ECONOMIC AND BUDGET ISSUE BRIEF

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Federal Estate and Gift Taxes

The federal government uses a linked set of taxes on estates, gifts, and generation-skipping transfers to tax transfers of wealth from one generation to the next and to limit the extent to which wealth can be given away during life to avoid taxation at death. Federal taxes on transfers of wealth at death have been enacted in various forms since 1797, initially to raise revenue during crisis or war, and have been modified periodically over time.[1] The United States has collected revenues from the current form of the tax—an estate tax—since 1916. A gift tax, first introduced in 1924, prevents wealthy individuals from avoiding the estate tax by transferring wealth while they are alive.

Federal transfer taxes have historically made up a relatively small share of total federal revenues—accounting for 1 percent to 2 percent of total revenues in most of the past 60 years. The Congressional Budget Office (CBO) projects that, under current law, federal revenues from estate and gift taxes will be $420 billion, or 1.2 percent of total revenues, over the 2010–2019 period.

Since 1977, less than 2 percent of adults who die each year have typically left estates large enough to be taxable. Because of recent increases in the amount of an estate that is exempt from taxation, a relatively small percentage of estates are taxable today. In 2007, 17,400 taxable estate tax returns were filed; most were for deaths in 2006, representing about 0.7 percent of adult deaths in that year. The average tax rate for taxable estates—calculated as the estate tax liability divided by the value of the net taxable estate (the value minus certain deductions, such as charitable bequests and bequests to a spouse)—has remained near 25 percent since the 1940s, even as the share of estates subject to the tax fluctuated because of changes in the value of the effective exemption amount.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the estate tax beginning in 2001, primarily by increasing the amount of an estate that is exempt from taxation and by reducing the top marginal tax rate (the rate that applies to the last dollar of an estate). Under that law, the effective exemption amount is $3.5 million in 2009, and the top marginal tax rate is 45 percent. In 2010, the estate tax is temporarily repealed. Starting in 2011, the estate tax is reinstated with an effective exemption amount of $1 million and a maximum marginal tax rate of 55 percent (plus a 5 percent surtax on taxable transfers between $10.0 million and $17.184 million).

The scheduled repeal of the estate tax in 2010, followed by a reversion to a $1 million effective exemption amount thereafter, has raised interest in modifying the estate tax. Proposals include making permanent the repeal of the estate tax; maintaining the current system of estate taxation, with estates paying tax on amounts exceeding a specified exemption amount; and replacing the estate tax with an inheritance tax. The House of Representatives recently passed legislation (H.R. 4154) that would permanently retain the estate and gift taxes at the parameters in place for 2009.

1. For a thorough description of the history of wealth transfer taxes, see Barry W. Johnson and Martha Britton Eller, "Federal Taxation of Inheritance and Wealth Transfers," in Robert K. Miller and Stephen J. McNamee, eds., *Inheritance and Wealth in America* (New York: Plenum Press, 1998), pp. 61–90; Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, "The Estate Tax: Ninety Years and Counting," *SOI Bulletin* (Summer 2007), pp. 118–128, www.irs.gov/pub/irs-soi/ninetyestate.pdf; and John R. Luckey, *A History of Federal Estate, Gift, and Generation-Skipping Taxes*, CRS Report for Congress 95-444 (Congressional Research Service, January 16, 2009).

Table 1.

Federal Transfer Tax Rates and Effective Exemptions, by Year of Transfer

	Estate Tax			Gift Tax		Federal Treatment of States' Wealth Transfer Taxes (Percent)	
	Exemption	Rate (Percent)		Exemption	Top Rate		
Year	(Millions of dollars)	Bottom	Top	(Millions of dollars)	(Percent)	Credit	Deduction
2001	0.675	37	55 [a]	0.675	55 [a]	100	0
2002	1.0	41	50	1.0	50	75	25
2003	1.0	41	49	1.0	49	50	50
2004	1.5	43	48	1.0	48	25	75
2005	2.0	43	47	1.0	47	0	100
2006	2.0	45	46	1.0	46	0	100
2007	2.0	45	45	1.0	45	0	100
2008	2.0	45	45	1.0	45	0	100
2009	3.5	45	45	1.0	45	0	100
2010	Unlimited	Repealed	Repealed	1.0	35	0	100
2011 and Beyond	1.0	41	55 [a]	1.0	55 [a]	100	0

Source: Congressional Budget Office.

a. In 2001 and in years after 2010, a 5 percent surtax is imposed on wealth transfers between $10.0 million and $17.184 million. The surtax is designed to recapture the benefits of the graduated rate structure of the estate tax and results in an effective marginal tax rate of 60 percent on wealth transfers in that range.

How the United States Taxes Transfers of Wealth

The federal government levies three types of taxes on transfers of wealth:

- An estate tax on the net value of assets transferred to other individuals when a person dies,
- A gift tax on the value of gifts that a person gives to others during that person's lifetime, and
- A generation-skipping transfer tax on some transfers of wealth at death to certain heirs.

All three taxes contain provisions that effectively exempt some portion of the transfer from taxation. Table 1 summarizes legislated changes to estate and gift taxes since 2001.

Estate Tax

The executor of the estate of someone who dies in 2009 must file a federal estate tax return and pay federal estate taxes within nine months of the date of death if the value of the gross estate exceeds $3.5 million.[2] The gross estate generally includes all of the decedent's assets, his or her share of jointly owned assets, gifts and gift taxes paid within three years of death, and, in certain cases, life insurance proceeds. The value of the estate's assets is usually determined as the market value on the date of death. A fixed credit, known as the unified credit, effectively exempts the first $3.5 million of the estate from taxes in 2009, and a tax rate of 45 percent is applied to the value of the taxable estate that exceeds $3.5 million. The effective exemption becomes unlimited for deaths in 2010, effectively repealing the estate tax, and drops to $1 million in 2011.

Deductions can reduce the amount of an estate that is taxable. Allowable deductions include charitable bequests, debts, and the full value of transfers to a surviving spouse. Because each spouse can use the unified credit, married couples can effectively double the amount exempt from estate taxes (to $7.0 million in 2009) through careful tax planning; any tax that is due is usually paid when the surviving spouse dies. For 2009, the amount of any estate or inheritance taxes paid to a state government is also deducted from the value of the estate. (For additional details, see Box 1.) Before 2002, federal estate taxes were reduced by a credit (rather than a

2. Most federal estate tax revenues for deaths in calendar year 2009 will be received in fiscal year 2010.

Box 1.

State Taxes on Inherited Wealth

Before the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, estates received a credit against their federal estate tax liability for any estate, inheritance, legacy, or succession tax paid to a state. Under EGTRRA, the credit for those state taxes was phased out over four years and replaced by a deduction. The Congressional Budget Office estimates that converting to a deduction caused federal estate tax revenues to be about $3.4 billion higher in 2006 than they would have been if the credit had been retained.

Before EGTRRA, every state levied such taxes in a way that ensured that their tax collections on transfers of wealth at death were at least the maximum amount the federal government allowed to be taken as a credit. In fact, 24 states pegged their estate tax statutes to the federal tax code in such a way that eliminating the tax credit for state taxes on wealth transfers would have effectively reduced the states' receipts from such taxes to zero. In 2001, taxable estates claimed credits for over $6.2 billion in estate and inheritance taxes paid to states.

Faced with losing significant amounts of revenue because of the changes in EGTRRA, many states acted to retain an estate tax, and others decided to have no estate, inheritance, or gift taxes. As of 2009, 23 states continued to collect either an estate or inheritance tax, either by changing their statutes to decouple them from the federal statute or by retaining or enacting estate or inheritance taxes that are not tied to the federal tax.[1] States' taxes on inherited wealth fell from 1.4 percent of their total tax receipts in 2000 to 0.7 percent in 2008.[2]

1. Elizabeth McNichol, *State Taxes on Inherited Wealth Remain Common: 23 States Levy an Estate or Inheritance Tax* (Washington, D.C.: Center on Budget and Policy Priorities, December 16, 2009).
2. U.S. Census Bureau, *Annual Survey of State Government Tax Collections* (2000, 2008), www.census.gov/govs/statetax/index.html.

deduction) for the state taxes on inherited wealth.[3] Under current law, that deduction will revert to a tax credit in 2011.

Gift Tax

In 2009, a taxpayer may make an annual tax-free gift of up to $13,000 to each recipient. (Married couples may exclude $26,000 of gifts per recipient, and taxpayers may make unlimited tax-free gifts to spouses and charities.) The annual limit is indexed for inflation. The recipient of the gift does not have to include the amount of the gift in his or her taxable income. A donor pays tax on gifts above that amount during his or her life only when the cumulative amount of annual gifts above the $13,000 limit exceeds the $1 million gift tax exemption. The effective estate tax exemption and the $1 million gift tax exemption are not cumulative; when a person who has given gifts dies, the estate tax exemption is reduced by the total amount of the gift tax exemption used during the decedent's life. In all years, pure carryover basis applies to assets given during life, meaning that the recipient of a gift assumes the basis of the donor—generally the original cost of the asset—for computing capital gains.

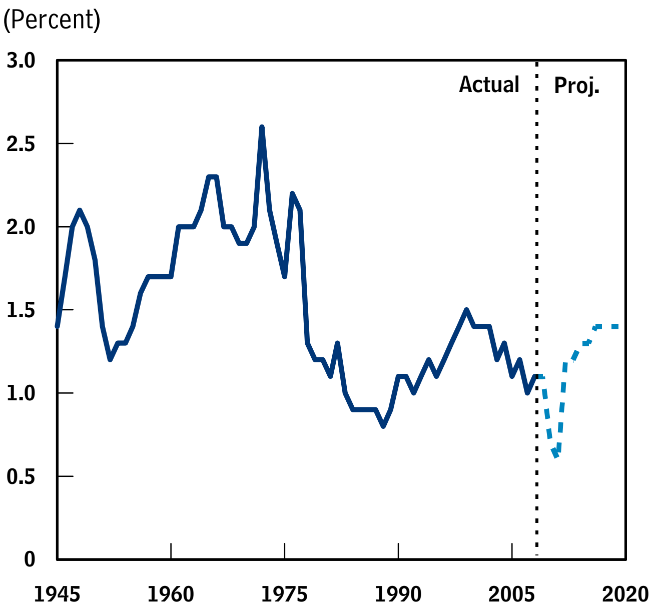
Generation-Skipping Transfer Tax

The generation-skipping transfer (GST) tax is levied at the highest estate tax rate (45 percent in 2009) on transfers directly from a decedent to an heir who is more than one generation younger than the decedent, such as a grandchild. The exemptions for the GST tax and the estate tax are the same, and married couples can again double-up on the exemption with estate planning. GSTs are also subject to applicable estate and gift taxes, making the total tax on GSTs so high that very few estates make

3. A tax deduction reduces the amount of income or wealth subject to taxation, whereas a tax credit directly reduces the amount of tax owed. A tax credit of, say, $1,000 reduces tax liability by more than does a tax deduction of the same amount.

Figure 1.

Estate and Gift Tax Receipts as a Percentage of Total Receipts, Fiscal Years 1945 to 2019



Source: Congressional Budget Office based on data in *Budget of the United States Government, Fiscal Year 2010: Historical Tables*, Table 2.5, www.whitehouse.gov/omb/budget/Historicals.

such transfers. Under current law, the GST tax will be repealed for 2010 and reinstated in 2011.

Estate and Gift Tax Collections

Since 1945, estate and gift tax receipts have consistently remained near or below 2 percent of federal revenues. In recent years, they have been less than 1.5 percent of federal tax revenues (see Figure 1).

Under current law, revenues from estate and gift taxes will total $420 billion, or 1.2 percent of revenues, over the 2010–2019 period, CBO forecasts (see Table 2). About $364 billion (87 percent) of that total is from estate tax receipts, and the remaining $56 billion (13 percent) is from gift tax receipts, an unusually large portion of which are concentrated in fiscal year 2011.[4]

The pattern of those receipts is irregular during the first few years because EGTRRA has complicated the strategic use of gifts to transfer wealth to heirs before a benefactor's death—a significant element of estate planning for many taxpayers. The law gave taxpayers an incentive to defer taxable gifts until 2010, when the gift tax rate would be lower than in earlier years. It also gives people an incentive to make gifts in 2010 at the 35 percent gift tax rate rather than wait until 2011 or thereafter, when most gifts would be taxed at a rate of 55 percent and bequests to heirs would be taxed at rates between 41 percent and 55 percent.

CBO's projections of estate and gift tax receipts reflect those incentives. Despite the repeal of the estate tax in 2010 (which will result in virtually no estate tax receipts in 2011), CBO projects that gift tax receipts will be much higher than usual in 2011, primarily because of taxable gifts given in 2010 (when the tax rate on gifts is reduced to 35 percent) in anticipation of the scheduled return in 2011 of an effective exemption amount of $1 million for estates and generation-skipping transfers and a top marginal tax rate of 55 percent.[5] Most of those receipts are from deferred and accelerated gifts that would otherwise have been given in other years. Projected receipts after 2011 primarily reflect the more stable estate tax rates and effective exemption amounts in current law.

The share of estates that were taxable rose substantially between 1950 and the mid-1970s, when that share reached almost 8 percent, but has declined sharply since then (see Figure 2 on page 7). Since 1977, generally about 1 percent to 2 percent of adults who died each year have left estates large enough to be taxable. In 2000, before EGTRRA was enacted, 51,200 estates were taxable, representing 2.2 percent of adult deaths in that year. EGTRRA reduced the percentage of estates that were taxable. For example, 17,400 taxable estate tax returns were filed in 2007; most were for deaths in 2006, when the effective exemption amount was $2 million, representing about 0.7 percent of adult deaths in that year.

The impact of inflation on fixed exemption amounts explains much of the growth in the share of estates that

4. Generation-skipping transfer taxes account for only about one-half of one percent of estate and gift tax receipts, although the GST tax serves an important role in preventing the erosion of estate and gift tax bases.

5. In 2001 and in years after 2010, a 5 percent surtax is imposed on wealth transfers between $10.0 million and $17.184 million. The surtax is designed to recapture the benefits of the graduated rate structure of the estate tax and results in an effective marginal tax rate of 60 percent on wealth transfers in that range.

Table 2.

CBO's Projections of Receipts from Estate and Gift Taxes, August 2009

(Billions of dollars)

	Actual		Projected											
Type of Tax	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2019
Estate	23.6	25.7	20.9	14.5	1.1	31.7	37.0	40.0	42.7	45.2	47.8	50.5	53.4	363.9
Gift	2.4	3.2	1.4	1.0	14.7	3.4	1.9	3.6	5.5	6.0	6.3	6.6	6.9	55.8
Total	**26.0**	**28.8**	**22.3**	**15.4**	**15.7**	**35.1**	**38.9**	**43.6**	**48.2**	**51.2**	**54.1**	**57.1**	**60.3**	**419.7**

Source: Congressional Budget Office.

were taxable between 1950 and the mid-1970s (see Figure 2 on page 7). The amount of an estate exempt from taxation remained at $60,000 from 1942 through 1976. Inflation eroded the value of that exemption over time, making an increasing share of estates taxable. Starting with the Tax Reform Act of 1976, a series of laws resulted in annual increases in the amount of estates and gifts exempt from taxation, until the effective exemption amount reached $600,000 in 1987 (slightly above $1 million in 2008 dollars).[6] The nominal value of that exemption remained fixed through 1997 (the inflation-adjusted value of the exemption declined between 1987 and 1998) and has been increased sharply since then, reaching $2.0 million in 2005 and $3.5 million in 2009, culminating in a one-year unlimited exemption in 2010. After 2010, the effective exemption amount drops to $1 million.

Larger estates pay a significant portion of the estate tax. In 2007, taxes on gross estates valued at more than $20 million were 36 percent of total estate taxes for that year, and taxes on gross estates valued at more than $10 million accounted for 55 percent of total estate taxes.

Since the 1940s, estate and gift tax payments have averaged about 25 percent of the net taxable estate (the value of the estate after allowable deductions but before subtracting the effective exemption amount). The underlying structure of the estate tax provides for graduated tax rates, under which smaller estates face a lower tax rate. In recent years, increases in the amount of the estate exempt from taxation and reductions in the highest marginal tax rates exempted smaller estates from the estate tax and made the rate structure much flatter (that is, it reduced the difference between the highest and lowest marginal tax rates). The net result was that the average tax paid by the now smaller number of taxable estates rose slightly for returns filed from 2005 through 2007, to about 27 percent of the value of the net taxable estate.

The Impact of Estate and Gift Taxes

Like most taxes, estate and gift taxes affect taxpayers' behavior, particularly their decisions about how much to save, work, and give to charity. The taxes also affect people's decisions about when to sell appreciated assets and when and how to transfer wealth to others. A frequently expressed concern is whether the estates of owners of family farms and small businesses can afford to pay estate taxes without liquidating assets.

Consumption, Saving, and Work Effort

The estate tax could have varying effects on consumption, saving, and work effort, depending on people's motives for leaving bequests to heirs. Consensus is lacking about which motives predominate or even about whether people work and save more or less as a result of estate and gift taxes.[7] A lower estate tax makes it cheaper for people to leave money to their heirs, which could encourage people to work more or save more to leave larger bequests. But a lower estate tax also means that

6. The Tax Reform Act of 1976 also made substantial changes to estate and gift taxes. It imposed the tax on generation-skipping transfers and created the unified framework for estate and gift taxes—that is, a single, unified estate and gift tax credit and tax rate schedule.

7. For a discussion of those issues, see Donald J. Marples and Jane G. Gravelle, *Estate and Gift Taxes: Economic Issues*, CRS Report RL30600 (Congressional Research Service, December 4, 2009); and James R. Hines Jr., Joel Slemrod, and William G. Gale, eds., *Rethinking Estate and Gift Taxation* (Washington, D.C.: Brookings Institution Press, 2001).

people can make the same after-tax bequest with a smaller amount of savings, which might induce them to work and save less. Alternatively, some people might acquire wealth largely for other purposes and leave it as a bequest only if they died before they expected to. In that case, changes to the estate tax would have little effect on saving or work effort. Furthermore, to the extent that a lower estate tax increases the size of bequests after taxes, potential *recipients* may work less or increase their consumption.[8] The empirical evidence on the effect of the estate tax on consumption, saving, and work effort is inconclusive.

Family Farms and Small Businesses

A commonly expressed concern is the effect of the estate tax on family farms and small businesses, including the possibility that heirs may be forced to liquidate the business to pay the estate tax. As with the general public, most owners of family farms and small businesses are unlikely to owe estate tax. About 2.1 percent of farmers (1,137) and 2.4 percent of small-business owners (8,291) who died in 2005 had to file estate tax returns.[9]

The vast majority of estates, including those of farmers and small-business owners, had enough liquid assets to pay the estate taxes they owed in 2005.[10] However, estates involving farms or small businesses are slightly less likely than other estates to have sufficient liquid assets to cover their estate taxes. In 2000, when the effective estate tax exemption amount was $675,000, 138 (or about 8 percent) of the estates of farmers who left enough assets to owe estate taxes faced a tax payment that exceeded their liquid assets, compared with about 5 percent of all estates that owed taxes. Those numbers are upper bounds, however, because the definition of liquid assets used on estate tax returns excludes some money held in trusts, which could also be used to pay estate taxes. The increase in the exemption amount since 2000 probably further mitigated the impact on small businesses. Moreover, the estate tax currently includes several provisions that owners of family farms and small businesses can use to mitigate its effect. For example, heirs are allowed to pay the tax in installments over 15 years at low interest rates, and several special valuation provisions allow some assets to be assessed at less than their market value.[11]

The complexity of the estate tax, especially for estates with illiquid assets, such as farms and closely held businesses, might make complying with the tax costly. Although estimates of estate planning costs vary widely, the most comprehensive analysis of compliance costs finds that they amounted to about 7 percent of estate tax receipts in 1999.[12] Those costs are likely to be higher for estates with less liquidity; special rules apply to such

8. See David Joulfaian, *Inheritance and Saving*, Working Paper 12569 (Cambridge, Mass.: National Bureau of Economic Research, October 2006); and Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, vol. 108, no. 2 (May 1993), pp. 413–436.

   Some evidence suggests that the recipient of a bequest that increases his or her financial resources is slightly more likely to become an entrepreneur and develop a successful small business. However, the evidence also suggests that children with parents who were successful entrepreneurs are more likely to be successful entrepreneurs themselves, regardless of the size of their financial inheritance. See Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, vol. 102, no. 1 (February 1994), pp. 53–75; Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Entrepreneurial Decisions and Liquidity Constraints," *Rand Journal of Economics*, vol. 23, no. 2 (Summer 1994), pp. 334–347; and Thomas Dunn and Douglas Holtz-Eakin, "Financial Capital, Human Capital, and the Transition to Self-Employment: Evidence from Intergenerational Links," *Journal of Labor Economics*, vol. 18, no. 2 (April 2000), pp. 282–305. A summary of the literature about the effect of financing constraints on entrepreneurship can be found in William Kerr and Ramana Nanda, *Financing Constraints and Entrepreneurship*, Working Paper 15498 (Cambridge, Mass.: National Bureau of Economic Research, November 2009).

9. Marples and Gravelle, *Estate and Gift Taxes.*

10. Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses* (July 2005).

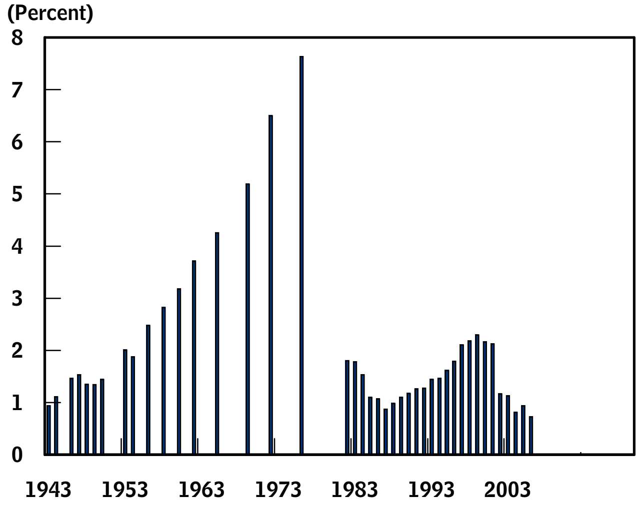
11. For a discussion of some of these provisions, including the qualified family-owned business interest provision, minority discounts, and special-use valuation, see Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses*; and Jane G. Gravelle and Steven Maguire, *Estate Taxes and Family Businesses: Economic Issues*, CRS Report RL33070 (Congressional Research Service, November 27, 2009).

12. Charles Davenport and Jay A. Soled, "Enlivening the Death-Tax Death-Talk," *Tax Notes*, vol. 84 (July 26, 1999), pp. 591–630.

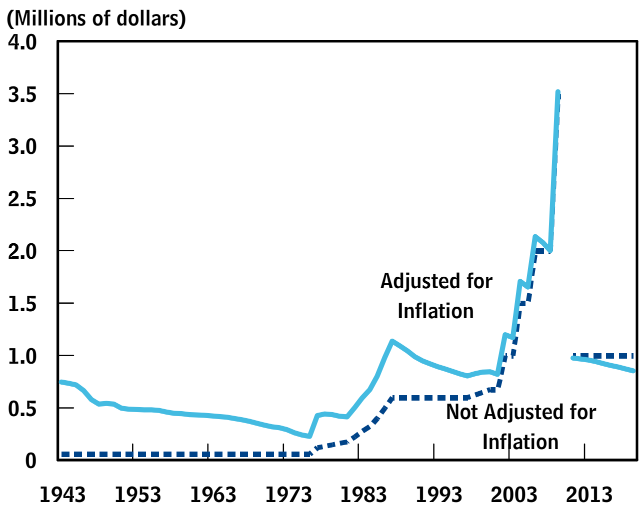
Figure 2.

Estate Tax Returns

Taxable Estate Tax Returns, as a Share of Adult Deaths, 1943 to 2006[a]



Effective Exemption for the Estate Tax, by Year of Death, 1943 to 2019[b]



Source: Congressional Budget Office based on data from the Internal Revenue Service.

a. Data for taxable estate tax returns are from Internal Revenue Service, *SOI Bulletin*, vol. 28, no. 4 (Spring 2009), Table 17, pp. 222–223, www.irs.gov/pub/irs-soi/09sprbul.pdf. Data are shown only for years for which Statistics of Income (SOI) data are available. Data after 2004 are CBO estimates based on information from various *SOI Bulletins*, www.irs.gov/taxstats/indtaxstats/article/0,,id=210646,00.html.

b. The exemption is unlimited in 2010 and is therefore not shown in the figure. Inflation-adjusted data after 2008 are CBO projections.

estates, with the goal of ameliorating the tax burden.[13] However, it is difficult to identify how much of the costs of estate planning result directly from the estate tax as opposed to the costs of general estate planning, which would be needed even in the absence of the tax.

Charitable Giving

Most gifts to charity are either charitable bequests specified in a decedent's will or charitable donations made during life. The tax code may influence the amount of giving by affecting both the cost of giving (relative to that of other possible uses for the money) and the amount of wealth available to individuals to give. The estate tax and the individual income tax affect both factors.

Charitable bequests are exempt from the estate tax, thus lowering the price of charitable bequests relative to fully taxable bequests to heirs. A charitable organization receives one dollar for every dollar left as a charitable bequest, whereas an heir might receive 55 cents for every dollar left as a bequest (with a marginal estate tax rate of 45 percent). However, the estate tax lowers the potential size of an inheritance, which might make an individual less likely to donate to charity.

Larger estates bequeath a larger percentage of their assets to charity than do smaller estates. Estates valued at less than $20 million bequeathed 5 percent ($7.3 billion) of their assets to charity, compared with 21 percent ($12.4 billion) of assets for taxable estates valued at over $20 million. Most studies have found that the estate tax clearly increases charitable bequests and probably increases charitable donations during life.[14]

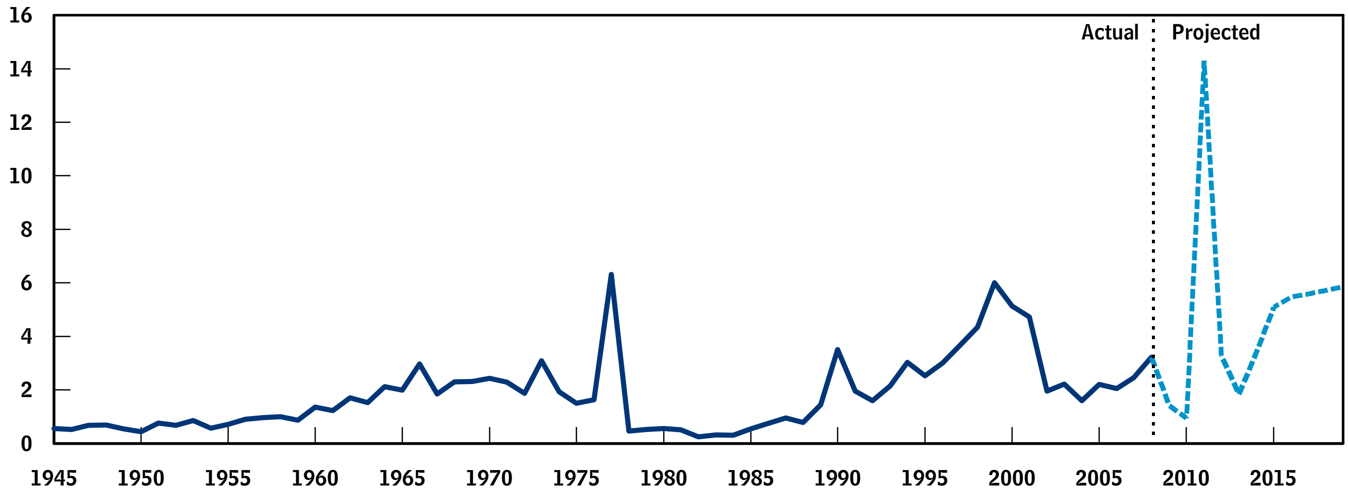
13. For more information about the rules applying to family-owned businesses and their possible economic effects, see Joint Committee on Taxation, *Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform*," JCX-23-08 (April 2, 2008), pp. 14–24. For a summary of much of the research on the cost of complying with the estate tax, see William G. Gale and Joel Slemrod, "Overview," in Hines, Slemrod, and Gale, eds., *Rethinking Estate and Gift Taxation*.

14. David Joulfaian, "On Estate Tax Repeal and Charitable Bequests," *Tax Notes*, vol. 123 (June 8, 2009), pp. 1221–1229; and Congressional Budget Office, *The Estate Tax and Charitable Giving* (July 2004).

Figure 3.

Gift Tax Receipts, Fiscal Years 1945 to 2019

(Billions of 2008 dollars)



Source: Congressional Budget Office based on data in David Joulfaian, *The Federal Gift Tax: History, Law, and Economics*, OTA Paper 100 (Department of the Treasury, Office of Tax Analysis, November 2007), Table 6, p. 44, www.ustreas.gov/offices/tax-policy/library/ota100.pdf; and Internal Revenue Service Data Books, various years, www.irs.gov/taxstats/article/0,,id=211513,00.html. Data after 2008 are CBO projections.

The Timing of Wealth Transfers

Estate and gift taxes, in combination with the progressive income tax schedule, create a number of incentives for taxpayers to transfer wealth to their relatives as gifts during life instead of through bequests at death.[15] How much those taxes affect the amount of gifts is not clear, but in timing their wealth transfers, the wealthy appear to be very responsive to their expectations of changes in tax rates and to differences between estate and gift tax rates. For example, when the Tax Reform Act of 1976 raised the maximum gift tax rate from 57.75 percent to 70 percent, gift tax receipts quadrupled in the months between the law's enactment and its effective date (see Figure 3).

After the enactment of EGTRRA in 2001, taxpayers cut their taxable gift giving by more than half, partly in anticipation of the repeal of the estate and generation-skipping transfer taxes and the reduction in the tax rate on gifts to 35 percent in 2010. Under current law, CBO anticipates a surge in taxable gifts in 2010, as seen by the spike in CBO's forecast of gift tax receipts in 2011, when the tax on gifts given in 2010 will be due.

The gift tax is retained under EGTRRA even in 2010, when the estate tax and the generation-skipping transfer tax are repealed. The gift tax serves an important role in protecting the income tax base and discouraging wealthy individuals from using gifts and the progressive income tax rate schedule to reduce taxation. In the absence of a gift tax, a high-income taxpayer could give assets with a low tax basis but a high current value as a gift to an individual in a lower tax bracket, who could sell them and pay taxes at his or her lower tax rate.[16] That recipient could then give the proceeds back to the high-income taxpayer. Similarly, a high-income taxpayer could give an asset that generates a lot of taxable income to someone in a lower tax bracket, who would pay less tax on that income. By taxing large lifetime transfers of wealth, the gift tax discourages those types of transactions and the resulting loss of revenue.

15. In a progressive tax schedule, the tax rate increases as the taxable amount increases.

16. Current law specifies that gifts of assets receive carryover basis—generally the original cost of the asset.

Box 2.

The Estate Tax and Capital Gains

The interaction between the income tax treatment of capital gains and the estate tax treatment of inherited assets is an important part of estate taxation. Under the income tax, when an asset is sold for more than the price at which it was purchased, the seller realizes a capital gain, which generally is subject to income taxation. The taxable gain is measured as the difference between the cost of purchasing the asset (its basis) and the value of the asset when the gain is realized.

Individuals can avoid paying tax on capital gains by holding the assets until death. Capital gains on appreciated assets in an estate are not subject to income taxation when the owner dies. In addition, except in 2010, heirs receive stepped-up basis on inherited assets. In that treatment, the basis of the asset is generally measured as an asset's fair market value on the date of the decedent's death rather than as the original price the decedent paid for the asset. Capital gains taxes will be due only if the heir sells the asset, and the heir is liable only for capital gains tax assessed on the increase in the asset's value from the date it was inherited until the date it is sold.

When the estate tax is temporarily repealed in 2010, the calculation of basis for assets transferred from a decedent changes. In 2010, a "modified carryover basis" will be used for inherited assets. Under pure carryover basis, the basis of assets in the hands of an heir is generally the same as it was in the hands of the decedent. Under modified carryover basis, selected assets have their basis stepped-up by up to $1.3 million and by an additional $3 million for assets left to a surviving spouse. The basis of any assets that do not receive that step-up is generally measured as the price that the decedent originally paid for the asset.

Capital Gains Realizations

The current treatment of capital gains in the tax code allows an individual to avoid realizing capital gains by holding onto assets until death. As a result, the purchaser of an asset that has appreciated may be reluctant to sell it (the lock-in effect), thereby reducing realizations of capital gains during his or her lifetime (see Box 2). However, the step-up in basis at death under estate tax law (except in 2010) eliminates the incentive for the individual who inherits the asset to hold on to it, because no capital gains tax is due on any appreciation that occurred before the asset was inherited.[17]

The estate tax, however, reduces the benefit of holding an asset until death, even with a step-up in basis. No income tax would be due on the appreciation of the asset when it was bequeathed, but the entire value of the asset (including its basis) would be part of the estate subject to the estate tax. Some research suggests that, on net, higher estate taxes result in slightly higher capital gains realizations and that reducing estate tax rates could result in lower realizations.[18]

Under current law, a modified carryover basis will apply in 2010 to the first $1.3 million of inherited capital gains ($4.3 million for married couples). To the extent that inherited assets receive carryover basis instead of stepped-up basis, individuals who expect to die in 2010 with a large estate may be more willing to sell appreciated assets before death, and some unrealized capital gains and losses

17. As described in Box 2, under stepped-up basis, the basis of an asset for tax purposes is generally measured as an asset's fair market value on the date of the decedent's death.

18. Gerald Auten and David Joulfaian, "Bequest Taxes and Capital Gains Realizations," *Journal of Public Economics*, vol. 81, no. 2 (2001), pp. 213–229.

may be unlocked.[19] However, heirs of assets that received carryover basis may be less likely to sell them, because capital gains tax is due when they are sold.

Policy Options for Changing the Taxation of Wealth Transfers

The House of Representatives recently passed legislation (H.R. 4154) that would permanently extend estate and gift tax law as it stands in 2009—that is, with an effective exemption amount of $3.5 million for the estate tax and the generation-skipping transfer tax, with no adjustment for inflation, and a tax rate of 45 percent. In its August 2009 report *Budget Options, Volume 2*, CBO discussed a number of other options for modifying estate and gift taxes, including permanently extending the law in effect in 2009 (but unlike H.R. 4154, adjusting the exemption amounts for the estate and GST taxes for inflation) and permanently repealing the estate tax.[20]

This brief examines those three alternatives and a fourth, which would apply an inheritance tax to each person inheriting assets. All three estate tax options examined in this brief, including H.R. 4154, would retain the gift tax with a $1 million exemption amount, but that sum would not be indexed for inflation, thus reducing its value over time.[21] An inheritance tax would probably be combined with modifications of the existing estate and gift taxes. CBO discusses those particular options to highlight the key issues involved in changing the taxation of wealth transfers; as always, the agency makes no recommendations regarding policy choices.

19. In fact, very wealthy individuals who believe that they will die in 2010 and believe that the estate tax will be repealed in that year have an incentive to sell certain assets with capital losses before they die. Under the law's modified carryover basis regime, certain unused capital losses can be used by the estates of people who die in 2010 to increase the available basis step-up above $1.3 million (or $4.3 million for spouses).

20. Congressional Budget Office, "Modify the Estate and Gift Tax Provisions of EGTRRA," *Budget Options, Volume 2* (August 2009), Revenue Option 48, pp. 239–241. The staff of the Joint Committee on Taxation (JCT) provided the revenue estimates for those options. The JCT's revenue estimates are based on CBO's March 2009 baseline; that baseline differs slightly from CBO's August 2009 baseline, which is used elsewhere in this brief.

21. Because the gift tax serves an important role as a backstop to the income tax, repealing it or raising the exemption amount would reduce federal revenues.

The three options that provide specific ways to modify or repeal the estate tax would reduce federal revenues. An inheritance tax could increase or decrease revenues, depending on how it is structured, including any associated changes to the estate and gift taxes.

The Congress could instead choose to make no changes to current law and allow the estate tax to expire at the end of 2009 and reappear in 2011 with an effective exemption amount of $1 million and a top tax rate of 55 percent (see Table 1 on page 2). CBO projects that revenues from estate and gift taxes under current law will total $420 billion over the 2010–2019 period (see Table 2 on page 5).

Permanently Repeal the Estate Tax

The first option would make EGTRRA's provisions for estate and gift taxes in 2010 permanent. Thus, the estate and the generation-skipping transfer taxes would not be reinstated, and the gift tax exemption would remain at $1 million. In addition, this option would permanently retain the modified carryover basis that EGTRRA specifies in 2010 for some transferred assets. This set of changes would have the largest impact on revenues and would elicit the largest behavioral response from taxpayers. The staff of the Joint Committee on Taxation estimates that those changes together would reduce revenues by $502 billion between 2010 and 2019 (see Table 3).

The revenue loss from repealing the estate tax exceeds CBO's forecast of estate and gift tax revenues under current law because changes to estate tax law would affect receipts from individual income taxes by inducing changes in capital gains realizations. People inheriting assets with carryover basis are more likely to hold on to them rather than to sell them and pay more capital gains tax than they would have owed under stepped-up basis. Hence, repeal would reduce revenues from capital gains taxes. A permanent repeal would also significantly reduce gift tax receipts, because wealthy individuals would be unlikely to make taxable gifts when they could instead make tax-free bequests at death.

The revenue loss would be slightly offset because charitable bequests and lifetime charitable giving would be likely to fall as a result of repeal, increasing individual income tax revenues. However, the existing income tax deduction for charitable gifts would remain and would continue to

Table 3.

Estimated Change in Revenues from Modifications to Estate and Gift Taxes

(Billions of dollars)

Modification	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total 2010-2014	Total 2010-2019
Permanently Repeal the Estate Tax	-1.0	-18.8	-41.5	-48.3	-53.7	-58.6	-63.0	-68.4	-72.0	-76.6	-163.3	-501.9
Make 2009 Law Permanent[a]												
Without indexing (H.R. 4154)	0.5	-0.6	-18.3	-21.8	-25.4	-28.7	-31.1	34.0	-35.9	-38.3	-65.7	-233.6
With indexing	0.5	-0.7	-18.6	-22.3	-26.0	-29.6	-32.4	-35.8	-38.1	-41.1	-67.2	-244.2
Memorandum:												
CBO's Projections of Estate and Gift Tax Revenues Under Current Law	15.4	15.7	35.1	38.9	43.6	48.2	51.2	54.1	57.1	60.3	148.8	419.7

Sources: The staff of the Joint Committee on Taxation and the Congressional Budget Office.

a. The two variations of this option would set the exemption amounts for the estate tax and the generation-skipping transfer tax at $3.5 million and the tax rate at 45 percent. The second variation indexes the exemption amount for the estate tax and the generation-skipping transfer tax for inflation and is an updated estimate of the option presented in the Congressional Budget Office's August 2009 report *Budget Options, Volume 2*.

increase such giving above the amounts that would be seen if the gifts were motivated by altruism alone.

Repealing the estate tax would simplify the tax system and would eliminate the need for large estates to file estate tax returns and pay estate tax. Although repeal would reduce the filing burden on estates, it would increase recordkeeping for estates with very large capital gains and for their heirs, who would have to know the basis of any asset they inherited. Some assets would receive stepped-up basis; for other assets, heirs would have to determine and document the price the decedent paid, despite the difficulty of tracking asset values across generations. Carryover basis would also be difficult for the Internal Revenue Service to administer.

Repeal would eliminate a progressive element of the federal system because only relatively large estates are taxed. Because heirs probably bear at least a portion of the burden of the estate tax, the tax may be less progressive when measured against the assets of heirs than when measured against the decedent's estate, but to the extent that heirs of taxable estates are wealthier than average, the estate tax still contributes to the overall progressivity of the federal tax system.[22] Raising other federal taxes to make up for the revenues lost from repealing the estate tax might shift more of the federal tax burden to less affluent households.

Repealing the estate tax would spare all family farms and small businesses from the tax. It would also reduce state income tax revenues for states that have not broken the link between their estate taxes and federal statutes governing estate taxes.

Make 2009 Law Permanent Without Indexing the Exemption Amounts

The second option, which is identical to H.R. 4154, would keep the tax rate at 45 percent and maintain the effective exemption amounts for the estate and GST taxes at $3.5 million beginning in 2010 and not adjust them

22. David Joulfaian, *Inheritance and Saving*, discusses the average pre- and postinheritance wealth of a sample of heirs. A discussion of the relative burden of the estate tax on heirs or donors is in Lily L. Batchelder and Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate and Inheritance Taxes*, 3rd Annual Conference on Empirical Legal Studies Papers (October 28, 2008), http://ssrn.com/abstract=1134113.

for inflation.[23] The stepped-up basis would continue to apply to assets transferred from a decedent, and a deduction for state taxes on inherited wealth would be provided. The exemption amount for the gift tax would remain at $1 million. Those changes would reduce revenues by $234 billion over 10 years, according to the JCT.

Retaining the estate tax at the parameters in effect for 2009 would affect people's behavior less than would repealing the tax. Relative to current law, it would increase the number of estates resulting from deaths in 2010 that would be subject to the estate tax, but after 2010 it would lower the number of estates that would pay that tax. After 2010, raising the effective exemption to $3.5 million would reduce charitable giving, thus raising individual income tax receipts (charitable gifts made during life are deductible from taxable income). Compared with repeal, however, setting the effective exemption at $3.5 million would increase charitable giving. The retention of the deduction for a state's estate and inheritance taxes in this option would raise revenues compared with the reversion to a credit for state taxes as scheduled under current law.

Setting the effective exemption amount at $3.5 million in 2010 would nearly eliminate the incentive to make large taxable gifts to relatives in 2010, reducing projected gift tax receipts in 2011. It would increase receipts from estate and gift taxes between 2011 and 2013, because taxpayers would no longer shift wealth transfers from those years into 2010 to reap the benefits of the 35 percent tax on gifts and the repeal of the GST tax in that year.

Make 2009 Law Permanent and Index the Exemption Amounts

The third option would make 2009 law permanent while also indexing the amount of the estate and GST exempt from taxation. This option would reduce revenues but would avoid the phenomenon in which inflation erodes the value of the exemption amount, resulting in a larger share of the population being required to pay the tax over time. The JCT estimates that those changes would reduce revenues by $244 billion over 10 years, about $11 billion more than not indexing the estate tax exemption amount for inflation.

Create an Inheritance Tax

An inheritance tax provides an alternative method for taxing transfers of wealth. It would be applied separately to each person inheriting assets. The inheritance tax could be set up so that heirs with lower income or less wealth paid a lower tax than did heirs with higher income or more wealth, so that smaller inheritances would be taxed at lower rates than larger inheritances, or so that closer relatives paid lower taxes than more distantly related heirs.[24] Most countries that tax wealth transfers use inheritance taxes rather than estate and gift taxes.

There is no consensus as to whether such a tax system would be more or less complex than the current one. Although an inheritance tax might eliminate certain tax-planning strategies used to reduce estate and gift taxes, it would require more taxpayers to file returns, and estates would still need to keep records and file information returns.

23. For further information, see Joint Committee on Taxation, *Technical Explanation of H.R. 4154, The "Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009,"* JCX-57-09 (December 3, 2009), www.jct.gov/publications.html?func=startdown&id=3637; and *Estimated Revenue Effects of H.R. 4154, The "Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009,"* JCX-58-09 (December 3, 2009), www.jct.gov/publications.html?func=startdown&id=3638.

24. For a discussion of inheritance taxes, see Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax,* Hamilton Project Discussion Paper 2007-07 (Washington, D.C.: Brookings Institution, June 2007).

This brief was prepared by Pamela Greene. It and other CBO publications are available at the agency's Web site (www.cbo.gov).

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