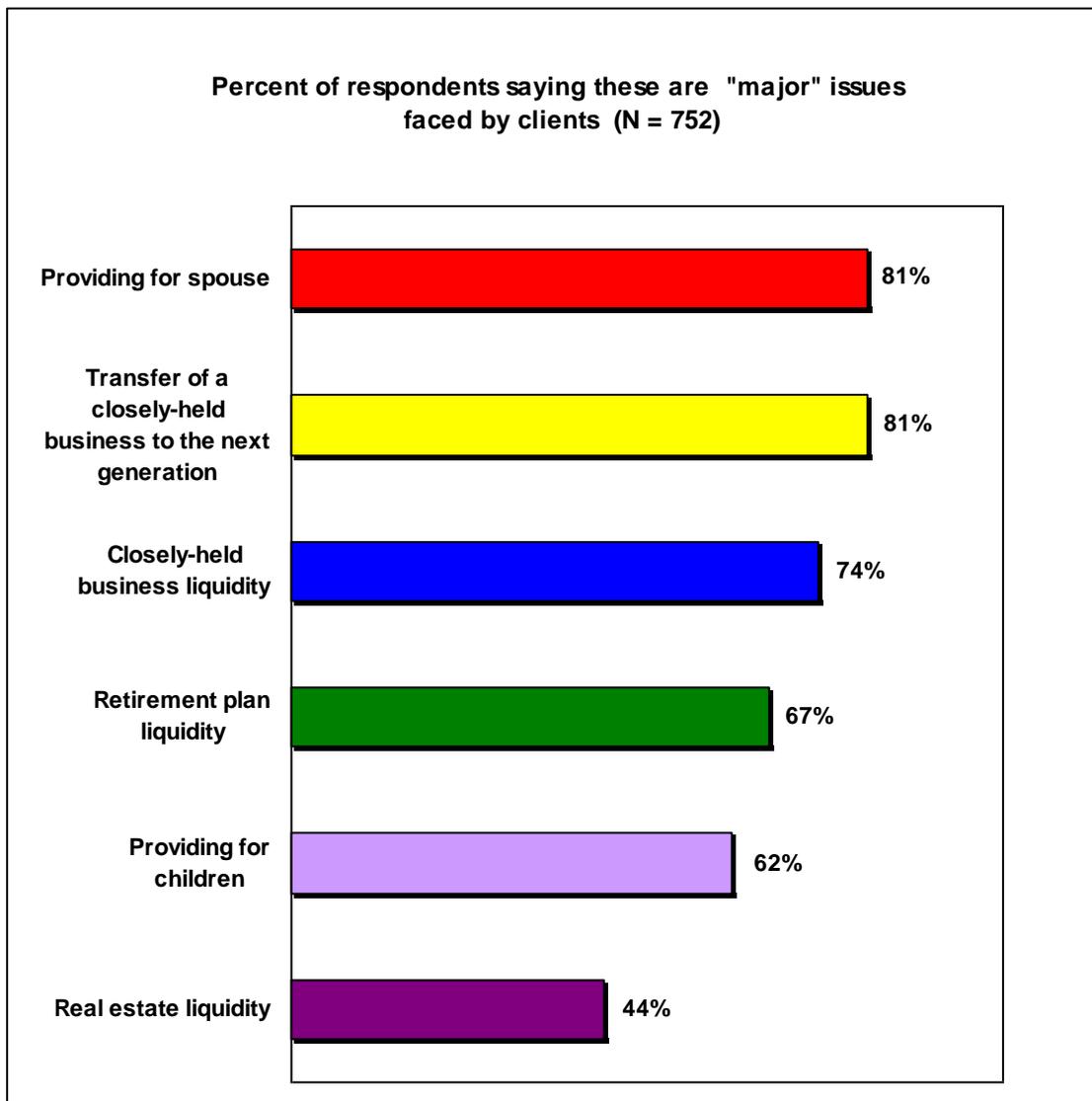


MAJOR ISSUES FACED BY CLIENTS

The transfer of a closely held business to the next generation was ranked by 81 percent of respondents as being a major transfer tax and succession issue faced by their clients.

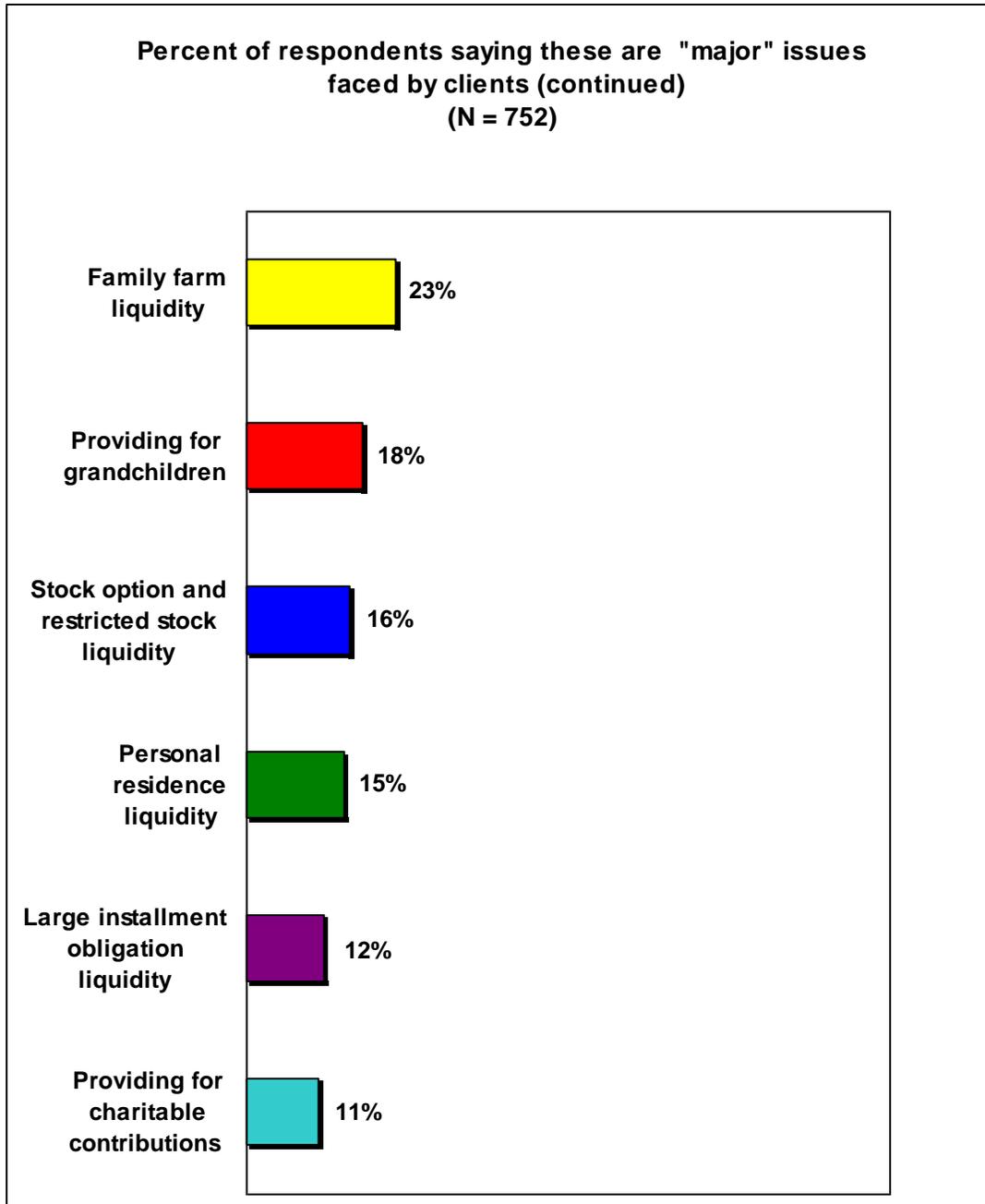
The only issue that was categorized as “major” as frequently as transferring a business was providing for a spouse (81 percent). Providing for children was a major issue facing clients for 62 percent of respondents. Liquidity issues related to closely held business interests and retirement plans were the only other “major” issues noted by a majority of respondents.

Related to closely held business and farm liquidity, almost 13 percent of respondents said that one or more of their clients were forced to sell a closely held business or family farm to pay estate tax in 1999. Almost 45 percent indicated that one or more additional clients would have had to sell a business absent planning or counseling.



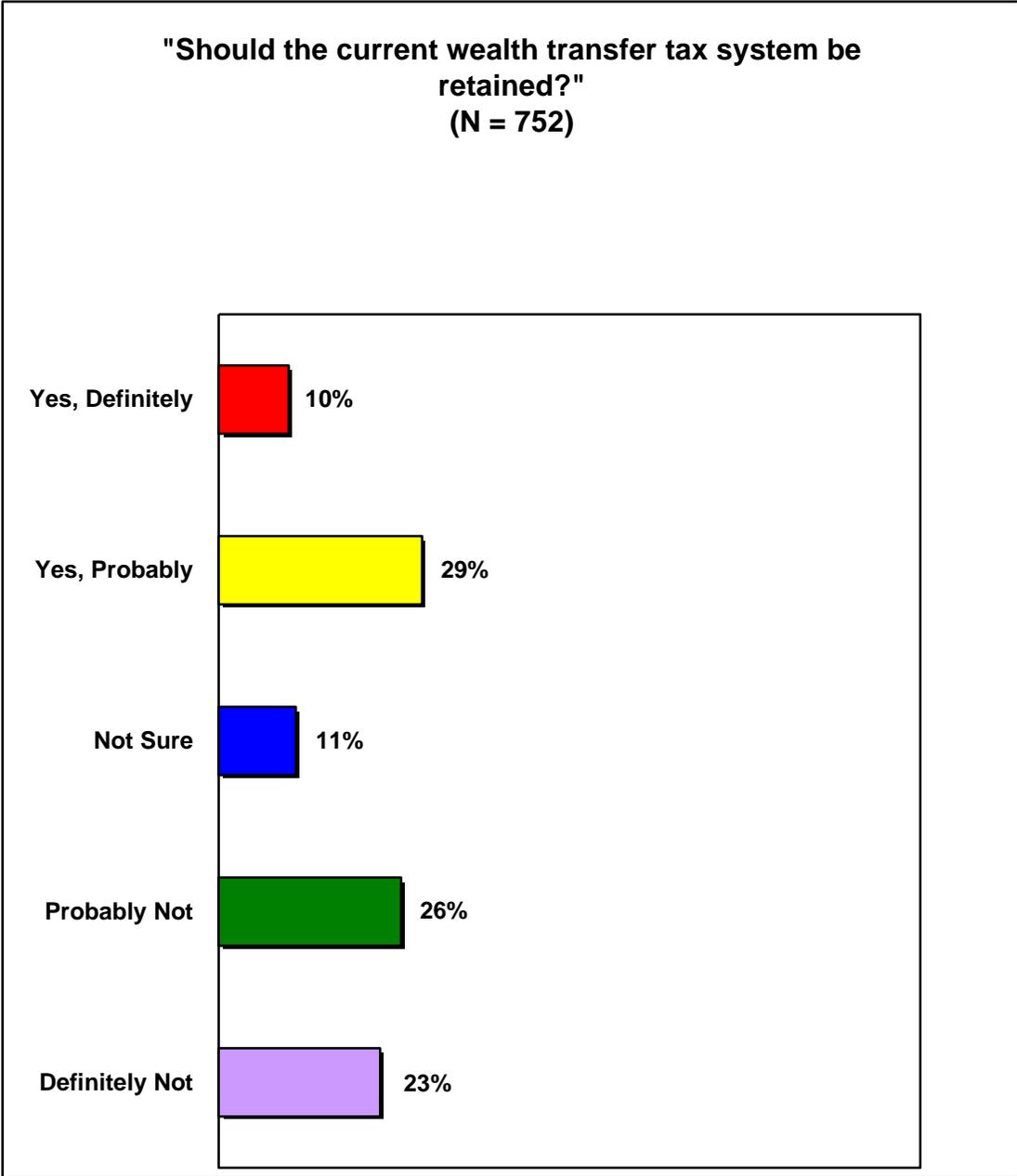
MAJOR ISSUES FACED BY CLIENTS (continued)

Providing for charitable contributions and large installment obligation liquidity were considered major issues faced by clients for only 11 percent and 12 percent of respondents.



ATTITUDES TOWARD RETAINING THE CURRENT SYSTEM

Respondents had mixed views on the issue of whether the current wealth transfer tax system should be retained. While 49 percent said the current transfer tax system probably or definitely should not be retained, 39 percent said the current system probably or definitely should be retained.



ADVANTAGES AND DISADVANTAGES OF THE CURRENT SYSTEM

As shown in the table below, respondents stated that the **advantages** of the current system are: it redistributes wealth; it forces clients to consider succession planning issues; it encourages giving to charities; it provides a revenue source to the federal government; it provides a step-up in basis for assets passing at death; and it is a lucrative source of revenue for CPAs and attorneys.

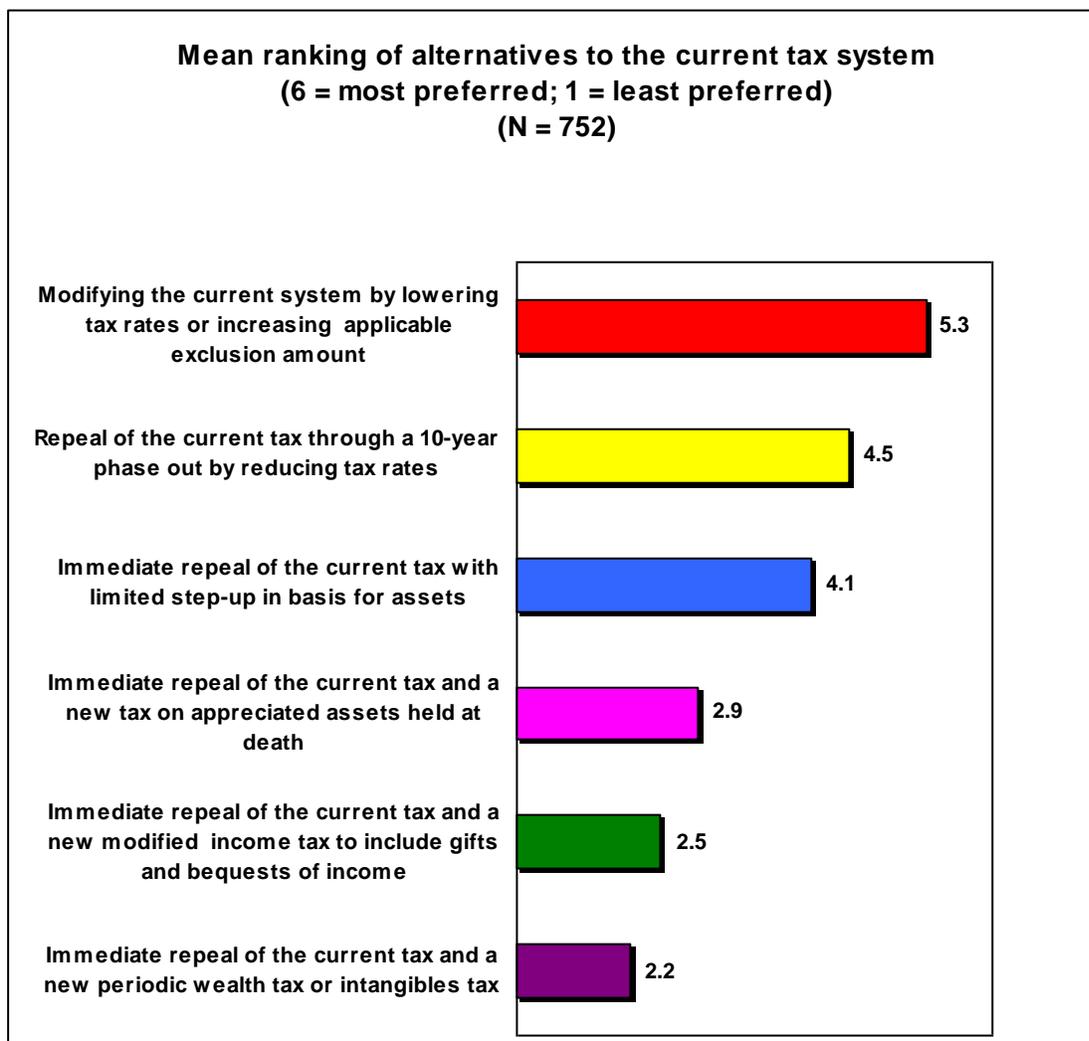
According to respondents, **disadvantages** of the current system include: its complexity; its high marginal tax rates and low exemption amount, the liquidity problems caused by the tax, the cost of planning and compliance, and the feeling that the tax penalizes even moderately wealthy taxpayers and results in double taxation.

“WHAT ARE THE ADVANTAGES OF THE CURRENT SYSTEM?”	“WHAT ARE THE DISADVANTAGES OF THE CURRENT SYSTEM?”
<ul style="list-style-type: none"> • Redistributes wealth • Forces succession planning • Encourages giving to charities • Provides step up in basis of assets • Provides a revenue source for the federal government • Is lucrative for CPAs and Attorneys 	<ul style="list-style-type: none"> • Is too complex • Contains exclusions/exemptions that are too low • Demands costly planning • Penalizes wealthy and even moderately wealthy taxpayers • Is a mechanism for double taxation • Causes liquidity problems • Contains “confiscatory” tax rates • Is “a royal scam, grossly unfair, extortionate, destructive, unAmerican, etc.”

PREFERENCES FOR ALTERNATIVES TO THE CURRENT SYSTEM

We asked respondents to rank six **alternatives** to the current system. The most preferred alternative was: "Modifying the current system by lowering tax rates or increasing the applicable exclusion amount," followed by "Repeal of the estate, gift and GST tax through a 10-year phase out accomplished by reducing tax rates." The latter option was preferred by practitioners who felt strongly that the current system should be abolished. Immediate repeal of the current transfer tax with a limited step-up in basis was the third most preferred alternative.

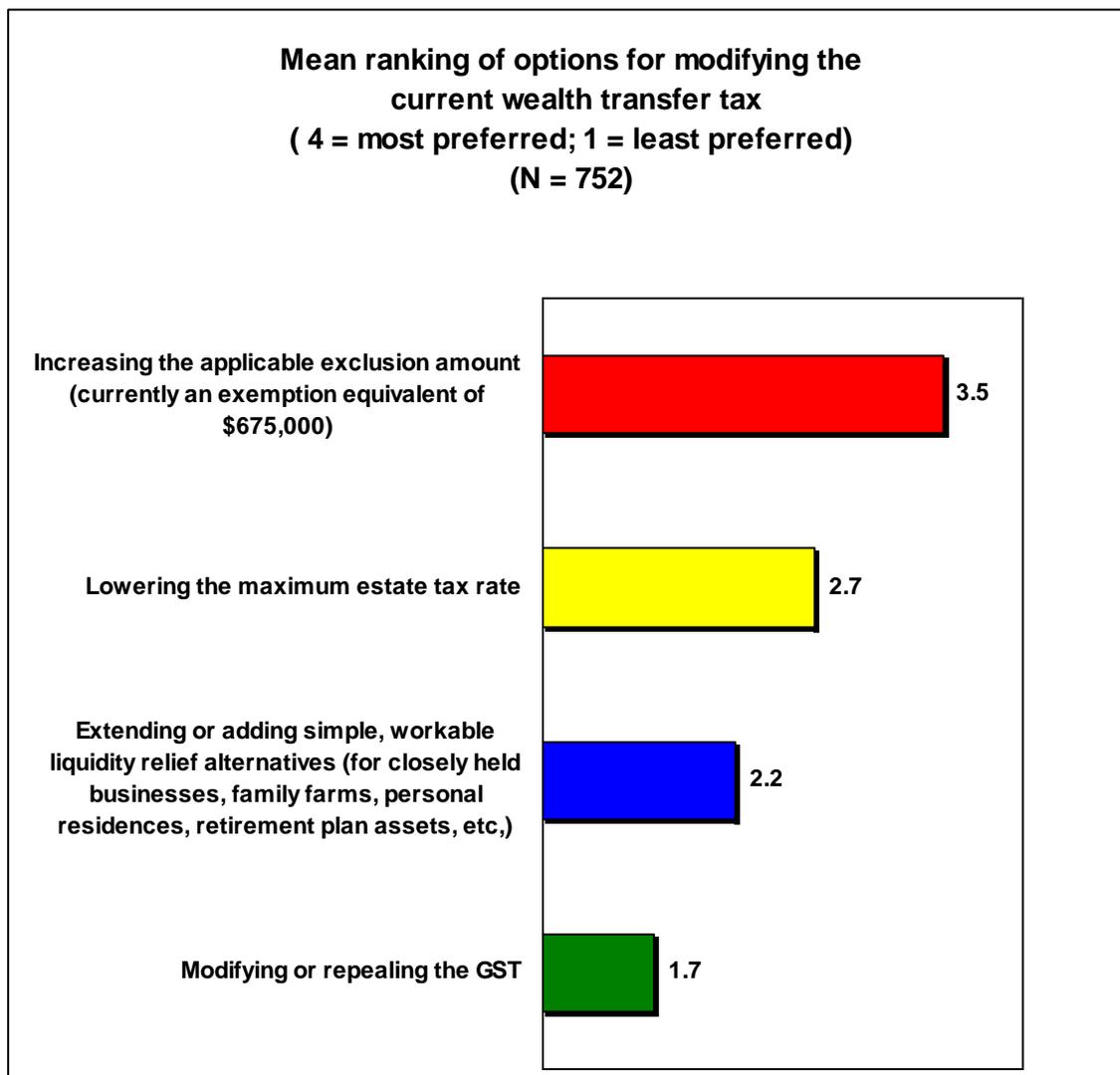
The least preferred alternatives were: "Immediate repeal of the current estate, gift and GST tax, with a new tax on appreciated assets held at death," "Immediate repeal of the current estate, gift and GST tax, with a modified comprehensive income tax that would include gifts and bequests in income," and "Immediate repeal of the current estate, gift and GST tax, with a new periodic wealth tax or intangibles tax."



PREFERENCES FOR MODIFYING THE CURRENT SYSTEM

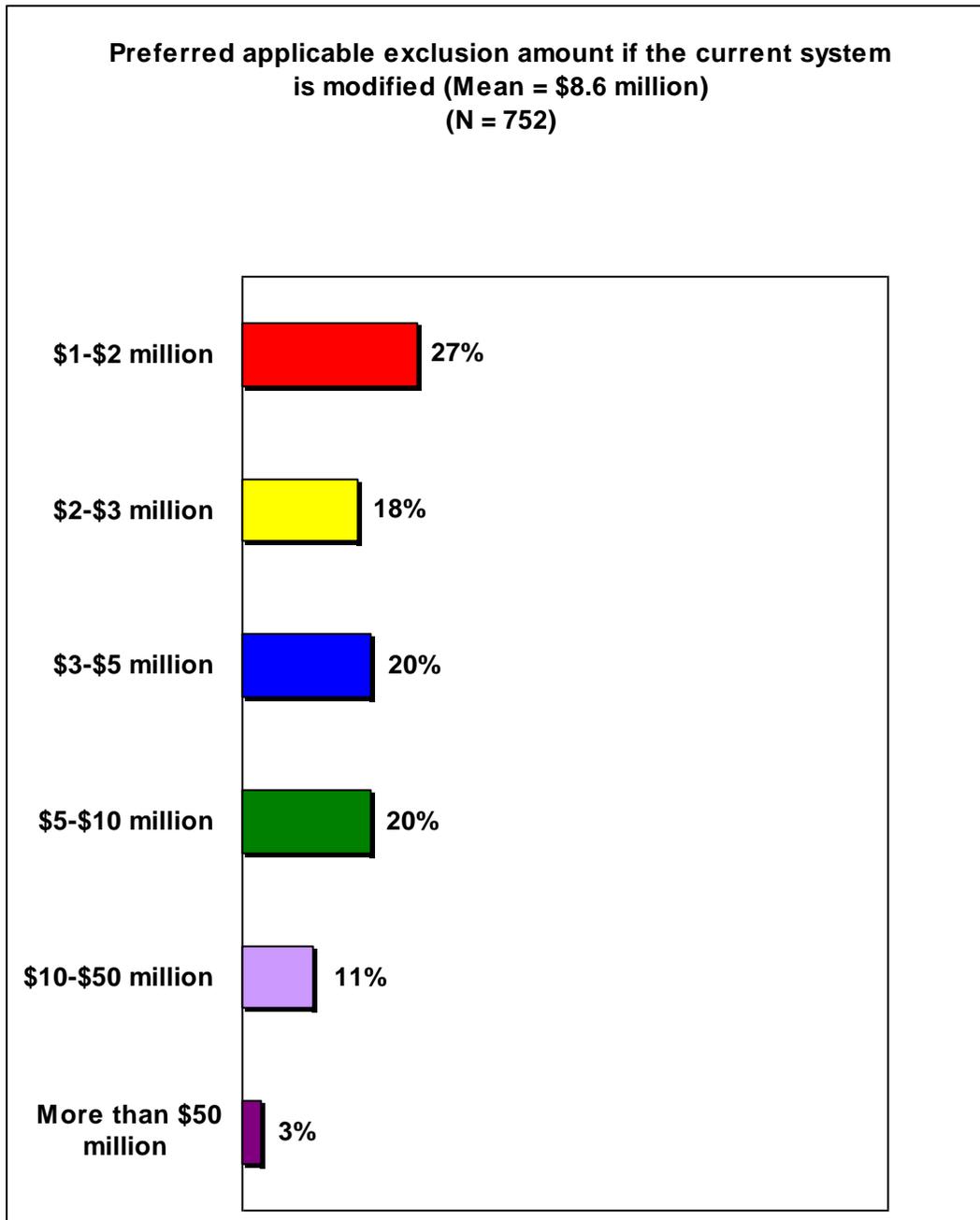
The survey asked practitioners to rank various options for **modifying** the current system. "Increasing the applicable exclusion amount..." was ranked highest, followed by "lowering the estate tax rate..." and "extending/adding workable liquidity relief alternatives..."

Although GST modification/repeal was ranked lowest relative to the other three options, GST exemption allocation traps and other complexities persist and remain a significant concern to practitioners (lawyers and bankers as well as CPAs) and taxpayers. Major GST exemption allocation modifications and related relief measures have been jointly advocated by all of these practitioner groups and were included in bills passed by Congress in 1999 and 2000, but vetoed by the President.



PREFERRED APPLICABLE EXCLUSION AMOUNT

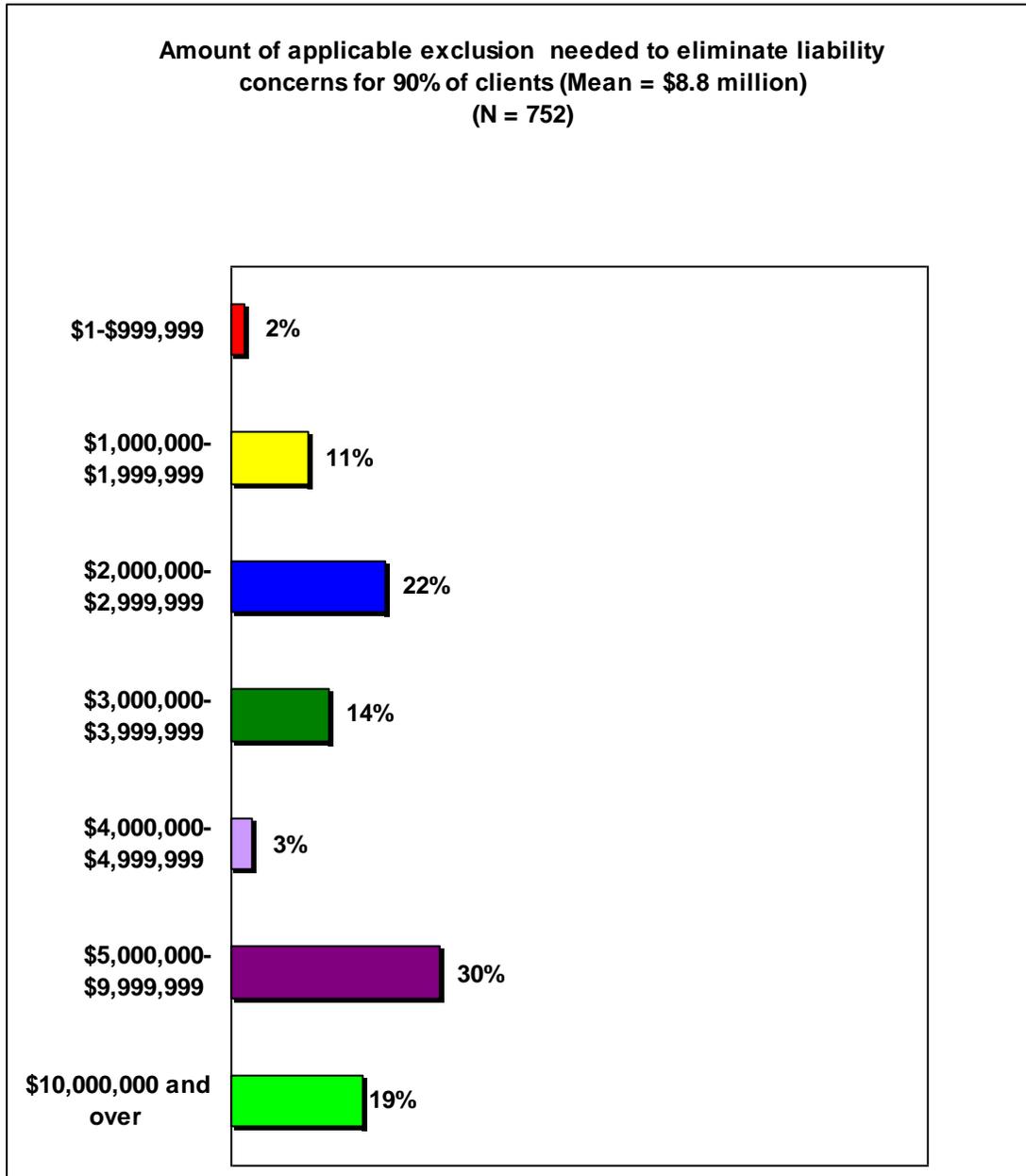
Survey respondents were asked what the applicable exclusion amount should be if the current transfer tax system is modified (but not overhauled). While responses varied greatly, the mean response was \$8.6 million and the median was \$3.5 million. Also, 85 percent of respondents thought that the applicable exclusion amount should be \$10 million or less.



APPLICABLE EXCLUSION

Survey respondents were asked how large the applicable exclusion amount would need to be today to eliminate estate tax liability concerns for 90 percent of their clients.

While responses varied greatly, the mean was \$8.8 million and the median was \$4.0 million.

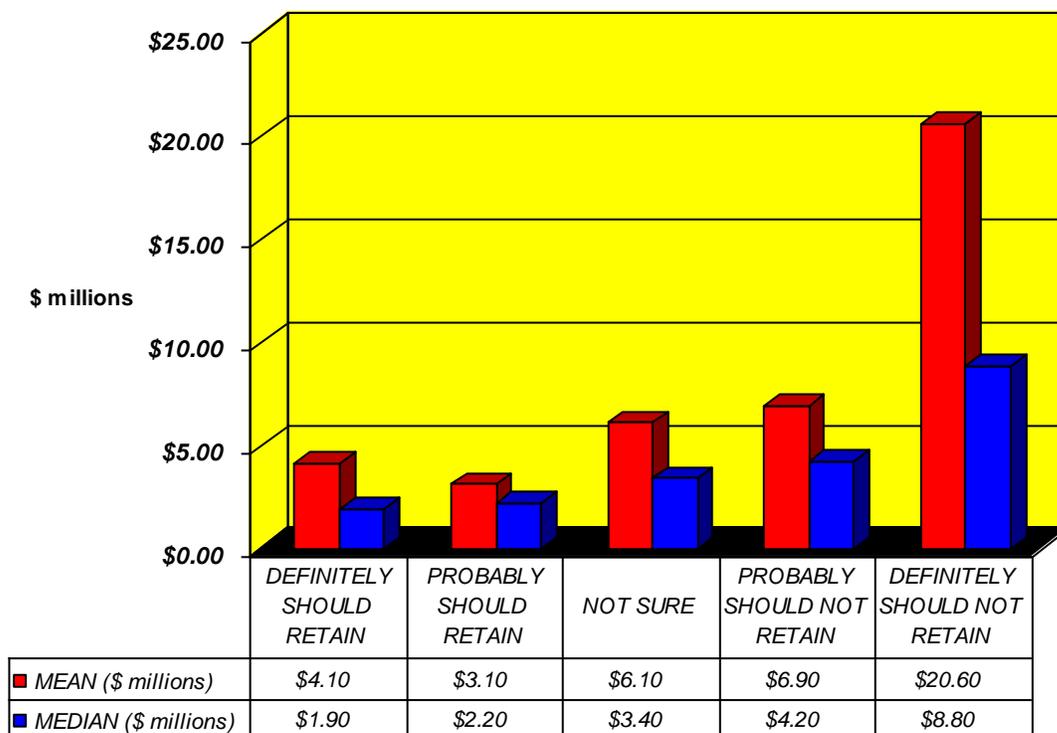


APPLICABLE EXCLUSION AMOUNTS BY PREFERENCES FOR RETAINING THE CURRENT SYSTEM

As would be expected, respondents who thought the current transfer tax system should be retained preferred a lower applicable exclusion amount than those who thought that the current transfer tax system should not be retained.

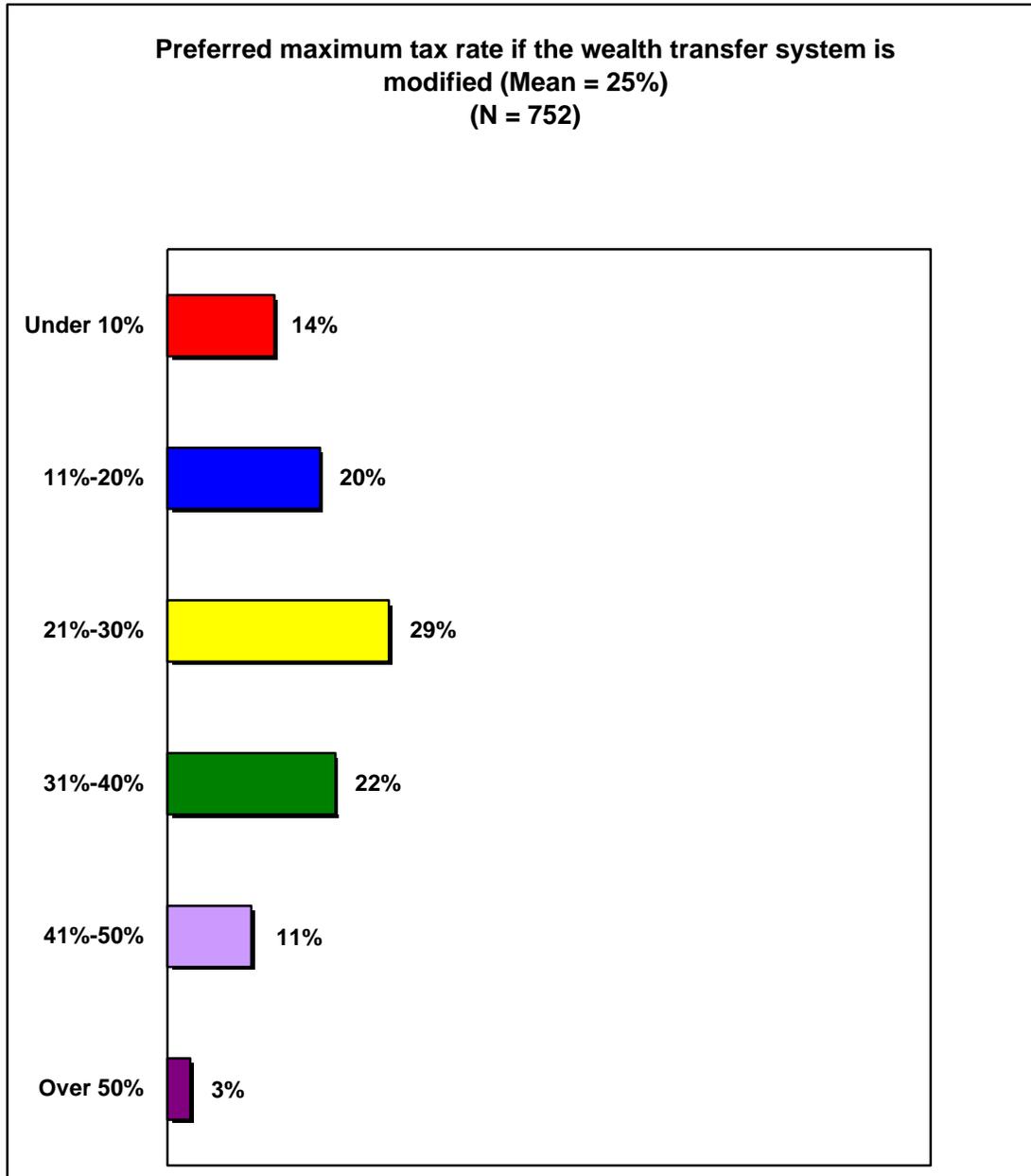
Respondents who thought that the current wealth transfer system should definitely not be retained preferred an applicable exclusion amount exceeding \$20 million.

**Preferred applicable exclusion amounts for respondents with different viewpoints as to whether the current wealth transfer system should be retained
(N = 752)**



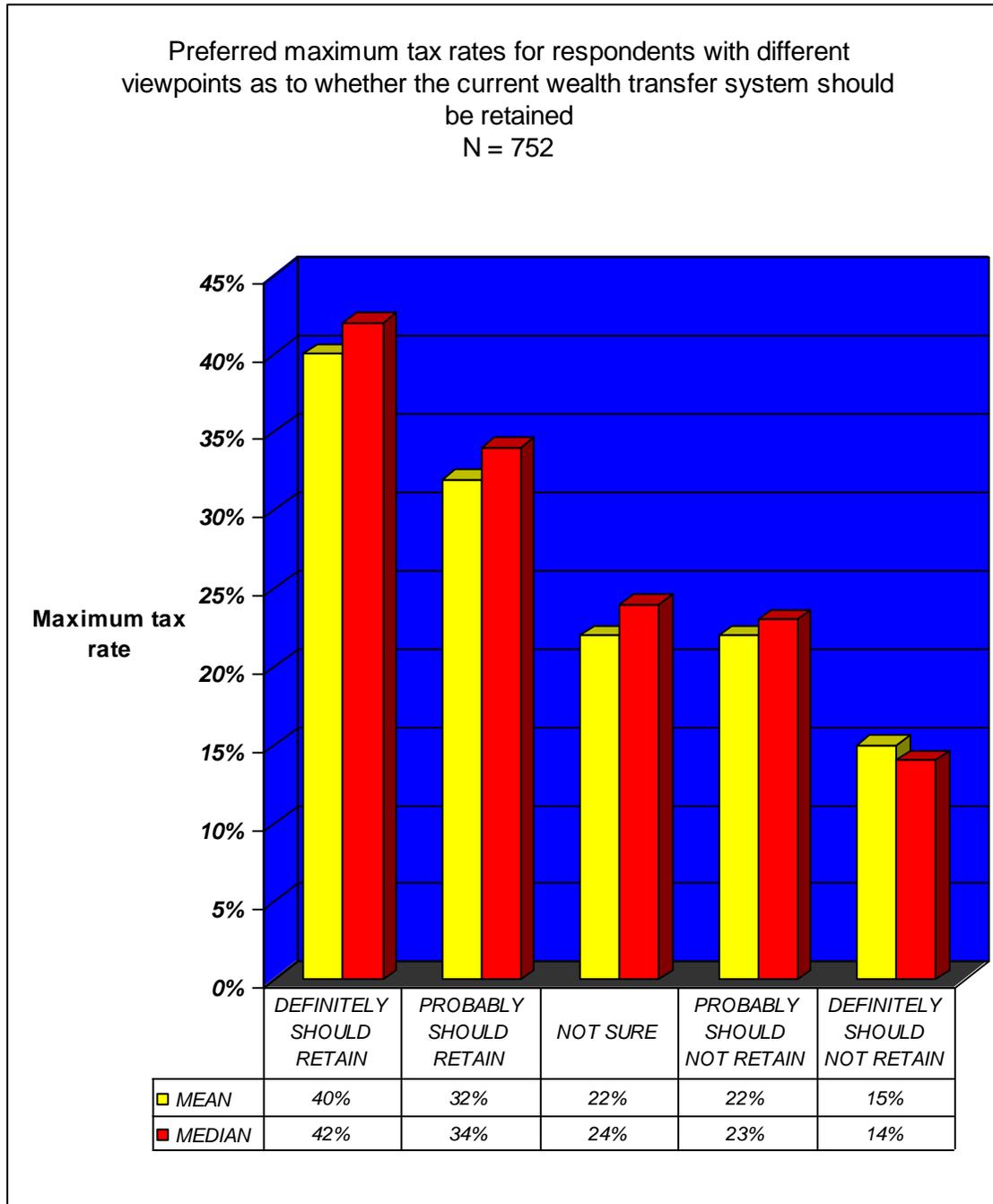
PREFERRED MAXIMUM TAX RATE

If the current system is modified (but not overhauled), surveyed tax practitioners thought the maximum tax rate should be 25 percent (mean and median). Also, 85 percent of respondents thought that the maximum tax rate should be 40 percent or less.



ATTITUDES TOWARD MAXIMUM TAX RATE BY PREFERENCES FOR RETAINING THE CURRENT SYSTEM

As would be expected, respondents who thought that the current transfer tax system should be retained prefer higher maximum tax rates than those who thought that the current system should not be retained.



CARRYOVER BASIS

One of the options considered by Congress would repeal the estate, gift, and GST tax and provide a limited step-up in basis for assets with carryover basis for assets in excess of that amount. Survey respondents were asked whether they thought calculating carryover basis for several categories of assets would cause significant problems for their clients.

A majority of respondents indicated that calculating carryover basis would definitely or probably cause significant problems for their clients for the following assets:

- Collectibles (77 percent),
- Other personal property and household goods (77 percent),
- Mutual funds held by clients (65 percent), and
- Listed securities (58 percent).

Calculating carryover basis for a personal residence or other real estate was viewed to be less problematic, but still was viewed as causing significant problems for clients by 42 percent and 45 percent of respondents, respectively.

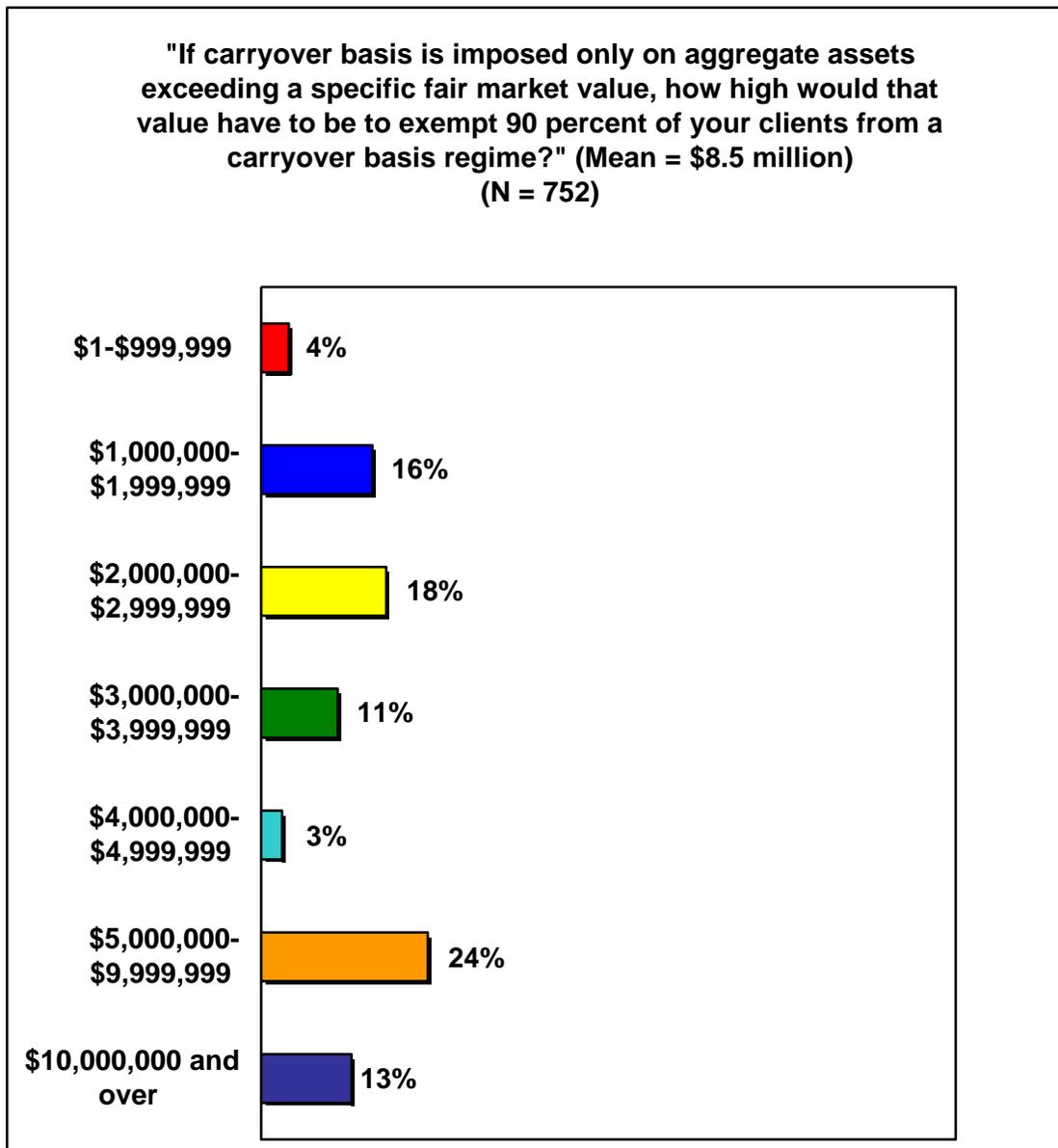
On the other hand, a substantial percent of respondents thought that calculating carryover basis would definitely or probably not cause significant problems for clients with respect to:

- A personal residence (51 percent),
- Other real estate (46 percent),
- Listed securities (39 percent),
- Mutual funds held by clients (31 percent),
- Other personal property and household goods (22 percent), and
- Collectibles (14 percent).

CARRYOVER BASIS

Respondents were asked how high a step-up in basis would need to be in order to exempt 90 percent of their clients from a carryover basis regime.

While there was a great deal of variation in responses, the mean was \$8.5 million and the median was \$3.0 million.



IMPLICATIONS FOR RESTRUCTURING THE ESTATE AND GIFT TAX SYSTEM

Based on the survey results, AICPA Tax Section members see advantages and disadvantages to the current estate and gift tax system. While 49 percent thought that the current wealth transfer tax system should not be retained, 39 percent thought that it should be retained.

Along with providing for a spouse and children and the transfer of a closely-held business to the next generation, liquidity issues relating to closely-held businesses and retirement plans were considered major issues faced by clients by over 60 percent of surveyed AICPA Tax Section members.

If the current system is modified, the preferred alternative is to modify the system by increasing the applicable exclusion amount or by reducing tax rates.

Although surveyed members varied a great deal in their opinions concerning the appropriate applicable exclusion amount, increasing the applicable exclusion amount to a minimum of \$4 million to \$8 million per taxpayer would eliminate estate tax liability concerns for 90 percent of surveyed member's clients.

Most of the members surveyed (85 percent) preferred a maximum tax rate of 40 percent or less.

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