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The Socio-Economics of the Federal Estate Tax: Why Do So Many People Hate (or Love) This Centenarian?

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I. INTRODUCTION

The federal estate tax will reach its 100th birthday on September 8, 2016.[1] Most centenarians are celebrated for making it 100 years. They are congratulated on morning news shows, and people send them nice cards. Sadly, the estate tax's birthday will likely go largely unnoticed. During most of its 100 years, the tax has had detractors calling for its immediate demise, even though the tax has historically affected only the estates of the wealthiest 1-8% of American families.[2] Today, fewer than

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1. Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756.
2. Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, *The Estate Tax: Ninety Years*

1% of families incur the tax.[3]

This Essay explores the reasons why taxpayers despise the estate tax when it is very unlikely that those taxpayers, or their families, will ever have to pay it. Furthermore, this Essay supports the retention of the estate tax. The remainder of this Essay discusses the socio-economic value of keeping the estate tax, enacted "to raise revenue during a time of war, enhance the progressivity of the tax system, and curb concentrations of wealth," all of which are just as important today as they were 100 years ago.[4]

II. THE ESTATE TAX: A VISCERAL REACTION BY SOME AND SUPPORT FROM OTHERS

The estate tax seems to evoke a visceral reaction from people. Politicians have branded it the "death tax" and have built political platforms around revoking it. In April of 2015, for example, Republican Senator John Thune and Congressman Bill Flores wrote:

> Thankfully, the federal policy that combines the two [referring to death and taxes] by taxing estates when a loved one passes away is close to extinction. Enacted nearly 100 years ago, the death tax places a significant burden on families that want to achieve the American dream—securing a better future for their children—by passing down a small business or a family farm from one generation to the next. The policy is also widely unpopular, with nearly 70% of Americans saying they want to see it repealed permanently. Repealing the death tax restores fairness for American families, and is a step toward a 21st century, pro-growth tax code.[5]

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and Counting, IRS 125, https://www.irs.gov/pub/irs-soi/ninetyestate.pdf (last visited Nov. 24, 2015).

3. Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System*, 1 (Mar. 16, 2015), https://www.jct.gov/publications.html?func=startdown&id=4744.

4. Paul L. Caron, *The One Hundredth Anniversary of the Federal Estate Tax: It's Time to Renew Our Vows*, 57 B.C. L. REV. __ (forthcoming 2016).

Professor Paul Caron of Pepperdine is well known for his great work on the TaxProf Blog. He beat me to the punch writing about the 100th birthday of the estate tax in his recently completed article: *The One Hundredth Anniversary of the Federal Estate Tax: It's Time to Renew Our Vows*. A brief overview of the forthcoming article can be found at: http://taxprof.typepad.com/taxprof_blog/2015/09/caron-the-one-hundredth-anniversary-of-the-federal-estate-tax-its-times-to-renew-our-vows.html.

In his article, Professor Caron does a much greater statistical analysis than was appropriate for this Essay. His conclusion, like mine, is that the estate tax is an important element in alleviating the wealth disparity in the United States.

5. John Thune & Bill Flores, *Time for the Estate Tax to Die*, USA TODAY (Apr. 16, 2015,

Average taxpayers see the estate tax as another way for the government to tax them after death when they feel they are already taxed so much during life. For example, I am fortunate to have the opportunity to teach a Tax Policy Seminar this semester at The University of Mississippi School of Law, and I asked the students on the first day to tell me what topics they thought they might be interested in. The second student I called on said she wanted to write a paper on why the estate tax should be repealed. I asked her why she felt that way, and she said that it just seemed wrong to tax people one last time on money and property when they had been paying taxes their whole lives. When I asked whether it would change her opinion if she knew that fewer than 1% of Americans pay the tax under the current system,[6] she responded "no," stating that as long as the tax exists, Congress could always expand it to include smaller estates. This seems to be one of the biggest fears about the estate tax, but its almost 100 years of existence has shown that repeal is not likely to happen. In that regard, and given that this is a Law and Socio-Economics Symposium and not a tax-focused one, it will be helpful to examine the types of estates actually affected by the current estate tax structure. For those readers who are not tax lawyers or professors, I recommend that you not operate heavy equipment or drive a vehicle when you read this next section.

A. The Current Estate Tax Limits

Each year, the Internal Revenue Service issues the tax rates for the coming year. The estate tax exemption for 2015—the amount an individual can leave to heirs without having to pay the federal estate tax—is $5.43 million per person.[7] A married couple has a combined exemption in 2015 of $10.86 million in taxable wealth that it can transmit to the next generation, without paying a penny of estate tax.[8] The top federal estate tax rate is 40%.[9]

The important thing to remember is that the tax is assessed only on the person's taxable estate.[10] For example, if an individual has a life

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6:56 AM), http://www.usatoday.com/story/opinion/2015/04/16/death-tax-abolish-thune-column/25816117/.

6. Joint Committee on Taxation, *supra* note 3, at 1.

7. William Ruane, *26 CFR 601.602: Tax Forms and Instructions*, IRS 19, http://www.irs.gov/pub/irs-drop/rp-14-61.pdf (last visited Nov. 24, 2015).

8. Chye-Ching Huang & Brandon Debot, *Ten Facts You Should Know About the Federal Estate Tax*, CENTER ON BUDGET AND POLICY PRIORITIES (Mar. 23, 2015), http://www.cbpp.org/research/ten-facts-you-should-know-about-the-federal-estate-tax#_ftn12.

9. 26 U.S.C.S. § 2001(c) (LEXIS through 2013 legislation).

10. 26 U.S.C.S. § 2001(a) (LEXIS through 2013 legislation). Generally, the taxable estate is

insurance policy payable to her family worth $1 million, even though her family would receive that $1 million in wealth upon the death of their loved one, the $1 million would not be part of the decedent's taxable estate if someone else owned the policy.[11] So, if the deceased's spouse owned the insurance policy on her life, and the proceeds of the insurance went directly to her children, there is no estate tax on that $1 million, and it would not be counted towards the $5.43 million exemption amount. Charitable contributions, likewise, do not count towards the $5.43 million.[12] Accordingly, with the help of a good estate planner, an individual's estate could transmit a much greater amount than $5.43 million without incurring the estate tax.

Furthermore, the law allows a married couple to transmit $10.86 million, tax free, by allowing portability of one spouse's exemption to the other.[13] Thus, the unused portion of the first spouse's $5.43 million exemption amount on their death can be used by the second spouse. I can say with absolute certainty that I am in no danger of ever having to pay the estate tax!

Additionally, the annual gift exclusion amount is $14,000.[14] This means that each person can make an annual gift of up to $14,000 that will not count as a taxable transmission of wealth. For example, a taxpayer with five grandchildren could give each grandchild $14,000 per year for a total distribution of $70,000 per year. Over a ten-year period, that means that the taxpayer could transmit $700,000 in gifts that would not be part of his taxable estate upon death.

Even more compelling is the fact that a taxpayer can make annual gifts of stock, or other appreciating assets, valued at $14,000 per year. Assuming a similar scenario as above, where a taxpayer gifts his five grandchildren $14,000 in stock per year over a ten year period for a total of $700,000 in stock gifts, if the stock appreciated 10% in ten years, the total value in the estate would have been $770,000. If the taxpayer had kept the stock, rather than gifting it, the amount included in his taxable

the gross estate with funeral expenses, administration expenses, claims against the estate, and unpaid mortgages or indebtedness deducted. 26 U.S.C.S. § 2053(a)(1)-(4) (LEXIS through 2002 legislation). The gross estate is defined by 26 U.S.C.S. § 2031(a) (LEXIS through 2014 legislation) as: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

11. 26 U.S.C.S. § 101(a)(1) (LEXIS through 2013 legislation).

12. 26 U.S.C.S. § 2055(a)(1)-(5) (LEXIS through 2007 legislation).

13. Huang & Debot, *supra* note 8; *See also* 26 U.S.C.S. § 2010(c)(4)(A)-(B) (LEXIS through 2013 legislation).

14. Ruane, *supra* note 7, at 19.

estate would be the value of the stock at the date of death. However, by making annual gifts, the taxpayer was able to avoid the estate tax on the gift amount, plus any appreciation that occurred prior to his death.

Since each person can take advantage of the annual gift exclusion, a married couple can give up to $28,000 per year per person.[15] Thus, if a taxpayer is married, he and his spouse can double the amount of wealth passing from their collective estate tax-free. As a result of these high exemption amounts, the Joint Committee on Taxation estimates that 99.8% of estates owe no estate tax at all: "Only the estates of the wealthiest 0.2% of Americans—roughly 2 out of every 1,000 people who die—owe any estate tax."[16]

Why then, do so many Americans support the repeal of the tax?

B. Surprising Haters of the Estate Tax

It is not surprising that wealthy Americans support estate tax repeal. What is surprising is the support for repeal from those in lower-income, minority communities.[17] The September/October 2002 issue of the *Poverty & Race Newsletter* chronicled this anomaly in "Race, Poverty and the Estate Tax" by Gary Bass, Ellen Taylor and Cate Paskoff.[18] The authors of the article pointed out that "[i]n April 2001, Black Entertainment Television (BET) founder and billionaire CEO Robert Johnson and 48 other African American business leaders placed a full-page ad supporting repeal of the estate tax in the Washington Post and the New York Times."[19] In that ad, "Johnson and his cosigners also claimed that the estate tax is particularly unfair to African Americans."[20]

The argument that the estate tax hurts the African American community more than others is simply a political manipulation, much like rebranding the estate tax as the "death tax." In a time when income inequality in our nation has reached alarming levels, the estate tax is designed to tax very large accumulations of wealth, allowing it to be redistributed to communities in need.[21] Furthermore, the tax produces

15. Joint Committee on Taxation, *supra* note 3, at 12 (Table 1).

16. Huang & Debot, *supra* note 8.

17. *See* Rebecca Safford, Note, *Information Asymmetry, Race, and the "Death Tax,"* 13 WASH. & LEE J. CIVIL RTS. & SOC. JUST. 117, 119 (2006).

18. Gary Bass, Ellen Taylor, & Cate Paskoff, *Race, Poverty, and the Estate Tax,* POVERTY & RACE RESEARCH ACTION COUNCIL, http://www.prrac.org/full_text.php?text_id=767&item_id=7799&newsletter_id=64&header=Race+%2F+Racism&kc=1 (last visited Nov. 24, 2015).

19. *Id.*

20. *Id.*

21. Safford, *supra* note 17, at 131.

revenue for the federal government, mitigating the need to raise money from other sources.

Calling the estate tax a "death tax" is intended to invoke the idea that every person dying owes the tax. This has been an effective device for garnering support for repeal of the tax from those who actually benefit from its imposition. The repeal of the estate tax would only increase wealth and income inequality in our nation.[22]

1. The Truth About Family Farms and Businesses

Those who wish to repeal the tax argue that it destroys family businesses and farms.[23] This argument, while effective in garnering support for the repeal of the estate tax, is not supported by the evidence. According to the Tax Policy Center, fewer than 25 estates owning small family businesses or small farms owed the estate tax in 2013.[24] The tax owed by those estates was less than 5% of their value, on average.[25] Furthermore, farms and businesses subjected to the tax can take advantage of a special valuation provision in the code, which allows a reduced value of a farm or business, provided that the heirs agree to continue its use.[26] This helps to alleviate concerns when a family farm might be the only major asset of an estate that would be assessed at fair market value based on surrounding property, resulting in the farm needing to be sold to pay the estate taxes.

For example, the Smiths, a family with few liquid assets, own a farm in an area that is experiencing an increase in major developers. The presence of these major developers has inflated the land values in the area. The Smiths have been offered several millions for the land, which the developer intends to use to build a strip mall in a growing population. The Smiths, however, have no intention of selling the farm, and the Smith children plan to continue farming it after their parents' deaths. Upon the death of Mr. and Mrs. Smith, if the farm is kept in the family and the Smith children agree to actively farm the land for another ten years,[27] the property will qualify for reduced valuation for estate tax purposes.

22. *Id.* at 129.

23. *See, e.g.*,Thune & Flores, *supra* note 5.

24. Tax Policy Center, *Table T13-0020* (Jan. 9, 2013), http://taxpolicycenter.org/numbers/Content/PDF/T13-0020.pdf. *See also* Huang & Debot, *supra* note 8.

25. *See* Huang & Debot, *supra* note 8.

26. *See generally* 26 U.S.C.S. § 2032A (LEXIS through 2004 legislation).

27. 26 U.S.C.S. § 2032A(d) (LEXIS through 2004 legislation).

Accordingly, despite rhetoric to the contrary, small family farmers are rarely, if ever, forced to sell their farms to pay estate taxes.[28] On the other hand, if a wealthy Hollywood star has an estate worth $100 million and invests in a vineyard in the Napa Valley, it is likely that the star's "family farm" would be subject to the estate tax. It would be unfair to include the star's farm in the calculation of family farms subject to the tax.

2. The Truth About "Double Taxation"

Many estate tax detractors have argued that the estate tax is a second tax on property that has already been subject to the income tax. The fact is that, according to a study by the Center on Budget and Policy Priorities, the majority of wealth subject to the estate tax is comprised of unrealized appreciation on capital assets (stocks, real estate, and other investments).[29] Because the Federal Income Tax does not assess a tax on inheritances[30] and because the potential gain on appreciated property is permanently forgiven under the current step-up in basis provisions of the Internal Revenue Code,[31] such appreciated property will escape all taxation if not subject to the estate tax. Without the estate tax, therefore, large accumulations of wealth could pass tax-free, further widening the disparity between the rich and the poor.

C. Self-Interested Lovers of the Estate Tax

Since I have questioned the good faith of powerful interests who want to repeal the estate tax, I thought it would only be fair to point out that there are lovers of the tax whose main interest is that they make

28. I taught a distance class for the Stetson College of Law's LL.M program in Elder Law a few years ago. The class dealt with retirement planning and included a section on the estate tax. The students in the class were all attorneys practicing all over the country. I once commented that, statistically, small farmers never really needed to worry about losing their farms to the estate tax. One of the students, a lawyer in Minnesota, pointed out that many of his clients were dairy farmers and that, despite those statistics, the estate tax was a major issue for them and their families.
See also David Cay Johnston, *Talk of Lost Farms Reflects Muddle of Estate Tax Debate*, THE NEW YORK TIMES (Apr. 8, 2001), http://www.nytimes.com/2001/04/08/us/talk-of-lost-farms-reflects-muddle-of-estate-tax-debate.html?pagewanted=all (stating that even the American Farm Bureau Federation was unable to provide an example of a small farm being lost due to the estate tax).

29. Chuck Marr & Chye-Ching Huang, *President's Capital Gains Tax Proposals Would Make Tax Code More Efficient and Fair*, CENTER ON BUDGET AND POLICY PRIORITIES (Jan. 18, 2015), http://www.cbpp.org/cms?fa=view&id=5260.

30. 26 U.S.C.S. §102 (LEXIS current through Pub. L. 114-93, approved Nov. 25, 2015); *See also* Bass et al., *supra* note 18.

31. *See generally* 26 U.S.C.S. § 1014 (LEXIS through 2015 legislation).

money from its existence. These self-interested supporters include tax and estate planners (like me), banks, and insurance companies. There is, in fact, an entire industry built around helping wealthy individuals avoid the estate tax. For example, I once consulted for a major national bank, which held a substantial number of Crummey Trusts. Crummey Trusts were named for D. Clifford Crummey, who created the concept.[32] In 1968, the United States Court of Appeals for the Ninth Circuit found that the Crummey Trust device did not violate the tax code,[33] and the trusts have been called Crummey Trusts ever since.

A Crummey Trust allows an individual to take advantage of the $14,000 annual gift exclusion even though the gift is transferred into trust.[34] The annual gift exclusion is available only for present interest gifts,[35] and gifts to a trust typically do not qualify.[36] A Crummey Trust achieves the desired effect of a present interest gift by offering the recipient a window of time to take immediate control of the gift equal to the amount of the current year's transfer to the trust.[37] If the recipient fails to do so during that window, the gift becomes part of the trust and is subject to the trust's distribution conditions.[38] However, since the recipient had the opportunity to receive the funds outside of the trust, the gift is deemed to be a current interest, qualifying it for the annual exclusion.

Banks holding Crummey Trusts send a letter to the beneficiary each year stating that they have a period of time, generally 30 days, to decide to withdraw the gift from the trust. The letters often state that should the beneficiary decide to take the money, no further contributions will be made in future years. In other words, the gift qualifies for the annual gift exclusion because the beneficiary is given the power to withdraw the funds. This is true even though the letter often says essentially, "You better not withdraw the money, or else I will not give you any more."

The bank I worked for charged a fee that was a percentage of the funds held in trust, plus an administrative fee for sending the Crummey

32. Crummey v. Comm'r of Internal Revenue, 397 F.2d 82 (9th Cir. 1968) (see caption where petitioner's name is D. Clifford Crummey); *see also* HOWARD M. ZARITSKY, *¶ 4.08 Crummey Trusts, in* TAX PLANNING FOR FAMILY WEALTH TRANSFERS DURING LIFE: ANALYSIS WITH FORMS (Thomson Reuters, current through 2015) (claiming the trust's name comes from this case).

33. *Crummey*, 397 F.2d at 88.

34. ZARITSKY, *supra* note 32.

35. 26 U.S.C.S. § 2503(b) (LEXIS through 1997 legislation).

36. *See Crummey*, 397 F.2d at 84-86 (discussing the different tests that determine whether gifts to a trust are present or future interests).

37. *Id.* at 88.

38. ZARITSKY, *supra* note 32.

letters. If the estate tax went away, there would be no more need for the Crummey Trust, which exists solely as a device to avoid that tax. The Crummey Trust is just the tip of the iceberg of products and devices created and sold with no other purpose than to avoid the estate tax. It is not surprising, therefore, that those benefitting financially from its existence are its strongest supporters.

D. The Best Socio-Economic Reason for Keeping the Estate Tax

In addition to the self-motivated reasons for keeping the estate tax, there are good arguments in favor of the tax that serve no interest other than what is fair and effective.

The tax is projected by the Congressional Budget Office to produce $246 billion in revenue from 2016-2025.[39] All of this revenue would come from the wealthiest estates. Repeal of the tax would require replacement of that revenue through other taxes or budget cuts. Cuts to programs often have a disparately negative affect on the poor, who rely on those programs to a much greater extent than the wealthy.

Furthermore, because the estate tax is designed to tax only the highest value estates, it is a very progressive tax, paid by those who have benefited most from living in this country.[40] Many wealthy people understand and appreciate that their fortunes were built because of the opportunities they, and their families, had living in the United States.[41] In fact, when I suggested estate tax planning devices to a wealthy client, he stated that his children would have plenty, and that he was privileged enough to be in a position to owe the estate tax. He was proud to give something back to his country.

III. CONCLUSION

Instead of reviling the estate tax and calling for its repeal, Americans should be asking the Today Show to announce its 100th birthday. It is a tax designed to reduce wealth inequality and raise revenue. It is the most progressive tax in the federal tax system, and we should be celebrating it, not seeking to kill it.

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39. Amber Marcellino et al., *Updated Budget Projections: 2015 to 2025*, CONGRESSIONAL BUDGET OFFICE (Mar. 9, 2015), https://www.cbo.gov/publication/49973. *See also* Huang & Depot, *supra* note 8.

40. Jeffrey Rohaly & Katherine Lim, *Wealth Transfer Taxes: Who Pays the Estate Tax?*, TAX POLICY CENTER, http://www.taxpolicycenter.org/briefing-book/key-elements/estate/who.cfm (last updated June 13, 2011).

41. *See generally* WILLIAM H. GATES, SR. & CHUCK COLLINS, WEALTH AND OUR COMMONWEALTH: WHY AMERICA SHOULD TAX ACCUMULATED FORTUNES (2002).