Should We or Should We Not

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The debate on whether we should or should not place restrictions on inheritances has been ongoing from early civilizations to the present, and will soon reach a climax in the U.S. Senate. Yet, to the best of my knowledge, nobody is currently casting this debate in terms of restrictions on inheritances. But in effect that is what estate taxes are, and so we should take a closer look at what it means to place restrictions on inheritances.

Restrictions on inheritances can range from outright forfeiture of assets on the death of the owner, to limitations on assets, to taxation programs that impose heavy burdens on inheritances. As early as 700 B.C. there appears to have been a 10% tax on the transfer of property at death in Egypt. In the first century A.D. Emperor Caesar Augustus imposed a tax on successions and legacies to all but close relatives. In feudal Europe the sovereign owned all of the land and individuals had merely the right of use during their lifetimes. On death the right of use could be passed on only upon a payment to the sovereign. And in England, the Rule Against Perpetuities [which we still have with us to this day] was developed more than 700 years ago through the Common Law to place restrictions on how long an individual could restrict the ownership of land, in effect, to his descendants.

Philosophically the debate on what the rights of inheritance should be has continued over the centuries. The English philosopher John Locke in the 17th Century argued that citizens had the God given right to own as much property as they could employ their labor upon, but not to own excessive amounts at the expense of the rest of

society. Further he argued that the right to bequeath accumulated property to children was divinely ensured. But a century later the great English jurist William Blackstone, in his Commentaries on the Law of England, wrote that possession of property ended with the death of its owner and, thus, there was no natural right to bequeath property. He concluded that the government had the right to regulate the transfer of property from the deceased owner to his successors.

In the early years of our republic Supreme Court Chief Justice John Marshall, among others, defended an individual's natural right to own property but also expressed his belief that inheritance was a civil, not natural, right and affirmed the right of the individual states to regulate it. Justice Roger Taney in 1850 in *Mager* v. *Grima* stated "If a State may deny the privilege [of inheritance] altogether," it may, when it grants the privilege, attach any conditions which it deems appropriate. During and following the Industrial Revolution, writer after writer called for restrictions on inheritances ranging from outright prohibition to confiscatory inheritance taxes. One of the leading proponents of a substantial inheritance tax was the industrialist Andrew Carnegie. In his essay, "The Gospel of Wealth" he advised that "the thoughtful man" would rather leave his children a curse than the "almighty dollar". According to Carnegie, the parent who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts the son to lead a less useful and less worthy life than he otherwise would. An advocate against the leveling of wealth distribution, he strongly believed that individuals should be encouraged to amass great wealth and spend it, not on opulent living, but on important, carefully planned works for the public good. Carnegie also advocated a confiscatory inheritance tax, which, he suggested, would force the

wealthy to be more attentive to the needs of the state – to use their money for noble causes during their lifetimes.

Since the beginning of our nation restrictions on inheritances have taken the form of taxes on assets passing at death. Much of this taxation came at the level of the individual states but periodically there was also tax at the federal level. These federal taxes were generally quite low and temporary, used primarily to fund extraordinary financial demands such as a war. In 1916, with World War I raging in Europe and threatening to involve the United States, Congress was forced to find additional sources of revenue and in May 1916, Representative Cordell Hull of Tennessee introduced a proposal for a Federal estate tax in response to what he called "the irrepressible conflict" between the rich and the poor. He proposed an excise tax on estates prior to the transfer of assets to the beneficiaries, rather than an inheritance tax. He stated that this would form "a well-balanced system of inheritance taxation between the Federal government and the various States" and could be "readily administered with less conflict than a tax levied upon the shares." [Thus was his boundless optimism; if he could only see into what a hydra-headed monster his creation has grown.]

The estate tax enacted in 1916 was fairly generous in its exemption and its rates topped out at 10% on amounts exceeding $5,000,000 [today's equivalent more than $60,000,000 if adjusted for inflation and over $1,000,000,000 if adjusted for the measure of relative wealth.] Over the years Congress adjusted the rates from time to time, reaching 77% on very large estates and retreating to 55% approximately 25 years ago but on a very much lower threshold. Currently the rate is 46% on all of the net estate exceeding the $2,000,000 exemption.

After 90 years experience with the estate tax some conclusions can be drawn. First: The estate tax system is incredibly complex and very difficult to administer. Second: There is a high likelihood that the estate tax creates negative revenue because its total revenue in 2004 was only approximately $21.5 billion which was most likely more than fully offset by loss of income tax revenue and the costs of administration. Third: As to very high net worth individuals the estate tax is, to some considerable degree, a voluntary tax because through careful, early planning, legitimate tax avoidance strategies and charitable gifts, the impact of estate taxes can be very significantly reduced.

In 2004, 62,718 Federal Estate Tax Returns were filed. Most of these relate to deaths in 2003 [when the exemption was $1,000,000] as the return is due 9 months after date of death and often is not filed until 15 months after date of death. Of the returns filed, 30,276 [or approximately 48%] involved actually taxable estates, and of these taxable estates 21,152 [or approximately 70%] involved gross estates of less than $2,500,000. Of the $21.5 billion in revenue raised, $13.187 billion, or more than 61%, came from the approximately 3,500 estates having gross assets of more than $5,000,000. It is estimated that this year [2006] only approximately 6,350 estates will actually pay any estate tax, or approximately 27/100th of 1 percent of the persons dying in this country during the year.

As to the complexity of the estate tax I can be a very strong witness. For more than fifty years I have spent most of my professional time in the field of estate planning. The body of law with which I work does not only involve the actual Internal Revenue Code [two volumes consisting of 4992 pages] but also the law of trusts and estates, property law, corporate and partnership law, and much else from the body of general civil

law. And then there are the regulations issued to interpret and effectuate the Internal Revenue Code, the Revenue Rulings issued to interpret the Code and Regulations, the Technical Advice Memoranda, and the vast body of Private Letter Rulings which, although not of precedential value, do provide a glimmer of insight into IRS thinking.

I am a member of the American College of Trust and Estates Counsel (ACTEC) and the vigorous discussions which go on in the publications of ACTEC, the California Trust and Estates Quarterly and many others, and in the on-line discussion forums which ACTEC provides its members are illustrative of the complexities of the estate tax.

The economic effects of the estate tax can be ceaselessly debated. A study by Stanford University Economist B. Douglas Bernheim concluded "Although it is very difficult to estimate these effects precisely, in recent years true estate tax revenues may well have been negative." In any event, one fact is very clear, the revenue from the estate tax in 2003 was approximately 1.1% of the total federal tax revenue, a very small portion indeed. One thing we do not know is how much the government spends to collect this limited revenue and how much taxpayers pay to advisors and to create structures to avoid paying the tax.

The estate tax has been called a "voluntary tax", and, while the persons writing out large checks to the U.S.Treasury would disagree vehemently, to some considerable degree that is an accurate characterization as to individuals of great wealth. Persons of moderate wealth [i.e. persons with a net worth of less than $5,000,000 or a married couple with a net worth of $10,000,000] feel limited in the way they can avoid the estate tax through lifetime transfers, charitable gifts and many of the other programs. They feel that they must retain their wealth to assure that they will be comfortable in their later

years and they are hesitant to give up control over their somewhat limited wealth because of the uncertainties facing them. And after their death they wish to provide for their children, grandchildren and other heirs. On the other hand, persons of high wealth can afford to dispose of a large part of their wealth during their lifetime and can afford to hire people such as me to show them how they can do so in tax efficient ways. Thus they transfer significant portions of their wealth to their children and grandchildren or other heirs during their lifetime and reduce their estates on death through charitable gifts so that they pay relatively little, if any, estate taxes.

If the estate tax is so ineffective, overly complex and undesirable, why haven't we repealed it already? There are many in Congress who would and who believe that what little revenue may be lost by a repeal will be more than offset by Section 1022 added to the Internal Revenue Code to become effective for persons dying after December 31, 2009, when the repeal of the estate tax is to become effective. This section, which has received very little comment, very significantly reduces the step-up in adjusted basis for income tax purposes that now occurs at death and therefore should significantly increase income tax collections through larger taxable capital gains and reduced depreciation deductions.

On the other hand there are those, including me, who believe that the estate tax should be retained because, despite all of its problems, it is an effective restriction on inheritances. In a 1935 message to Congress President Franklin Roosevelt stated:

> "The transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and and sentiments of the American people. The desire to provide security

> for oneself and one's family is natural and wholesome, but it is adequately served by a reasonable inheritance. Great accumulations of wealth cannot be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others. Such inherited economic power is inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our Government. Creative enterprise is not stimulated by vast inheritance. They bless neither those who bequeath nor those who receive."

An article in the April 5, 2006, Wall Street Journal reported that in 2004 the top 1% of American families held 33.4% of the nation's net worth, up from 32.7% in 2001. Such concentration of wealth would seem inconsistent with the sentiments expressed by President Roosevelt and, as noted earlier, similar sentiments expressed by Andrew Carnegie. More recently William Gates, Sr. has been a very strong advocate in favor of the retention of the estate tax; and other very wealthy persons, such as Warren Buffett, also support the retention of the estate tax as an effective device – not to create revenue for the government, but as limiting the intergenerational transmission of vast wealth. Besides these lofty and socially highly desirable goals the estate tax also generates significant charitable bequests which may be difficult to reproduce by other means.

But if we retain the estate tax we should assure that it impacts only the wealthiest of our people. We should raise the exemption to $5,000,000 per person [$10,000,000 per

married couple] and index the exemption to prevent it being eroded by inflation. We should set the rate of tax at either the 45% rate which under current law goes into effect in 2007, or return to the prior rate of 50%. The result would be that the estate tax would impact only a very tiny portion of our population who, however, control a significant portion of our country's wealth. This small number of very wealthy persons has the means of protecting themselves and their families from the impact of the estate tax and yet, at the same time, society would be benefited. We should retain restrictions on inheritances. It is a win-win situation for all.

Author's Note: In preparing this paper I borrowed liberally from a number of articles and papers, including, but not limited to, a major article by Professor Edward J. McCaffery in the November 1994, Yale Law Journal, a paper by Barry W. Johnson and Martha Britton Eller of the Internal Revenue Service, a paper by Gary Robbins of the Heritage Foundation, a Congressional Joint Economic Committee Study of June 2003, and various Treasury Department studies and statistics.