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Tax Revision Studies, 1937 - Volume V

Tax Revision Studies, 1937: Volume V

Estate and Gift Taxes

VOLUME V

Tax Revision Studies, 1937

ESTATE AND GIFT TAXES

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Summary and
Recommendations

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - ESTATE AND GIFT TAXES

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Part I: Structural Revision of the Federal Estate Tax

The accompanying memorandum examines in some detail those features of the Federal estate tax which may be deemed worthy of revision in the interest of maximum equity and greater productivity. The more significant of the conclusions are as follows:

1. The specific exemption of $40,000 may well be reduced to $20,000. While no particular case can be developed for precisely that figure as opposed to one slightly higher or lower, evidence is abundant that the present figure is too high. A reduction of the specific exemption to $20,000 would make the estate tax more effective on smaller estates and thus increase revenue. It would, in addition, bring Federal exemption into better conformity with the exemptions provided by State laws, thus eliminating one potent field of interstate variation, yet leaving it at a level above that generally recognized as adequate to provide a tax-free subsistence fund to the decedent's dependents.

2. The suggestion that the specific exemption provided by the estate tax recognize the number of beneficiaries and their relationship to the decedent, is not considered desirable for immediate adoption. That either an inheritance tax or an estate tax which recognizes the number of beneficiaries and their relationship to the decedent would make for greater equity, can be readily conceded. However, the accompanying administrative difficulties are believed to outweigh the net addition to equity which could thus be obtained.

3. With respect to the three types of specific exemptions (constant, conditional, and vanishing) now in use in various countries, the vanishing type of exemption is singled out as the one most desirable. The constant exemption ignores the very argument to which it presumably owes its existence, namely, the discrimination in favor of the relatively small estates by granting the privilege of bequeathing a tax-free fund for the maintenance of the decedent's dependents. On the contrary, it bestows a tax advantage which grows larger rather than smaller with the increase in the size of the estate. The conditional exemption, on the other hand, is too arbitrary for it fails to provide a gradual transition from non-taxability to taxability. The vanishing exemption is considered most desirable. It recognizes the necessity of granting tax-free bequests for the support of dependents in the case of small estates, and does not, like the constant exemption, perpetuate the same advantage in the case of large estates, and hence does not impair the productivity of the tax.

4. In connection with the manner of taking exemptions, it is observed that if the vanishing exemption is adopted, the necessity for specifying that the exemption be taken from the lowest bracket will be eliminated. In the event, however, that the constant exemption is retained, it will be desirable either to specify that the exemption be deducted from the lowest bracket or to replace the present exemption - expressed as a deduction from the otherwise taxable base - by an exemption expressed in terms of a constant tax credit. While it is recognized that an exemption in terms of tax credit is psychologically undesirable because it seems smaller to the taxpayer than a corresponding exemption deductible from a tax base, considerations in the interests of equity and productivity are judged to be more significant. The elimination of the tax advantage inuring to large as opposed to small estates from a constant exemption deductible from the top bracket and the consequent destructive effects upon estate tax revenues, are vital considerations.

5. An examination of the treatment of insurance leads to the conclusion that the present exclusion from the taxable base of $40,000 of insurance payable to named beneficiaries should be eliminated. While the practice of providing a liquid fund for one's family is socially desirable, no valid reason can be presented why that form of asset should be singled out for especially favored treatment. Such exclusion of insurance from the taxable base serves to double the size of the specific exemption and thus affords a greater tax advantage to the larger as opposed to the smaller estates, and in addition, of course, results in an impairment of the productivity of the tax.

6. The proposal that insurance for the payment of estate taxes be rendered tax free is not recommended. The contention that estate taxes may subject an estate to forced liquidation is recognized; the Government's obligation to prevent such liquidation, however, is not conceded. The facts that the exclusion of such insurance would defeat progression, impair revenues and deprive the Government of one of its relatively few opportunities to employ the principle of ability to pay as a criterion of taxation, are sufficient justification for including all insurance in the taxable estate.

7. The present treatment of property previously taxed (excluding such property from taxation when the two successive deaths occur within five years) strives for the elimination of multiple taxation, one of the existing inequities in the estate tax. However, the present provision limiting the period of grace to precisely five years is conducive to inequity and should be replaced by a graduated scale ranging from a complete exemption of property previously taxed in cases where the two deaths occurred within one year to exemptions of 20 percent in those cases where the interval between the two deaths is more than four but not more than five years.

8. With respect to the present policy of granting full exemption to charitable bequests, stress is laid upon the inequity resulting from the fact that the tax reduction inuring to estates of different size from a given bequest is widely different, ranging from zero to as much as two-thirds of the entire bequest. While the entire elimination of this form of exemption is deemed undesirable, it is proposed that the present full exemption of charitable bequests be eliminated and in its place a tax credit substituted, such tax credit to bear that ratio to the total tax liability which 50 percent of the charitable bequest bears to the net estate. This procedure would not unduly discourage charitable bequests and would, in a moderate manner, equalize the tax benefits accruing from the exemption to estates of various size, increasing at the same time tax revenue.

9. It is suggested that the present bracketed rate structure be replaced by one on a totality basis. The contentions that the Federal Government has never employed a totality rate schedule and that the bracket rate structure permits a smoother degree of progression are significant, to be sure. They are secondary, however, in light of the considerations that a totality rate structure allows for an increase in the effective rate of taxation without any apparent increase in the statutory rate schedule and reflects the weight of the tax burden more correctly. Top bracket rates, which under the bracket system

appear confiscatory may, when considered in relation to the tax burden on the total estate, be moderate and can be expressed as such in a totality rate schedule. It is considered good public policy to recognize the general public's lack of understanding of bracket rates through the use of totality rates with adequate equalizing provisions at the break-over points.

10. With reference to the level of estate tax rates, it is suggested that the 1935 rate schedule be replaced with a new rate schedule on the totality basis ranging from 1 percent on net estates above a $20,000 vanishing exemption to 75 percent on net estates of $100,000,000 and over. It is readily defended on the ground that an upward revision of the rate structure, with a view to enhancing the effectiveness of the tax on small and medium size estates, is imperative in the interests of productivity and essential in the interests of equity. The rate structure proposed would produce a substantial increase in revenue with a minimum of administrative difficulty and public opposition. It would add a justifiable addition to the tax burden falling upon middle size estates without interfering with the desire of the individual to provide his heirs with the necessities of subsistence.

11. It has been urged that the tax burden imposed on transfers of property at death recognize the prior wealth of the beneficiary. Although such procedure would be theoretically desirable in the interest of equity, the innovation involves a refinement of a finer order than that commensurate with other features of the present tax system and threatens to involve legal and administrative difficulties, some arising in connection with the determination of prior wealth and others from the necessity of taking due cognizance of the ultimate beneficiaries. It is concluded that present efforts at revision could more profitably be directed in other channels.

12. It is suggested that the practice of affording the executor of an estate an option between valuation for tax purposes as of date of death or one year hence be eliminated. Since the estate tax is a tax on transfer of property at death, no logical justification grounded in economic reasoning can be found for the recognition of property values as of any subsequent date. While in periods of rapidly declining values it may be deemed expedient to temporarily alleviate injustice by shifting the date of valuation one year hence, the practice on the whole is undesirable. At all events, now that the downward trend of security values has reversed itself, the plea of expediency has lost its force and the option can produce only administrative difficulty.

13. With respect to community property, it is urged that the Federal Government take a definite position. It is recognized that in the interest of greater productivity it may be desirable to sterilize the community property principle, in which case a utilization of the "right of management and control" concept may prove fruitful.

14. At present when property which has enhanced in value is transferred by inheritance, the capital gains escape income taxation. The constitutional concept of income precludes the taxing of such capital gains under the income tax. To eliminate this inequity, it is proposed to impose a compensatory tax in the form of an additional estate tax on capital gains that have accrued to real estate, stocks and bonds, in the following manner: A tentative tax is to be computed at the regular estate tax rates on the entire amount of the gross estate without the allowance of any deductions whatsoever. Against this tentative tax there is to be permitted a tax credit, computed at the regular estate tax rates on an amount which will be the sum of the adjusted bases for real estate, stocks, and bonds, and the current market of all other gross estate assets. The difference between the tentative tax and the tax credit thus determined will be the capital gains transfer tax or the "initial estate tax" liability which is to be allowed as a deduction for the purpose of computing the basic estate tax.

15. In view of the corollary relationship of the estate and the gift tax it follows that the adoption of any of the above proposals with respect to the estate tax should be accompanied by parallel revisions of the gift tax.

Part II: Coordination of the Federal Estate and the Federal Gift Tax

In this section there is examined the lack of coordination between the existing Federal estate and the Federal gift tax and there is outlined the procedure whereby the two taxes can properly be integrated. The more significant of the conclusions are as follows:

1. The gift and the estate taxes are complementary constituents of the tax system. As such, they should be properly coordinated. Coordination, however, does not require that the tax burdens imposed upon two complementary tax bases be identical. All that it requires is that the differential in the tax burdens imposed upon either of the two complementary tax bases express the preferential treatment the Government desires to accord the one as compared with the other and that the extent of that preferential treatment available to different individuals bear a rational relationship to the amount of their property transfers.

2. The Federal estate and gift taxes are in pressing need of coordination because: (a) The gift tax has greatly reduced the effectiveness of the estate tax by affording substantial opportunity for reducing tax liability incident to property transfers; (b) the opportunity for reducing tax liability in this manner is not uniformly available to all individuals but accelerates more than in proportion to their transferable wealth; (c) the reduction in the tax liability incident to property transfers available through inter vivos

gifts is greater than that required by public policy; and (d) the distribution of estates through inter vivos gifts encouraged by the preferential treatment accorded it for tax purposes and the consequent reduction of property transfers subject to the estate tax has reduced the amount of inheritance and estate tax revenue available to the States.

3. Partly as a result of the lack of coordination between the estate tax and the gift tax, transfer taxes occupy a relatively minor role in the American revenue structure, notwithstanding the fact that they comprise one of the two main constituents of the tax structure capable of the application of the ability to pay principle.

4. The advantages accruing from the use of inter vivos gifts are no doubt greater than those contemplated by Congress. The legislature did desire to encourage the distribution of estates during the lifetime of their owners, but not to the extent and in the disproportionate manner actually provided by the present law.

5. A coordination of the estate and the gift tax can be achieved by viewing inter vivos gifts as installments of property transfers and viewing the taxes on such gifts as payments on account of transfer taxes. The two taxes are mutually interdependent. They derive from identical origins and fall upon interchangeable transactions and, therefore, barring legal consideration to the contrary, should be combined.

6. Such coordination can be achieved by the following administratively relatively simple device: (a) Retain the 25 percent differential inherent in the existing gift tax and the estate tax rate structure; (b) change the existing net gift tax base to a gross base, comparable to that used in the taxation of estates; (c) consider the taxes paid on inter vivos gifts as installment payments on account of final estate taxes; (d) include in the taxable base at the time of death not only the residual estate remaining after gifts, but also the value of property previously reported for gift tax purposes; (e) compute a tentative estate tax liability upon all of the property disposed of by the decedent both during his lifetime and at his death; (f) credit against this tentative tax liability (1) gift taxes paid and (2) such a premium upon such gift taxes as suffices to express the tax advantage it is desired to afford inter vivos gifts.

7. The device herein proposed for the coordination of the Federal estate and the gift tax may possibly be subject to the following objections: (a) That it is impractical for it implies a stationary estate tax and gift tax rate structure and that in the event of future rate changes, tax liability would have to be recalculated retroactively to the first gift; and (b) that the accumulation of gifts for ultimate inclusion in the residual estate for gift tax purposes may be unlawful because title to the property distributed through inter vivos gifts is not held by the decedent at the time of his death. The first of these criticisms is considered to have little force; the appraisal of the second must await judicial review.

8. The proposed coordinating device has numerous advantages: (a) It would present no additional administrative problems for a record of inter vivos gifts is already being maintained currently for gift tax purposes; (b) it will increase revenue from the estate and the gift tax by increasing the effective transfer tax rate, without an alteration of the existing rate structure; (c) the Federal Government will be enabled to accord precisely that encouragement to inter vivos gifts which is required by public policy, and which at the same time will be uniformly available to all individuals, and not vary more than in proportion to their wealth; (d) the proposed treatment of property transfers will be a logical corollary of the cumulative tax base and cumulative tax credit concept already employed in connection with gift taxes; (e) it will make the bases of the estate tax and gift tax identical; (f) it will eliminate the double use of exemptions and the double use of lower brackets in connection with property transfer taxes; (g) it will provide the machinery for eliminating the inequitable effect of gift taxes upon the estate and inheritance tax revenues of State governments without any reduction of Federal revenues; (h) it will forestall the present movement toward independent State gift taxes and thus will stifle a new and potent conflict which is arising between the Federal Government and the States.

9. The present practice of exempting $5,000 gifts made in any one year to any number of individuals is considered excessive. Its replacement by a maximum donor's annual exemption of $5,000, irrespective of the number of donees, is recommended.

Part III: Coordination of Federal and State Taxes on Property Transfers

In this section there is examined the lack of coordination between the existing Federal and State taxes on property transfers and there is outlined a procedure whereby the transfer taxes of these two jurisdictions can be properly coordinated. The more significant of the conclusions are as follows:

1. The taxation of identical tax bases by two separate and sovereign jurisdictions requires coordinate action. The absence of coordination is certain to produce undesirable economic and social consequences. That coordination is lacking in the field of property transfer taxation and has of necessity produced undesirable consequences requires no demonstration.

2. While the problem of eliminating conflicting Federal and State taxation is of more vital significance to the States than to the Federal Government, the latter cannot continue ignoring the problem, partly because the States themselves are unable to solve it but primarily because the Federal Government itself is earnestly interested in sound fiscal practice by all governmental units.

3. The adoption of the crediting device in 1924 and its expansion in 1926 signified a willingness on the part of the Federal Government to share its transfer tax revenue with the States, first in the ratio of 3 to 1 and later in the ratio of 1 to 4. Immediately following 1924 and 1926 the States attempted to conform their transfer tax systems to this Federally dictated pattern by imposing tax burdens approximately equal to 80 percent of the 1926 Federal estate tax rate schedule; the Federal Government, however, gradually annihilated the effectiveness of its own program by reducing the relative quantitative importance of the State tax credit.

4. The 1932, 1934 and 1935 Federal Revenue revisions served to dwarf the role of the States in the transfer tax field. In their efforts to counteract Federal action, the States resorted to the enactment of additional death taxes and the imposition of gift taxes, thereby adding to Federal-State conflict.

5. The failure of the Federal Government to attempt an elimination of the conflict before now is probably due to the fact that the extent of existing conflict is generally underestimated and the remedial effects of the crediting device are exaggerated.

6. The extent to which the crediting provision has failed to eliminate interstate variation in property transfer taxation is remarkable. Not only does the need for dual administration and dual taxpayers' compliance remain but in many respects there is probably as wide a diversity in State death duties as prior to the adoption of the crediting provision of 1924. Information obtained through a questionnaire submitted by the Division of Research and Statistics of the Treasury Department to the death tax administrators of the several States and an analysis of the several death tax laws reveals that variations with respect to (a) the type of taxes employed, (b) definition of gross estate, (c) valuation practice, (d) definition of net estate, (e) treatment of insurance, (f) size of specific exemption, (g) manner of taking the exemption, (h) rate structures, and (i) the tax burden imposed, collectively produce a heterogeneous State-by-State property transfer tax pattern.

7. As a result of these variations (a) the ratio of credits claimed for taxes paid to States against Federal estate tax liability to State inheritance and estate tax collections ranges from 0 to 92 percent; (b) the differential estate taxes passed by the various States in order to take advantage of the available Federal credit are limited in effectiveness because the taxes imposed by the States are in many cases in excess of the maximum Federal credit; and (c) the significance of the death taxes in the revenue structures of the various States ranges from 0 in one State to more than a fifth in another. In other words, interstate variations permeate all aspects of State death taxes leading to the unmistakable conclusion that the crediting provision in itself is not adequate for the elimination of interstate competition and Federal-State conflict in death taxation.

8. The proposals which have been advanced for the elimination of conflict in Federal-State taxation of property transfers fall into three general categories: (a) Separation of revenue sources, (b) modification of the crediting device and (c) Federal-State integration.

9. The relative merits of these proposals must be appraised in light of the following objectives: (a) That any change in Federal-State relations does not unduly reduce Federal revenues, (b) that it increases substantially or at least moderately State revenues, (c) that it not be coercive upon the States, (d) that it be of a type which can go into effect gradually and not be conditional upon the enactment of specific kind of legislation in all of the States, (e) that it disturb as little as possible the death tax legislation now on the books of the States, inspired in part by the Federal Government's crediting device, and (f) that it minimize as far as possible the need for dual administration and dual tax compliance.

10. In the light of the above enumerated criteria, none of the three general categories of proposals hitherto advanced for the elimination of Federal-State conflict in death taxation is acceptable.

11. Existing Federal-State conflict in the field of death taxation can be eliminated by combination of two previously proposed methods. Specifically, it is recommended that the Federal Government provide the States with an option as follows: Those States which continue to levy their own death taxes may continue to take advantage of the 80 percent credit allowed against Federal estate taxes under the 1926 Act. Those States, on the other hand, which will abolish their own death taxes will receive in lieu of this State tax credit a fixed proportion of Federal estate and gift tax collections in their respective States.

12. This option arrangement has numerous advantages: (a) It provides a gradual transition from the existing situation and can, therefore, go into operation immediately and need not be postponed until such a time as appropriate legislative action has been taken by all of the States; (b) the arrangement is in no sense coercive upon the States but will obviously be attractive to them; (c) it will eliminate the necessity for separate State administration and dual estate tax compliance; (d) it will not necessitate new State legislation either in the estate or gift taxation, but rather, will produce the gradual repeal of existing legislation; (e) it will contribute to the solution of the problem of State jurisdiction with respect to death taxation; (f) it will provide for a gradual simplification of the Federal estate tax structure itself by gradually eliminating the use of the 1926 rate schedule; and finally, (g) it will enhance general acceptability of the structural revisions of the estate and gift taxes themselves by providing for the gradual elimination of State taxes upon the same tax bases.

13. From point of view of the Federal Government, the disadvantage of the proposal lies in the fact that it will serve to transfer some revenue to the States which otherwise could be retained for Federal purposes. This, however, is no real disadvantage because the proposed structural revisions of the estate and gift tax will more than provide sufficient revenue to bridge the difference between the amounts which would have to be diverted to the States and the amount of the credits now allowed for taxes paid to States.

14. The proposed device will be acceptable to the States because it will obviate the necessity for dual administration and dual taxpayers' compliance at the same time that it eliminates interstate competition and increases State transfer tax revenues.

15. Finally, too much emphasis cannot be placed upon the necessity of making a start in the direction of Federal-State tax coordination. Death taxes offer a good starting point, particularly because of their wide use as sources of State revenue but primarily because they present an opportunity for adding substantially to State revenues without corresponding loss of Federal revenue. The resulting good will is certain to contribute immeasurably to the solution of Federal-State conflict in other fields of taxation.

Federal
Estate Tax

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - ESTATE AND GIFT TAXES

Part I: Structural Revision of the Federal Estate Tax

A. Introduction

A study of the Federal estate tax and its companion, the gift tax, has been made, as a result of which there are presented herein several suggestions for improvement. Some are desirable in the interest of equity and others are significant from the point of view of greater productivity. The recommended revisions fall into three categories: (a) structural revision of the Federal estate tax; (b) coordination of the Federal estate tax and the Federal gift tax from the point of view of enhancing their separate and collective effectiveness; and (c) coordination of the Federal estate and gift taxes with State death and gift taxes, with a view to eliminating tax conflict. These three categories of revisions, though interrelated, will be discussed separately in the order indicated.

I. Legislative history

The estate tax has been a continous element in the Federal tax system since September 9, 1916, when the first Federal estate tax (Title II, Revenue Act of 1916) went into operation under pressure of war finance. Prior to 1916 death taxes appeared only intermittently in the Federal tax system, usually in the form of inheritance rather than estate taxes. Significantly, some of these earlier death taxes also owed their existence to the exigencies of wars.

Since its adoption in 1916, the rates of the Federal estate tax have been changed eight times (Table I). In the 1926 Act the rates were reduced, leaving a rate schedule ranging from 1 percent on the first $50,000 to 20 percent on the part of the net estate in excess of $10,000,000. This Act continues in force today but is supplemented by an additional levy prescribed by Title II of the Revenue Act of 1935,* with a rate structure ranging from 2 percent on the first $10,000 to 70 percent on the part of the net estate in excess of $50,000,000.

* Actually, its effectiveness is confined to the calculation of the amount of credit for death taxes paid to States allowable against the 1935 Federal estate tax.

The gift tax was first enacted in 1924 for the principal purpose of preventing evasion of the estate tax through the making of inter vivos gifts. This tax was repealed two years later, as a result of concerted opposition by the several States. It was enacted anew in 1932 with rates at about 75 percent of those of the existing estate tax and with upward changes in the rate structure made in 1934 and 1935, has remained in force to date.

2. Revenue significance

During the fiscal year 1936 the Federal estate tax yielded $219,000,000 and the gift tax an additional $160,000,000. For the current fiscal year the yield from these two taxes is estimated at $249,000,000 and $25,000,000 respectively (Table 2). Since its enactment in 1916, the estate tax, together with the gift tax, have produced approximately $2,100,000,000. Beginning with a modest $6,000,000 in 1917, the yield of the estate tax had increased to $154,000,000 by 1921, but declined thereafter, reaching the low point in 1933 with a yield of only $34,000,000. The decline in Federal estate tax revenue which became particularly conspicuous after 1924, was due (1) to the operation of the crediting device for taxes paid to States, (2) to the increase in exemptions and decrease in rates, and (3) to the decline in security and other property values. Partly because of enactment of increased rates and partly because of rising property values, the yield from this tax has been on the upward swing.

These collections, even when added to the $100,000,000 collected annually by State governments, comprise a relatively small proportion of total tax and customs revenue raised in the United States. It will be seen from the table below that death taxes generally are more significant in the revenue structure of the other States, especially non-Federal States, than in that of the United States.

Approximate proportion of total revenues derived from death taxes in certain (mainly federal) states

State	Percent
Australia	4½
Canada	3
Great Britain	7
New Zealand	10
Union of South Africa	5
United States	2

Source: Interstate Commission on Conflicting Taxation, 1935 Progress Report.

The explanation of the relatively minor significance of death taxes in our revenue structure lies neither in the fewness of large estates nor in the lowness of maximum rates, <u>but rather in high exemptions and low rates on small and middle size estates</u>.

3. The case for Federal death taxes

In spite of its relatively minor revenue significance the Federal estate tax has been the subject of much controversy. With the passage of time, however, the traditional legal argument that death duties should be levied exclusively by the States has gradually given way before the onslaughts of economic necessity and interstate competition. Those arguing against the imposition of Federal death duties have maintained that the power to regulate transfers of property at death rests with the States, who are therefore the logical agents for imposing and collecting such transfer taxes; that the Federal Government has encroached upon a field preempted by the States; that under normal conditions the States' need for death tax revenues is greater than that of the Federal Government; that the necessity of probating estates in State courts makes State administration simpler, particularly with reference to the problem of valuation; that Federal death duties impose a geographical discrimination, placing the bulk of the Federal tax burden upon half a dozen States; and finally, that historically there has never been a permanent Federal estate tax, since the Federal Government has entered the field only in times of emergencies.

The proponents of Federal death taxation counter these arguments by the assertions that the legalistic argument in reference to property transfers falls to the ground from the decision of the courts that the Federal Government may constitutionally levy death duties; that it has been necessary for the Federal Government to encroach upon State territory in many fields which, however, is not necessarily undesirable but merely calls for active coordination; that the States' need for revenue is better served with Federal participation since it eliminates interstate competition and makes the effective imposition of State death duties actually possible; that the logic of the State administrative unit is not conclusive for, while State administrators and executors can compromise as to valuation disputes with reference to estates located within one State, they are powerless with respect to estates divided between two or more States; that some of the States have openly recognized the superiority of the Federal administration by accepting the Federal agents' valuation of the estate for State tax purposes; that the collection of

Exemptions

the bulk of the Federal revenue from six States is not of necessity geographical discrimination since it is due solely to the fact that these States claim as residents the wealthiest people of the country whose fortunes are built, not upon a local basis but upon a nation-wide foundation, logically calling for taxation on a national basis; that the imposition of Federal death duties is gradually acquiring a permanent character, now particularly vital since the Federal Government is in no position to abandon sources of revenue and should at all events retain such administrative machinery and experience as has been acquired.

Aside from the controversial issue of Federal-State priorities in the field of death taxation, the case for the Federal estate tax derives adequate economic merit from its characteristics as a direct tax. Sound fiscal practice requires that insofar as feasible, and barring imposts for regulatory purposes or for the benefit of special groups, the tax burden be distributed in accordance with the ability to pay principle. This requirement of progressiveness in taxation can be fulfilled only by a direct tax for in all other cases the burden ultimately falls upon individuals other than those who pay it in the first instance, rendering its distribution in accordance with preconceived standards of ability to pay a virtual impossibility.

The above statements, together with the open admission of State tax administrators that chaos would result in State death taxation from the abandonment of the field by the Federal Government, seem adequate to establish the propriety of Federal death duties.

B. Structural Revisions of the Federal Estate Tax

I. Various Estate Tax Exemptions

1. Specific exemptions

The 1932 Federal estate tax, as amended in 1935, provides for a specific exemption of $40,000. In the decade preceding 1926 the specific exemption had been consistently $50,000. In 1926, partly as a concession to those who demanded the Federal Government's withdrawal from the death tax field, the exemption had been increased to $100,000. It remained at that level until 1932 when it was again reduced to $50,000, only to be lowered the following year to $40,000.

Because of the relatively high magnitude of the specific exemptions, death taxation is limited to comparatively few large estates and the effective rate of taxation upon estates is reduced to a very low level. Some indication of the destruct've effects of high specific exemptions upon estate tax revenue may be gleaned from Table 3. Out of approximately 1,100,000 adult deaths annually, Federal taxes were paid on 8,655 estates in 1935; 5,104 in 1932; 6,364 in 1931; 7,028 in 1930 and 10,642 in 1925; at best, one return per one hundred adult deaths. In Australia during 1931 approximately 47,000 adult deaths produced 6,000 taxable returns. In Great Britain some 475,000 adult deaths produce annually approximately 150,000 taxable death tax returns.

Recognition should also be given to the fact that the exemptions provided in the tax laws of the American States are generally well below the Federal exemption, thus providing a potent field for interstate variation and interstate competition. While the exemptions afforded by the State death tax laws cannot be placed on a comparable basis because of the use of both inheritance and estate tax form, significant comparability can be obtained by relating the exemptions provided in the estate tax laws to those afforded a representative family (assumed to consist of a surviving wife, a minor child and an adult child) by the inheritance tax laws. This comparison is presented in Table 4. It will be observed that in nineteen of the forty-seven States, specific exemptions permitted amount to less than $25,000; in fourteen, they range between $25,000 and $50,000; in three between $50,000 and $75,000; and in only seven are they in excess of $75,000. The remaining four States afford exemptions ranging from $100 to $30,000 which, however, are not continuous in character but diminish or vanish with the increase of the taxable estate above the amount of the exemption.

These, in part, are the considerations responsible for the consensus that a reduction of the size of the specific exemptions would be desirable. Such a reduction, as already implied, is supported by a number of arguments: It would increase the yield of the estate tax; it would increase the effectiveness of the estate tax rate schedule; it would eliminate part of the existing interstate variation; it would be an extension of the principle of ability to pay in death taxation; and finally, it would bring the Federal estate tax into closer conformity with that of foreign countries.

Further support for a lower exemption may be found in the fact that the specific exemptions afforded by other countries are conspicuously less than the $40,000 exemption permitted by the Federal law. In Table 5 the specific exemptions provided in the death tax laws of several foreign countries are presented on a comparable basis. In the case of those countries which use inheritance taxes, the exemption shown is that afforded the surviving spouse. It should be noted that in comparison to the $40,000 exemption provided by the Federal Act, the exemptions provided by all foreign countries other than Australia, Germany and Canada, amount to less than $2,000. In the case of the Commonwealth of Australia the exemption is £1,000, or $4,000. Great Britain allows only an exemption of £100. Those permitted by the tax laws of Canada range from $1,000 to $25,000.

In opposition to a reduction of the exemption, it is frequently urged that such diminution of the specific exemption would increase difficulties of administration and would interfere with the individual's rights to provide his heirs with a decent standard of living.

The preponderance of the argument appears to be in favor of a reduction in the size of the specific exemption. The precise extent of that reduction, however, is subject to conjecture. Since the principle of granting exemptions emanates from the desire to provide for the dependents of the decedent, it has been suggested that the exemption be that amount which if invested, would yield the amount of income which it is desired to exempt from income taxation.* A 5 percent investment of $20,000, for instance, would yield $1,000 annually, or an amount equal to the relatively high exemption afforded a single individual under the Federal income tax. Whether this be an acceptable basis for determining the size of the estate tax exemption or not (and there is much that may be said in criticism of it), the $20,000 figure is not unreasonable. A reduction to $25,000 was actually approved by the House as early as 1917. Walradt in his confidential report to the Secretary, entitled "The Federal Estate and the Federal Gift Taxes," recommended a reduction to $50,000.

A reduction of the estate tax exemption below $20,000 has little in its favor. The desire to bequeath a substantial tax-free fund to one's heirs is too deeply entrenched in American social and economic concepts to be readily dislodged. Furthermore, the accompanying administrative task involved in the greatly increased number of tax returns would be disproportionately costly. Finally, the elimination of the insurance exemption recommended on page 14 below together with the proposed reduction of the specific exemption represents an effective exemption reduction to one-fourth of its present level. For these reasons it is recommended that the estate tax exemption be reduced to $20,000.

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* Originally suggested by Ely in Evolution of Industrial Society, p. 294, and more recently considered by the Interstate Commission on Conflicting Taxation (See its 1935 Progress Report).

2. Exemptions varying in accordance with number of beneficiaries, and their relationship to the decedent.

The Federal estate tax recognizes neither the number of beneficiaries nor the relationship of said beneficiaries to the decedent in the computation of the tax burden. Some students of the problem consider this a serious deficiency which should be corrected. Their grievance originates with the contention that the specific exemptions provided by death tax laws are designed to protect those who were dependents of the decedent prior to his death. In the guise of this reasoning, though actually in the hope of reducing tax liability, there has developed from time to time pressure for converting the present estate tax to the inheritance tax type of levy.

Others have suggested that the Federal estate tax be supplemented by an inheritance tax in the manner at present employed in a number of foreign countries and one or two of our own States. Great Britain, for instance, imposes in addition to the estate tax a legacy duty on personal property and a succession duty on real estate. Both of these are graduated but the degree of graduation is based on consanguinity and not on the size of each beneficiary's share. A similar situation prevails in France, in Germany, and some of the Canadian and Australian provinces. In the case of the American States, Oregon and Rhode Island supplement their inheritance taxes with estate levies.

In his message to Congress, dated June 19, 1935, the President said, in part:

> "I recommend * * * that in addition to the present estate tax there should be levied an inheritance, succession and legacy tax in respect to all very large amounts received by any one legatee or beneficiary."

Following the President's recommendation, the House actually passed H.R. 8794 which provided for an inheritance tax at rates progressing from 4 percent for the first $10,000 to 75 percent for shares over $10,000,000, in excess of a $50,000 exemption to spouse and near relatives and $10,000 exemption for all others. When the bill reached the Senate, however, the Administration and House proposal was rejected and in its place a further upward revision of the estate tax substituted.

Without entering here upon a detailed discussion of the relative merits of estate and inheritance taxes, it is suggested that the use of the inheritance tax either as a substitute for or as a supplement to the estate tax, would at present be undesirable. Inheritance taxes, to be sure, are more equitable but that additional equity is of a rather fine order. If equity is desired, the estate tax itself offers numerous opportunities which should be explored first. Furthermore, the estate tax is easier to administer. To quote the Joint Committee on Internal Revenue with respect to the estate tax:

> "(It) eliminates the necessity for considering the many complicated problems which arise in connection with the construction of wills and trusts, the application of probate laws, and the determination of the rights of the particular legatees. These problems would be especially difficult in the case of the Federal Government, as the regulatory control over the passing of property at death is reserved to the States and there is a great divergence in the various State laws."

It was largely its ease of administration that gained the estate tax the support of the National Chamber of Commerce and the National Tax Association. Furthermore, in order to yield the same revenue as an estate tax, the rates applicable to distributive shares under a graduated system of inheritance taxation would have to be substantially higher than those required by an estate tax in all cases and confiscatory in others.

However, required recognition of the number of beneficiaries and their relationship to the decedent need not necessarily imply the use of an inheritance tax. The same objective could be obtained by providing that type of an exemption in the estate tax. This is a procedure now employed in the North Dakota and New York estate taxes, and is one which is frequently used in foreign countries, particularly in New Zealand and in some Canadian and Australian states. In the New York law, for instance, a surviving spouse is allowed a $20,000 exemption, and each of the lineal descendants or ascendants are permitted an additional exemption of $5,000. All of these must, however, be taken from the first bracket and therefore cannot exceed $150,000. In the North Dakota law, the respective exemptions are $20,000 for surviving spouse, $5,000 to minor descendants, and $2,000 to adult descendants or ascendants.

It can be readily seen that exemptions provided in this manner could exceed in the aggregate the $20,000 total exemption recommended above. To guard against this contingency, and to forestall possible tax evasion by spreading legacies widely among members of the family, the above arrangement could be combined with a limit of $20,000 upon the aggregate exemption allowed against any single estate. If the exemptions were limited to surviving spouse and minor children of the decedent, the necessity for the maximum limit would not be absolutely essential, because of the relatively small size of the American family.

Proceeding from the philosophy that specific exemptions are intended to protect the decedent's dependents, it has been suggested that specific exemptions not only recognize the relationship of the beneficiary to the decedent, but that they recognize the life expectancy of the beneficiary. The plan was first proposed by Simeon Leland* and is explored in detail by Walradt in his confidential report on death and gift taxes, cited supra. As a corollary to this principle, it has been suggested that the case for an exemption afforded a child disappears when the child becomes of age, and therefore, that the exemption should be made to vary inversely with the age of the child, being maximum in the case of newly-born babes and disappearing entirely in the case of children 21 years old. By the same token, in the case of children who are mentally or physically incapacitated from ever earning a living, the exemption afforded should be large enough to yield a reasonable annual income during the life expectancy of the child - enough to make it unnecessary for them to become public charges.

That the arrangement described above, involving the recognition of the number of beneficiaries and their relationship to the decedent in determining the amount of the specific exemption would be desirable, is probably true. Nevertheless, because such a revision would involve a refinement of a finer order than that commensurate with the existing features of the estate tax, as well as with the existing features of our tax system as a whole, and because its operation would involve a more cumbersome administrative task, its adoption at present is not deemed desirable.

3. Constant, conditional, and vanishing exemptions

The $40,000 specific exemption provided by the present estate tax, the reduction of which is urged above, is a constant exemption; it is, in other words, unaffected by the size of the estate and is deducted from the total estate before determining net taxable value, no matter how large the estate.

The constant or continuous form of specific exemption is common, not only among the American States (Table 6), but also in some foreign countries. It is employed by the Commonwealth of Australia and by

* Taxation in Kentucky, p. 115.

several Canadian and Australian states. Its popularity notwithstanding, this form of exemption has little to recommend it other than simplicity. As already noted, a specific exemption can primarily be justified on the ground of the dependence of the beneficiary upon the decedent. Supplementary support may also be found for it in the ability to pay principle. When, however, the size of the estate exceeds the amount required for the support of the beneficiary, the need for and justification of the specific exemption disappears.

Two alternatives may be suggested for the rectification of this weakness of constant exemptions. One of these is the so-called <u>conditional exemption</u>. In this form of an exemption, an estate is untaxed as long as it does not amount to more than the amount of the exemption. When, however, the value of the estate exceeds the amount of the exemption, the entire estate is taxed. Maryland and Massachusetts and to a limited extent New Jersey death tax laws employ this feature at present. In its commonest forms, this type of exemption fails to provide for a gradual transition from nontaxable to taxable estates and therefore tends to work injustice. Thus, in many cases, an addition of $1 in excess of the exemption to the value of the estate increases tax liability by a substantial sum. In the case of the Commonwealth of Australia, for instance, an estate not exceeding £ 1,000 in value is wholly exempt, but an estate of £ 1,001 is dutiable in full at the appropriate rate, namely, 1 percent. To quote the Royal Commission, "The difference in valuation of £ 1 in these cases makes all the difference between total exemption and total dutiability." This difficulty of the conditional exemption may be overcome by the so-called step system, which provides that where estates not exceeding fixed amount are exempt from duty, the duty imposed on estates exceeding such amounts should not be greater than the excess of the estate over that amount. This is the principle employed in the British income and estate taxes.

A theoretically more acceptable alternative is the so-called vanishing exemption which provides for a gradual diminution of the specific exemption as the size of the estate increases. Let it be assumed that the specific exemption is $20,000. Under the vanishing exemption principle, estates amounting to less than $20,000 would be untaxed; but if the net value exceeds $20,000, the exemption would diminish in accord with a prescribed scale, until it reached the vanishing point. If, for example, the exemption diminishes $1 for every $1 by which the value of the estate exceeds $20,000, then if the total value were $21,000, the exemption would be $19,000 and the taxable amount $2,000; but if the value were $40,000 (which in that case would be the vanishing point) the whole amount would be taxable.

Obviously, this form of an exemption need not necessarily diminish dollar for dollar, but may just as easily decline at a lesser rate. A diminution of one dollar for every two dollars, for example, would eliminate all exemption at $60,000; one for every four dollars, at $100,000. The vanishing exemption, already employed in two estate tax laws (Kentucky and West Virginia), has the advantage of affording substantial justice to the beneficiary and at the same time assuring a marked increase in revenue by eliminating the exemption afforded medium- and large-size estates by the constant exemption.

Sight should not be lost of the fact that the use of the vanishing exemption complicates the task of tax computation, especially in instances of deficiency assessments or refund claims on estates not in excess of the vanishing point. In comparison with the gains in equity inherent in the vanishing exemption however these administrative difficulties are of secondary significance. It is therefore recommended that the present constant exemption be replaced by one based on the vanishing principle and that the exemption diminish dollar for dollar as the net estate exceeds $20,000, eliminating the exemption entirely on estates amounting to $40,000 or more.

4. Manner of taking and manner of providing exemption.

The present method of including the specific exemption as one of the deductions to be made from gross estate in order to arrive at taxable net estate, is undesirable. It is undesirable from the point of view of equity because the exemption is in fact taken at the rate applicable to the highest bracket and thus represents an unequal tax reduction which increases with the size of the taxable estate. The present $40,000 exemption represents an $800 tax benefit to a $50,000 estate as compared with a $28,000 benefit to a $50,000,000 estate.

In addition to its inequitable features, the present arrangement is undesirable because it involves a loss of revenue. It reduces the amount of the net estate in the top bracket that is subject to the highest rate of the progressive rate schedule applicable to a given estate.

That a specific exemption which is taken from the highest bracket is inequitable is obvious. It should be noted, however, that it works the greatest injustice in those cases in which the specific exemption is of the constant type. It disappears entirely in the case of the conditional exemption and is present in the case of the vanishing exemption only in the event that more than one rate is applicable to the lowest brackets before the exemption vanishes.

It should be recognized that this inequitable feature of specific exemptions is not confined to the present Federal estate tax and, in fact, is not confined to this particular feature of the Federal tax structure. It is present in the death tax laws of many States and many foreign governments and is also present in the Federal income tax.

In the case of State death taxes, twenty States provide that the specific exemption be deducted from the first bracket; twenty-one allow it to be taken from the last bracket; two have vanishing exemptions; two, conditional exemptions; and two others a combination of methods (Table 6). In Germany, where Class I and Class II beneficiaries are granted a continuous exemption, the exemption is deductible from the last bracket.

Obviously, the difficulty here presented will lose its significance if the above recommendation for vanishing exemptions is adopted. If, however, the present form of constant exemptions is retained, the inequity resulting from this difficulty should be rectified. So long as the present bracketed rate structure is retained, this can be accomplished by specifying that the exemption be taken out of the lowest bracket. The proposal involves no new principle. As already observed, it is incorporated in the death tax laws of almost half of the States.

If, however, the existing rate structure is replaced by one on the totality plan as recommended on page 21 below, then the inequity can be removed only by providing the exemption in terms of tax credit rather than in an amount deductible from the taxable base. Under this arrangement the tax liability is computed after deductions but before exemptions, and from the tax liability computed in that manner there is deducted the tax exemption. This is a procedure which has been followed in connection with certain State income taxes (Arizona, Iowa, South Dakota, Wisconsin), and may well be adopted in connection with the estate tax. It has the advantage of providing a uniform tax benefit to estates irrespective of size but, of course, does not incorporate the principle of vanishing exemption. The two could be combined, but that possibility is here no further explored since the vanishing exemption discussed above is more desirable. An exemption provided in terms of tax credit is psychologically undesirable in that it seems smaller to the taxpayer than one deductible from the tax base.

Insurance

However, in the event that a totality rate schedule is adopted but the specific exemption is retained without the incorporation of the vanishing exemption principle, the present method of providing an exemption in terms of a deduction from the tax base ought to be eliminated and in its place, an exemption in terms of tax credit substituted.

5. Insurance exemption

Under the present Federal estate tax, the first $40,000 of insurance payable to specified beneficiaries other than the executor, under policies taken out by the decedent upon his own life, is tax exempt. This provision was first introduced in 1918 and has been retained since. Its quantitative importance is revealed in Table 7.

From the social standpoint it is no doubt highly desirable that a man provide his wife and children with an assurance of a cash fund payable at his death. It does not follow, however, that such a fund should be free from the estate tax. If the fund is in the form of a bank account, it is subject to the estate tax. If it is in the form of insurance and does not exceed $40,000, it is tax exempt. Valid reasons for this discrimination have never been advanced. M. H. Hunter is convincing in saying, "The payment of insurance premiums is often looked upon primarily as an investment, with the payment at death as a return. This is true to a greater extent with the extremely large policies and <u>no good reason appears for allowing their deduction</u>." (Underscoring supplied.) 1/ Mr. H. F. Walradt, in his memorandum to the Secretary, previously cited, points out that "the main value of the present exemption is that it furnishes a selling point to insurance companies, whose agents do not fail to inform prospects that they can create an estate up to $40,000 by taking out life insurance and not have it subject to the Federal estate tax."

The practice followed by other countries with respect to insurance is varied. In the majority of cases, however, insurance is taxable in the same manner as other assets. Great Britain allows no discriminatory treatment in favor of insurance payable to named beneficiaries; neither do Australia, New Brunswick, Alberta, Ontario, or Quebec. Manitoba, on the other hand, allows a maximum exclusion of $10,000 of insurance payable to the widow and/or two children under eighteen years of age. Nova Scotia and Saskatchewan allow a maximum exemption of $5,000 for insurance payable to Class A beneficiaries.

1/ "The Inheritance Tax" in Annals of A.A.P.S.S., V. XCV, p. 173.

In the case of the American States the pattern is not different from that found in foreign countries. New York's provision is novel in that it allows an exemption for insurance payable to named beneficiaries of an amount equal to the extent to which $100,000 exceeds the specific exemption claimed. Alabama, Florida and Georgia follow the Federal law; Mississippi allows a $20,000 and California a $50,000 exemption for insurance payable to named beneficiaries; Pennsylvania, Massachusetts, and Illinois exempt such items in their entirety. Wisconsin includes in the taxable estate all insurance payable at death.

The $40,000 exclusion for insurance payable to named beneficiaries allowed by the present Federal law is significant in that it permits a 100 percent potential increase in the specific exemption allowable. Furthermore, this additional exemption is not uniformly applicable. A net estate consisting of $40,000 in general assets and $40,000 in insurance payable to named beneficiaries is not subject to the Federal estate tax. A net estate consisting of $80,000 in general assets is subject to an estate tax of $2,000. The value of this insurance exclusion increases with the size of the estate inasmuch as the exclusion is in effect deducted from the highest bracket subject to the tax. Thus, at $1,000,000, the insurance exclusion is worth $10,400 in tax dollars; at $5,000,000, $21,200; at $10,000,000, $26,000. The insurance exclusion serves to place a great number of estates in the nontaxable category, thus effecting a significant reduction in aggregate Federal revenues available from this source and should therefore be eliminated.

6. Insurance for the payment of estate taxes

It has been urged that insurance payable to the estate for purposes of paying the estate tax should be exempt. Section 801 of H. R. 12395 (74th Congress, 2nd Session), for instance, proposed that insurance be exempt to the extent of the actual estate tax liability but not in excess of $250,000. Such insurance is at present taxable under both the Federal and all but one (Arizona) of the State laws. Whatever the decedent leaves at death that has value represents taxpaying ability regardless of its form. To allow an exclusion for such insurance would discriminate in favor of the group of taxpayers who had seen fit to provide liquid assets for the payment of the tax in this form rather than in any number of other ways. Such an exclusion would, furthermore, defeat progression and thus relegate death taxes to a subsidiary position among the taxes in the fiscal system of the country; whereas the continuation of the recent efforts to increase the revenue from this tax source would seem to possess greater claim for support. As long as circumstances compel the extraction of more revenue from the several tax sources available to Government, it becomes difficult to justify raising the regressive excises, or even the progressive income taxes, while at the same time taking steps towards the effective reduction of the death taxes. In other words, the approach to the upper extreme in taxation, if it must be made, can be made most fittingly with the death taxes leading the procession.

Property Pre-
viously Taxed

It is argued in favor of excluding insurance for the purpose of paying estate taxes that where such insurance is not provided, it may be necessary for the decedent's beneficiaries to suffer heavy losses through forced liquidation. That such insurance should be provided is not questioned. What is questioned is making the proceeds from such insurance tax exempt. The British Committee on National Debt and Taxation, after noting the argument presented in favor of exempting life insurance which had been provided by the insured to meet death duties, stated: "Altogether, it is our opinion that differential relief in favor of this particular form of saving would not make for equity." It is concluded that insurance designed to pay the estate tax should continue to be included in the taxable estate.

7. Property previously taxed

The Federal estate tax exempts property previously taxed at the death of a prior decedent where the prior decedent died within five years of the second death and was subjected to the estate tax. This provision was first added to the estate tax in 1916, in part as a concession to soldiers, and has been retained to date.

The exemption of property previously taxed is usually based on the argument that "the decedent in paying the tax on the first succession paid for property from which he was unable to obtain his full quota of enjoyment and that such rapidly repeated taxation must necessarily wipe out family properties that otherwise would be handed down from generation to generation."* Furthermore, it is sometimes maintained that in large families, because of the high frequency of deaths, property transfers are more numerous leading to the excessive depletion of family fortunes through death taxes.

Strong argument can be made against this form of exemption. Shultz* puts the case as follows:

> "From a logical point of view, only the doctrine that an inheritance tax is a deferred property or income tax justifies such rebates; in fact, from the point of view of 'ability,' or 'equality of sacrifice,' a rapid series of successions would justify a higher tax on the later series of heirs, since the coming of the later heirs into possession of the property would be all the more unexpected. Moreover, a short possession of the property by the decedent is likely to be followed by a long possession by the next heir, since the latter comes into possession so much earlier, with the result that the amount of taxes collected evens out in the long run."

* William J. Shultz, The Taxation of Inheritance, 1926, p. 303.

Tax relief for quick deaths in computing death tax liability is not confined to the United States. The British death tax has recognized the problem continually since 1914. In that case, however, the exemption provided varies inversely with the interval between the two deaths and, furthermore, is confined only to property consisting of land, business carried on by a company or any interest in such land or business. The duty payable on the second death under the British tax is reduced as follows:

Where second death occurs within 1 year of the first death - by 50%
Where second death occurs within 2 years of the first death - by 40%
Where second death occurs within 3 years of the first death - by 30%
Where second death occurs within 4 years of the first death - by 20%
Where second death occurs within 5 years of the first death - by 10%

The estate tax of the Commonwealth of Australia takes no recognition of the problem. In the case of the Australian States, it is recognized only by Tasmania where it is provided that for estates not exceeding £4,000 no duty is payable with respect to any real estate which within five years before death passed to the deceased from his spouse, parents or child, and was subjected at that time to a death duty.

The Germans afford preferential treatment to quick deaths in the case of Class I and II beneficiaries. Their death tax law provides that property so situated which had been inherited within the preceding five-year period, and was then taxed in conformity with the present law, is at the time of the second death entitled to a 50 percent reduction; if succession takes place within five and ten years after the prior decedent's death, the tax is reduced 25 percent. It should be noted also that the recognition of quick deaths both in the English and the Tasmanian Law accord favorable treatment to real estate. This discrimination is based upon the theory that the capitalized (and taxable) value of real estate bears a particularly high ratio to current income and that favored treatment is therefore warranted. At the time of the Colwyn investigation, it was in fact urged that the exemption for quick deaths be extended in the case of agricultural real estate to deaths occurring within fifteen years.

The treatment of quick deaths in the Federal tax has had some influence upon State Statutes. Sixteen States, including New York, now make some recognition of such occurrence. In these, exemptions range from quick death occurring within one-year interval to those occurring within a six-year interval, and from those restricted to Class I beneficiaries to those wholly unrestricted.

It would appear that the case for the recognition of quick deaths is not very strong. At the time of the Colwyn investigation, in response to the Chairman's inquiry, "do you feel that it is a hardship in regard to estates where there happen to be rather frequent deaths in the course of a few years?" Mr. Dalton replied, "No doubt, there are hard cases from time to time but it is very much harder if your parents die and leave you nothing than if they die and leave you an estate upon which you have to pay a tax. It is not a grievance which I should put in the first rank of those to be relieved." The opinion expressed by Dalton was subsequently accepted both by the Colwyn Committee and the Royal Commission of Australia. The former said in part:

> "To a certain extent variations equalise out in the long run. This point, however, must not be pressed too far. There are so many variable factors in the history of estates, and the rates of duty are (to judge from the past) so liable to variation, that the future cannot be trusted to make amends for any present inequality. Nevertheless, it is fair to observe that quick succession may often be due to the first of the two persons deceased having enjoyed the estate for an exceptionally long period. He may have built up a business over a long term, and have died at the age, say, of 80, leaving his property to his son, then aged 50, who may have died within the next five or ten years, being succeeded in turn by his son, a young man of 25 or 30 with a life expectation of 40 or 35 years. Against the repetition of the burden within five or ten years must be set the long freedom of the estate from duty during the life of the first deceased, and the prospect of a further good period of immunity."

The recognition of quick deaths for tax purposes enjoys popular support. A sharp depletion of well established family fortunes through estate taxes occasioned by a quick succession of deaths is generally viewed with disfavor. It may be advisable that some recognition of the problem be retained.

It may be noted that quantitatively the situation is not very significant. During the two fiscal years, 1933 and 1934, when the Bureau of Internal Revenue handled a total of 15,872 returns, only 479 claimed deductions on account of property previously taxed for amounts representing less than two percent of reported gross estate. The British Inland Revenue Department estimated in 1927 that out of 6,000 or so estates exceeding £10,000 which pass each year, about 5 percent pass again within the next five years.

Charitable
Requests

While granting the advisability of continuing to recognize the special status of quick deaths, it should be emphasized that the present arrangement is arbitrary for it provides a 100 percent exemption in the case of a second death within five years and provides no exemption where the second death occurred one day after the five-year interval. It would be far more equitable if the degree of exemption were graduated by providing for a reduction of 100 percent where the second death occurred in the course of the first year; of 80 percent where the second death occurred in the course of the second year; of 60 percent where the second death occurred in the course of the third year; of 40 percent where the second death occurred in the course of the fourth year; and of 20 percent where the second death occurred in the course of the fifth year. Accordingly, it is recommended that the present uniform exemption be replaced by one graduated in accordance with the length of time intervening between the two deaths.

8. Charitable bequests

The exemption of charitable bequests under the present law, which has been in effect since December 31, 1917, serves to make the United States Treasury a major benefactor for charities. A decedent with an amount available for transfer equal in value to $50,000,000 can give away $20,000,000 at an effective cost to his heirs of but $6,200,000. The remaining $13,800,000 is in fact contributed by the Treasury. Thus, the present law respecting charitable bequests places the control of funds otherwise destined for public revenue in the hands of private persons. The Federal Government is allowing others to direct its expenditures. The desirability of such a procedure is, of course, subject to controversy. The important fact is that the upper brackets of the present rate structure are ineffective in producing revenue partly because of the complete exemption granted charitable bequests. For statistics on the relative significance of charitable bequests in the various "size of estate" groups see Table 8.

The inequity of the present exemption of charitable bequests as between taxpayers is shown in the following table:

Amount of estate	Amount of bequest	Rate applicable to bequest	Cost of bequest to taxpayer	Cost of bequest to Government
$ 100,000	$ 10,000	12%	$ 8,800	$ 1,200
500,000	60,000	23%	46,200	13,800
1,000,000	160,000	29%	113,600	46,400
2,000,000	460,000	35%	299,000	161,000
5,000,000	460,000	53%	216,200	243,800
10,000,000	960,000	65%	336,000	624,000
20,000,000	9,960,000	67%	3,286,800	6,673,200
50,000,000	29,960,000	69%	9,287,600	20,672,400

The foreign practice in respect to charitable bequests varies. Great Britain, Saskatchewan and Newfoundland tax charitable bequests. France, Germany, Quebec, Ontario and Australia exempt such bequests from taxation. Alberta, Yukon, and Manitoba allow an exemption of $2,000 for any one charitable bequest. Nova Scotia allows an over-all exemption of $25,000 for charitable bequests to be used within the Province.

In the case of the American States, thirty exempt bequests destined for use within the State, six grant unqualified exemption, the others grant either conditional exemptions or no exemptions at all.

It would be unwise in the case of the Federal law to eliminate completely the incentive for charitable bequests. It may be argued that such bequests serve a useful and necessary purpose in a well-ordered society. The present provision, however, has two faults. It defeats the primary purpose (revenue) of the progressive rate schedule and is inequitable between taxpayers by granting an advantage which increases with the size of the estate.

It would therefore appear desirable that the exemption granted charitable bequests be modified, and, in some acceptable manner, limited. Such limitations, however, should not be stated in terms of fixed number of dollars but rather as a fixed or varying percentage of the otherwise taxable value of the estate. The allowance of a charitable bequest exemption could be limited to a fixed percentage of the net estate, in a manner similar to that applicable to gifts by individuals, under the income tax law.

Conceivably, the proportion of the total estate thus made exempt may be varied inversely to the size of the estate. For purposes of illustration, estates whose value, including charitable bequests, exceeds: $10,000,000 may claim 20 percent of such bequests as an exemption; those between $10,000,000 and $5,000,000 may claim 25 percent of such bequests as an exemption; those between $5,000,000 and $1,000,000 may claim 50 percent of such bequests as an exemption; those between $1,000,000 and $500,000 may claim 75 percent of such bequests as an exemption; and those below $500,000 may claim 90 percent of such bequests as an exemption. A schedule designed in this manner, with appropriate provision at the breakover points, would have much to recommend it.

Rate
Structure

The first of the above proposals has the advantage of simplicity but remains subject to the criticism that the benefits accruing from the allowance provided in that manner would still be greater in the case of wealthy than poor donors. The second proposal may be so designed as to surmount this difficulty but remains subject to the criticism that the schedule, however designed, is arbitrary. It follows that a procedure must be sought which has both the virtue of simplicity and some semblance of equity.

To fulfill these requirements, it is proposed that charitable bequests be included in the taxable base for computation of tax liability but that the taxpayer be permitted a credit for charitable bequests in accordance with the proportion that 50 percent of the charitable bequests bears to the entire estate. Such a procedure would retain the benefits of the progressive rate schedule and at the same time afford an easily administered and uniform charitable deduction.

II. Rate Structure

1. Totality vs. bracket rates

The Federal estate tax achieves progression by the use of a bracket rate structure as opposed to the totality rate method employed by Great Britain, Australia and the Canadian provinces. Progression by totality has the advantage of producing greater revenue than a similar rate schedule on the bracket system, since the high rates of the upper schedule in a totality scheme apply to the entire estate instead of only to its limited fractions. The difference has great significance from the point of view of the public which looks only at the statutory rate schedule, ignoring the consideration whether it applies to the entire estates or only to its fractional parts, and is unable to realize that one form of tax is heavier than the other.

The totality rate method has one disadvantage which, however, can readily be corrected. Since the increased rate incidental to an estate falling in the next higher bracket applies not only to the amount in excess of that at which the rate changes but retrospectively to the first taxable dollar, it is possible that in the absence of provision for the amelioration of break-over points, the increased tax may be greater than the increase in the amount of the estate; and in consequence the beneficiary will actually receive less from a larger than from a smaller bequest. For example:

$250,000 taxable at 9 percent $22,500
$250,100 taxable at 10 percent 25,010

Increased tax due to the addition
of $100 to the estate ....$ 2,510

This difficulty is eliminated in the British tax by a provision that the tax cannot exceed an amount which is the sum of the tax at the next lower rate plus the excess in the value of the taxable estate over the maximum amount to which that lower rate applies. In other words, the tax in the $250,100 estate cited above would not be $25,010 but only $22,600 ($22,500 + $100).

It will be readily apparent that the British provision for the breakover points leaves much to be desired for at certain levels it works complete confiscation of sizeable added segments to the taxable base.

A more acceptable procedure is the "step-up" system employed in some of the Canadian laws. This provides for a gradual spanning of the rate differential between any two brackets of the rate schedule. Occasional inequities of secondary magnitude appear even in the "step-up" system but these are not significant. Under the proposed schedule, for example, an increase in the taxable estate from $59,999 to $60,000 would increase tax liability by about $12. Similar one dollar additions for the taxable base at $999,999 and $74,999,999 would increase tax liability by about $167, and $75, respectively. Because these occasional inequities are of minor quantitative importance in relation to the taxable estate and because the nature of the item taxed is such as to preclude the possibility of tax minimization on the part of the taxpayer, it is concluded that the "step-up" system should be employed, the above-cited difficulty notwithstanding. At all events the possibility of eliminating these minor inequities is always available in the adoption of the British amelioration device.

Since the totality rate method would tend to lessen the hostility of the general public to the necessarily heavy tax burden, providing at the same time greater productivity and increased equity, its adoption would be a worthwhile innovation in the Federal estate tax and is therefore recommended.

2. Upward revision of the rate structure.

The bracketed rate structure of the Revenue Act of 1935 ranges from 2 percent on the first $10,000 of the net estate to 70 percent on that portion of an estate in excess of $50,000,000. Only relatively few estates are subject to the tax since the $40,000 exemption and the $40,000 insurance exclusion serve to make the great majority of property transfers nontaxable. This is apparent from Table 9 - Number of Taxable Estate Tax Returns Filed by Net Estate Classes for years 1927 to 1935. In the interest of productivity it would therefore be desirable to make the estate tax rate structure more effective.

The charge that the present progressive rate schedule makes for the destruction of accumulated capital is unwarranted. In the first place, it is possible to extend the payment of the tax over several years where justifying circumstances can be demonstrated. Secondly, a wealthy man may purchase life insurance during his lifetime to pay the estate tax at his death. In that event the tax becomes little more than an auxiliary income tax. Furthermore, the basis of the capital destruction argument - that all revenues received by the Government represent total economic loss to the country - is unsound. To the extent that the Government continues to devote an increasing portion of its revenues to the construction of capital equipment and to the retirement of domestically-held national debt, there is no economic loss to the country from the payment of taxes to the Government.

The fact remains that the American Federal, State, and local tax picture is a conglomerate with an over-all tone of regressivity. Sales taxes, business taxes, and the so-called nuisance taxes are clearly regressive. The general property tax, the very backbone of the local tax structure, is a regressive tax. To redistribute the present tax burden more equitably, it is desirable that taxes which lend themselves to progression be more widely utilized. Death taxes clearly belong to this category. Unfortunately, in determining the degree of progression of a rate schedule, there is no true and unchanging theory or doctrine to guide us. There is no standard yardstick which may be applied.

The accompanying chart shows that the Federal estate duty is more lenient on the lower estate brackets and more harsh upon the upper estate brackets than any of the other (foreign) death duties plotted. The insert of that chart shows in greater detail the comparative treatment accorded the smaller estates by the death tax laws of some of the foreign countries and the United States. Experience has shown that the high rates on estates of $10,000,000 and over are practically inoperative due to the small number of returns subject thereto. Only two returns out of a total of 11,110 returns filed in 1935 reported a net estate of over $10,000,000. To increase governmental revenue there must be a stiffening of the lenient attitude towards estates of less than $1,000,000. The figures reported in Statistics of Income for 1934 show that for every decedent leaving a taxable estate of over $1,000,000, there were forty-two leaving taxable estates of less than $1,000,000. To increase revenue it is necessary to tax these forty-two more heavily. Increasing the rate applicable to the one million dollar estate and over can have very little revenue significance. Taxing the forty-two more heavily involves no injustice, but merely the principle of ability to pay. Any decedent who leaves an estate subject to the present Federal estate tax has left more to his heirs than 110 of his fellow decedents, who died without a taxable estate. The present Federal tax, therefore, hits only the wealthiest one percent of our population.

It is proposed that a totality rate schedule as outlined in the following table be adopted. The schedule recommended imposes a greater effective rate throughout the entire scale. It will, therefore, materially increase the revenue derived from this tax at the same time that the nominal rates are substantially reduced. The proposed schedule has been so prepared as to give the curve of progression a maximum smoothness. The division points and the rate fractions employed allow for quick computation of the tax. The rate is retarded in the first bracket due to the operation therein of the vanishing exemption.

The red curve on the accompanying chart traces the course of the proposed totality rate schedule, applicable to net estates above a $20,000 vanishing exemption, with rates ranging from 1.0 percent on taxable estates amounting to less than $100 to 75 percent on estates of $100,000,000 and over. The rate schedule rises at a steadily decreasing rate beginning with 1/50 of 1 percent per $100 at $40,000 and ending with 1/25,000 of 1 percent per $1,000 at $100,000,000. The graphic illusion of uneven progression is attributable to the use of a logarithmic scale. For purposes of comparison the proposed totality rate schedule has been converted into one on the bracket basis, which is presented on page 24 (a). Precise parity between the two schedules is, of course, impossible. That the effective variations between the two schedules, however, are of secondary importance, is revealed by the table presented on page 26.

While no attempt has been made to estimate the increase of estate tax revenue which would be produced by the proposed revision, the extent of the increase may be inferred from the comparison of present and proposed effective rates applicable to estates of various size presented below.

Estate Tax
Proposed Totality Rate Schedule

Taxable net estate (In thousands)	Rate of tax					
$ 0 - 40	1% plus	1/100	of 1% on each full	$100	by which the taxable base exceeds	0.
40 - 50	5% "	1/50	"	$100	"	$40.
50 - 60	7% "	1/50	"	$100	"	$50.
60 - 70	9% "	1/50	"	$100	"	$60.
70 - 80	11% "	1/50	"	$100	"	$70
80 - 90	13% "	1/100	"	$100	"	$80.
90 - 100	14% "	1/100	"	$100	"	$90.
100 - 250	15% "	1/15	"	$1,000	"	$100.
250 - 500	25% "	1/25	"	$1,000	"	$250.
500 - 700	35% "	1/40	"	$1,000	"	$500.
700 - 1,000	40% "	1/60	"	$1,000	"	$700.
1,000 - 2,000	45% "	1/200	"	$1,000	"	$1,000.
2,000 - 3,000	50% "	1/250	"	$1,000	"	$2,000.
3,000 - 5,000	54% "	1/400	"	$1,000	"	$3,000.
5,000 - 7,000	59% "	1/500	"	$1,000	"	$5,000.
7,000 - 10,000	63% "	1/1,000	"	$1,000	"	$7,000.
10,000 - 25,000	66% "	1/5,000	"	$1,000	"	$10,000.
25,000 - 75,000	69% "	1/10,000	"	$1,000	"	$25,000.
75,000 - 100,000	74% "	1/25,000	"	$1,000	"	$75,000.
100,000 and over	75%					

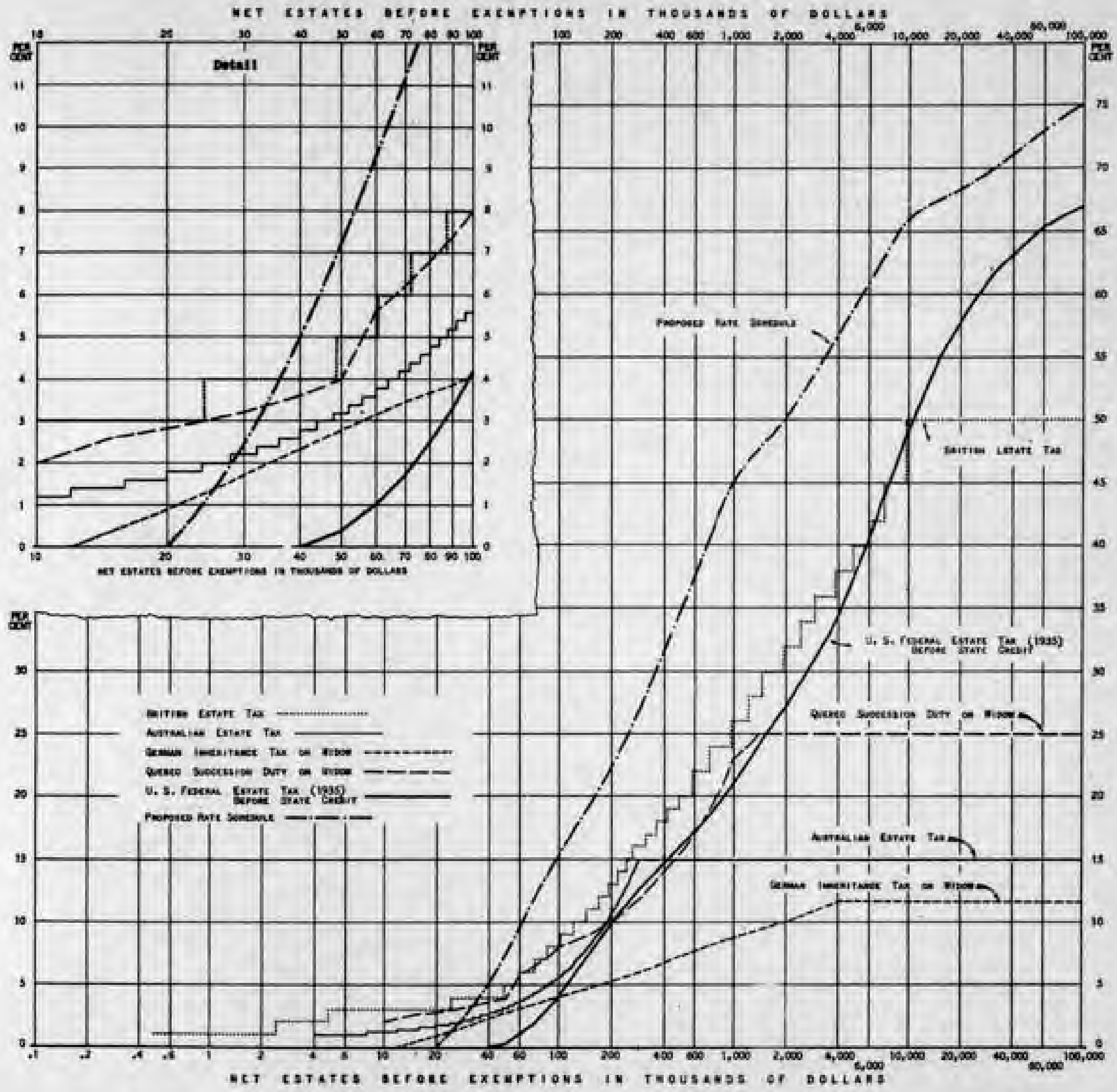
Estate Tax

Bracket Rate Schedule Approximating Proposed Totality Rate Schedule

Taxable net estate (In thousands of dollars)	Rate of tax	Amount of tax on higher amount
$ 0 - 10	2%	$ 200
10 - 20	4	600
20 - 30	6	1,200
30 - 40	8	2,000
40 - 50	15	3,500
50 - 60	18	5,300
60 - 70	22	7,500
70 - 80	24	9,900
80 - 100	26	15,100
100 - 200	31	46,100
200 - 300	35	81,100
300 - 400	43	124,100
400 - 500	51	175,100
500 - 750	54	310,100
750 - 1,000	58	455,100
1,000 - 5,000	62	2,935,100
5,000 - 10,000	70	6,435,100
10,000 - 25,000	72	17,235,100
25,000 - 75,000	77	55,735,100
Over $75,000	79	

Prior
Wealth

COMPARISON OF PROPOSED ESTATE TAX RATES WITH EFFECTIVE RATES OF DEATH TAXES IN VARIOUS COUNTRIES ON NET ESTATES BEFORE SPECIFIC EXEMPTIONS



Office of the Secretary of the Treasury
Division of Research and Statistics

Estate Tax: Effective Rates of Proposed Totality Rate, Approximating Bracket Rate and Present Law

Net estate before exemption	Effective rates: Totality rate	Approximating bracket rate	Present law	Proposed increase in effective rates
$ 25,000	.8%	.8%	-	.8%
30,000	2.0	2.0	-	2.0
35,000	3.4	3.4	-	3.4
40,000	5.0	5.0	-	5.0
50,000	7.0	7.0	.4%	6.6
60,000	9.0	8.8	1.0	8.0
70,000	11.0	10.7	1.7	9.3
80,000	13.0	12.4	2.5	10.5
100,000	15.0	15.1	4.2	10.8
250,000	25.0	25.4	11.4	13.6
500,000	35.0	35.0	16.1	18.9
700,000	40.0	40.4	18.3	21.7
1,000,000	45.0	45.5	21.1	23.9
3,000,000	54.0	56.5	31.2	22.8
5,000,000	59.0	58.7	38.0	21.0
7,000,000	63.0	61.9	43.6	19.4
10,000,000	66.0	64.4	49.4	16.6
25,000,000	69.0	68.9	60.3	8.7
75,000,000	74.0	74.3	66.4	7.6
100,000,000	75.0	75.5	67.3	7.7

3. Prior wealth of the beneficiary as third variable in the rate structure.

It has been advocated that a third variable, prior wealth of the beneficiary, be included in the estate tax rate structure; that, in addition to the size of the estate, the rate schedule be graduated in accordance with the financial status of the beneficiary before receipt of the legacy. The amount of the beneficiary's net income during one or a number of years has been suggested as a measure of his "prior wealth." That the introduction of the prior wealth of the beneficiary as a variable in rate making would be an acceptable extension of the ability to pay principle can be readily conceded. The case of the millionaire nephew receiving bequests from each of a dozen relatives and paying only nominal taxes on each of them without regard to bequests which have gone before, casts into broad relief the ineffectiveness of the present rate structure in taking into account ability to pay.

Valuation

Date of Valuation

However, problems of administration loom large in the path of such a provision. In 1919, an attempt was actually made in the German inheritance tax to recognize the prior wealth of the beneficiary. Additional percentages were added to the succession duty for each 10,000 M that the previous wealth of the heir (based on 1914 property assessments) exceeded 100,000 M; he was liable to an additional 10 percent if he already possessed 200,000 M; above this figure 1 percent was added for each additional 20,000 M of his prior wealth; but under no circumstance might more than double the original rate of the succession duty be paid, nor might the total tax exceed 90 percent of the legacy or inheritance. Administrative difficulties led to the elimination of this surtax in December 1923. A similar tax enacted in Italy in 1919 was abandoned for similar reasons four years later.

The principle could conceivable be adopted by the Federal Government, the prior wealth of the recipient being predicated upon the capitalized value of his net income as reported to the Bureau of Internal Revenue for one or more years.

The advisability of attempting to levy such a tax at the present time is highly doubtful. The courts might question the constitutionality of prior wealth as a proper basis for taxation. Furthermore, from a practical viewpoint, problems of administration would create numerous difficulties, some arising in connection with the determination of prior wealth and others from the necessity of taking due cognizance of the ultimate beneficiaries. In this latter respect the problems encountered would be akin to those inherent in an inheritance as opposed to an estate tax. Delay in tax settlement would be unavoidable.

At all events, the device would involve a refinement of a far higher order than that employed in the other features of the Federal tax system. Too much stress cannot be placed upon conserving all revenue revision opportunities for application into those channels where the probabilities of profitableness are greatest.

III. Valuation for tax purposes

1. Date of valuation

Prior to 1935 the value of an estate for death tax purposes had been determined as of the date of death. In that year an option was provided (Revenue Act of 1935), as follows:

> "If the executor so elects * * * the value of the gross estate shall be determined by valuing all the property included therein on the date of the decedent's death as of the date one year after the decedent's death * * * *"

W. D. Kelly, State supervisor of the Transfer and Inheritance Tax Bureau of New Jersey, stressed the need for such an option in 1930 1/, by pointing out that there have been instances of over a fifty percent shrinkage in the value of estates between the date of decedent's death and the date of final distributions. In many instances the residuary legatees received nothing due to the fact that specific amounts to other beneficiaries, together with the estate tax, consumed the entire amount of the reduced estate. Since widows and children are the most frequent residuary legatees, the practice of valuation at the date of death worked undue hardship in periods of declining values upon those who should receive the greatest protection. The present optional plan of valuation is a means of affording protection to such residuary legatees.

The provision of this option was prompted by the circumstance that all property values were rapidly declining. Now, however, that that trend has been interrupted and another price break of 1929 intensity is not anticipated the justification for the option no longer exists. In all instances of shrinkage, the executor will no doubt see fit to evaluate the property as of the date of distribution; conversely, in instances of appreciation in the value of the estate, the executor has the opportunity to evaluate as of the date of death. This dual valuation complicates the problem of administration. The option delays the levy of the tax inasmuch as the executor's right to affix the valuation as of one year subsequent to decedent's death makes it impossible to determine the amount of the tax until this later date. The present option is conducive to delay.

The practice of evaluating estates as of date of death is largely the practice the world over. Great Britain, Australia, Germany, the Canadian Provinces, as well as forty-two of the American States value the estate for tax purposes as of the date of death. Furthermore, the hardship befalling residuary legatees in period of declining values, pointed out by Mr. Kelly, may to a certain extent be assuaged by stating legacies in terms of percentages or proportions of the total estate rather than in fixed amounts.

L. H. Parker, Chief of Staff of the Joint Committee on Internal Revenue Taxation, was also impressed with the injustice of the failure of the Federal estate tax to recognize the shrinkage in the value of an estate between the date of death and the date when the tax is paid. As a remedy he recommended a compromise: That the death tax rate be determined by the value of the property at the date of the decedent's death, but that this composite rate be applied to the net value of the estate one year thereafter. However, the Parker proposal is even less acceptable than the optional method now in force. If it is desired to recognize valuation at the date of distribution, what logical reason can possibly be advanced for basing the rate on some earlier valuation which in terms of the present is non-existent? The acceptance of either of the two dates for valuation purposes must imply the simultaneous acceptance of that date for rate making purposes.

1/ Proceedings of the N.T.A. (1930), p. 333.

Community
Property

The practice of evaluating the estate as of date of death is sound. The tax is levied on the right to transfer. The transfer is effective legally at the time of death. The base of the tax - the value of the property transferred - should be determined as of the date of death. To remove the date of valuation away from the date of legal transfer to some arbitrary future date, simply because of delays in effecting distribution, does not seem to be sound policy.

Aside from pure economic considerations, the option should be eliminated because of the opportunities it affords for tax avoidance. In this connection the Miscellaneous Tax Unit of the Bureau of Internal Revenue cites among others the two following cases: Decedent A owned all or substantially all of the stock of a close corporation. The present option enables the executor during the year following the decedent's death to strip the corporation of substantially all of its surplus by declaring ordinary dividends which are extraordinary in amount. By the end of the year the value of the stock will be substantially less than it was on the date of the decedent's death. Decedent B left real estate to be administered by an executor or a trustee. If the executor elects valuation as of one year after death, such valuation would reflect shrinkage in value due to usage, depreciation and obsolescence. To permit the executor to rent an office building or operate a factory for a year and value it at the end of that time so as to reflect not only fluctuations in real estate values but wear and tear, depreciation and obsolescence, although enjoying the revenue from the rented building or the operation of the factory, the use of which to a large extent was responsible for depreciation, would be contrary to the spirit of the law.

These are but two of numerous examples which may be cited in support of the recommendation that Section 202 of the Revenue Act of 1935 which amended Section 302 of the Revenue Act of 1926 by the addition of new Subdivision (j), should be repealed.

2. Community property problem

Eight States - Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington - have adopted the community property concept. Under this principle, the combined property and income of the spouses (subject to certain minor limitations varying among the States) belong one-half to the husband and one-half to the wife. These eight States stand in contradistinction to the other forty States which have accepted the common law concept of marital property subject only to statutory variation.

The significance of these inter-State variations lies in the fact that the power of the Federal Government to levy a death duty upon the transfer of property at death is subject to State laws governing property rights, more specifically, to State laws governing the transfer of marital property at death. In the eight community property States, only the husband's one-half share of the community property is subject to the Federal estate tax. In non-community property States, on the other hand, the whole of such community property is subject to the tax at the death of the husband.

Under the present progressive rate schedule, residents of community property States obtain a great advantage over residents of strict common law States. On the basis of the present law, assuming a $1,000,000 net estate acquired during coverture, and assuming that the husband predeceases the wife by more than five years, the total Federal tax levied at both deaths in a community property State would amount to $286,216, whereas in a non-community property State the tax at both deaths would be $381,324 (assuming a static estate unaffected by interest accumulations in both instances). Thus the approximate tax advantage on such an estate to the resident of a community property State would be $95,108. Furthermore, the advantage would increase with the size of the estate.

The advantage of community property States over common law States with respect to the Federal estate tax levied at the time of the death of the first spouse is shown in the table below.

Table 1. Federal estate tax liability on estates of specified size in community and non-community property States*

Net estate before exemptions (In thousands of dollars)	Estate tax liability		
	Non-community property States	Community property States	
		Amount	Advantage
$ 50	$ 100	-	$ 100
65	540	-	540
75	1,050	-	1,050
100	3,000	$ 200	2,800
125	5,625	750	4,875
150	8,550	1,600	6,950
200	15,300	4,200	11,100
250	21,800	7,250	14,550
300	29,000	10,800	18,200
400	43,700	18,300	25,400
500	60,300	27,300	33,000
1,000	160,700	78,700	82,000
5,000	1,396,300	696,700	699,600
10,000	3,583,700	1,805,300	1,788,400
50,000	22,981,900	13,181,900	9,800,000

* (In making the comparison), it is assumed that each of the estates consisted of realty 50 percent, tangible personalty 25 percent, common stock 15 percent, insurance payable to wife 10 percent, and that the entire estate, with the exception of 20 percent of the realty acquired by the decedent prior to marriage, was acquired during coverture.

A disturbing factor from the standpoint of Federal revenue is the trend in the forty non-community property States away from the common law concept of the wife as a ward of the husband toward the community property concept of the wife as a partner in marriage. By 1931 twenty of these forty States recognized the validity of contractual relationships between husband and wife. 1/ Later data are not available. In such States it is possible for the husband

1/ Alabama, Arkansas, Colorado, Connecticut, Florida, Georgia, Iowa, Kansas, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New York, North Carolina, Ohio, Pennsylvania, South Carolina, South Dakota and West Virginia.

Capital Gains

and wife to form an equal partnership, the partnership to hold title to all property acquired during coverture. The formation of such a partnership places the husband and wife in substantially the same position with respect to their property as if they resided in a community property State.

The dual evils of inequity and loss of revenue arising from this source should be eliminated. The present indecisive status of the Federal tax law in regard to community property privileges is undesirable. A method recommended for immediate consideration, is to make the transfer of the right of management and control the basis of the tax. This would necessitate a prima facie presumption that management and control of community or marital property was vested in the husband. This proposal to make management and control the tax base has been advocated by the Treasury Department since 1920 in regard to the income tax. Such a proposal has never been incorporated into the tax law. The judicial attitude toward that procedure cannot be determined until it has actually been incorporated into law.

IV. Compensatory Tax on Accumulated Capital Gains

The existing lack of coordination between the capital gains features of the income tax and the property transfer taxes enables substantial capital gains to escape income taxation. Specifically, reference is had to the fact that when property which has enhanced in value is transferred by inheritance, the accretion in value escapes taxation under the capital gains tax. The transferor, never actually realizing his capital gains, is free of the tax; the transferee, on the other hand, having acquired the property at its higher value, cannot be held liable for taxes on capital gains accrued in the hands of the preceding owner (Section 113(a)(5), Revenue Act of 1936). This type of tax avoidance acquires particular significance in the case of closely held business assets and long-term capital holdings of families depending largely upon income from investments.

The elimination of this loophole is contingent upon the imposition of a compensatory tax on the occasion of the property transfer, such compensatory tax to be assessed on the basis of the accumulated capital gains. That the capital gains in question should be subjected to taxation is obvious. It should be kept in mind that this form of tax avoidance is not necessarily intentional. Investments are frequently held over long periods of time and passed from generation to generation because they represent long-term investments for income purposes. Failure to trade them and thereby realize on the capital gains may be due to inertia, to lack of acquaintance with investment procedure, or to conditions imposed by the benefactor. Furthermore, the individual who withholds assets from sale is somewhat at a disadvantage in comparison with the one who trades more frequently in that he is deprived of the flexible use of his resources. It follows that a tax imposed upon accumulated capital gains will tend to stimulate security trading on the part of those who otherwise would not do so. However, since we are here concerned with the plugging of a loophole which has the potentiality of rendering the basic capital gains tax ineffective, this latter consideration is of small significance.

The logical procedure for the treatment of these accumulated capital gains and one which has ample economic justification would be the imposition of the regular capital gains tax on the occasion of the property transfer by the incorporation of such capital gains either in the fiduciary income tax return filed for the estate or in the last income tax return of the deceased. Either of these procedures, however, is certain to be held unconstitutional.

Since it is impossible to apply the income concept to these capital gains, recourse must be had to some other treatment which will of necessity be less equitable. A workable procedure is available in the imposition of an additional estate tax with appropriate crediting for items in the estate not constituting capital gains. The rates employed in connection with the proposed capital gains transfer tax, which for statutory purposes may be referred to as the initial estate tax, would be identical with those employed for the basic estate tax.

The proposed capital gains transfer tax would be computed in the manner described below and would leave the determination of the basic estate tax unaffected excepting that the capital gains transfer tax liability would be allowable as a deduction from gross estate for the purpose of determining the net taxable estate.

The capital gains which it is proposed to tax under this new capital gains transfer tax are only those that have accrued to real estate, stocks, and bonds. This characterization, however, is not restricted to the real estate reported on Schedule "A" and stocks and bonds reported on Schedule "B" of the estate tax return, but also to those groups of real estate, stocks, and bonds which comprise jointly-owned property and are reported on Schedule "E", or represent interest in copartnerships and unincorporated businesses and are reported on Schedule "F" of the estate tax return. The procedure of valuation employed in the determination of the capital gains should be made to correspond to the valuation procedure employed for the purpose of determining capital gains in the income tax.

The capital gains transfer tax liability is to be determined as follows: A tentative tax is to be computed at the regular estate tax rates on the entire amount of the gross estate without the allowance of any deductions whatsoever. Against this tentative tax there is to be permitted a tax credit, computed at the regular estate tax rates on an amount which will be the sum of the adjusted bases for real estate, stocks, and bonds, and the current market of all other gross estate assets. The difference between the tentative tax and the tax credit thus determined will be the capital gains transfer tax or the initial estate tax liability which is to be allowed as a deduction for the purpose of computing the basic estate tax.

Capital losses on real estate, stocks, and bonds are to be computed on the same basis as is now done for the purpose of the income tax, but such losses are to be disallowed for the purpose of the initial estate tax to the extent that they are in excess of the taxable capital gains. In other words, the amount of the tax credit can never exceed the amount of the tentative tax on the total gross estate.

It follows that in some cases the computation inherent in the determination of the initial estate tax will result in little or no taxable gains. Furthermore, recognition of losses will serve as an incentive to hold on to worthless securities which would otherwise have been discarded, and will also encourage the purchase of securities involving great risk on the theory that should they prove worthless they could be used by the estate to offset initial estate tax liability. It may, therefore, be expected that the adoption of the proposed initial estate tax will bring to light a great supply of worthless investments which have gathered dust in the family vaults for many years. This consideration notwithstanding, losses must be recognized to the extent of the gains, for no recognition of losses whatever would represent a compromise in principle while the unlimited recognition of losses would, in some instances, result in a negative tax which would properly be creditable against the basic estate tax. Accordingly, losses must be limited to the extent of the gains.

The effects of the proposed initial estate tax are illustrated on the attached table which reveals the operation of the tax on estates of various sizes and of various composition. It will be observed that the computed initial estate tax liability bears no fixed relationship to what the tax liability would have been had the capital gains been fully realized and taxed under the income tax. The resulting inequity, however, is less than may at first hand be assumed, since the accumulated capital gains are in effect taxed at the top brackets of the estate tax schedule which bears a general relationship to the transferor's income level and thus to the relative income tax burden that would be imposed were such capital gains superimposed upon his normal regular income.

Operation of the Proposed Compensatory Tax on Accumulated Capital Gains in Conjunction with the Proposed Estate Tax

Gross estate	Composition: Real estate and securities: Adjusted basis	Capital gains	Market price	Other assets 1/: market price	Tentative tax on gross estate	Tax credit: Tentative tax on sum of cost (or other basis) of real estate and securities, and market value of other assets	Initial estate tax liability (Using revised proposed totality rate schedule)	Assumed deductions	Net estate (Gross estate minus deductions)	Net taxable estate (Net estate subject to tax minus initial estate tax)	Regular estate tax (Using revised proposed totality rate schedule)	Combined initial and regular estate tax	Estate tax liability without recognition of capital gains	Increase in tax due to recognition of capital gains
$ 30,000	$ 8,000	$ 2,000	$ 10,000	$ 20,000	$ 1,200	$ 1,064	$ 136	$ 6,000	$ 24,000	$ 23,864	$ 140	$ 276	$ 144	$ 132
	4,000	16,000	20,000	10,000	1,200	336	864	6,000	24,000	23,136	122	986	144	842
50,000	20,000	5,000	25,000	25,000	3,500	2,700	800	10,000	40,000	39,200	1,929	2,729	2,000	729
	10,000	15,000	25,000	25,000	3,500	1,575	1,925	10,000	40,000	38,075	1,828	3,753	2,000	1,753
75,000	30,000	10,000	40,000	35,000	9,000	6,500	2,500	15,000	60,000	57,500	4,830	7,330	5,400	1,930
	10,000	30,000	40,000	35,000	9,000	2,700	6,300	15,000	60,000	53,700	4,081	10,381	5,400	4,981
100,000	50,000	25,000	75,000	25,000	15,000	9,000	6,000	20,000	80,000	74,000	8,732	14,732	10,400	4,332
	25,000	50,000	75,000	25,000	15,000	3,500	11,500	20,000	80,000	68,500	7,261	18,761	10,400	8,361
300,000	150,000	50,000	200,000	100,000	81,000	62,500	18,500	60,000	240,000	221,500	51,093	69,593	58,392	11,201
	50,000	150,000	200,000	100,000	81,000	27,500	53,500	60,000	240,000	186,500	38,661	92,161	58,392	33,769
500,000	100,000	200,000	300,000	200,000	175,000	81,000	94,000	100,000	400,000	306,000	83,754	177,754	124,000	53,754
	300,000	100,000	400,000	100,000	175,000	124,000	51,000	100,000	400,000	349,000	101,070	152,070	124,000	28,070
1,000,000	500,000	250,000	750,000	250,000	450,000	306,250	143,750	100,000	900,000	756,250	309,558	453,308	390,000	63,308
	250,000	500,000	750,000	250,000	450,000	175,000	275,000	100,000	900,000	625,000	238,381	513,381	390,000	123,381
20,000,000	8,000,000	8,000,000	16,000,000	4,000,000	13,600,000	7,968,000	5,632,000	1,000,000	19,000,000	13,368,000	8,912,927	14,544,927	12,882,000	1,662,927
	5,000,000	5,000,000	10,000,000	10,000,000	13,600,000	11,050,000	2,550,000	1,000,000	19,000,000	16,450,000	11,405,405	13,955,405	12,882,000	1,073,405
100,000,000	-	100,000,000	100,000,000	-	75,000,000	-	75,000,000	2,500,000	97,500,000	22,500,000	15,412,500	90,412,500	73,027,500	17,385,000
	25,000,000	75,000,000	100,000,000	-	75,000,000	17,250,000	57,750,000	2,500,000	97,500,000	39,750,000	28,013,813	85,763,813	73,027,500	12,736,313
	40,000,000	40,000,000	80,000,000	20,000,000	75,000,000	43,500,000	31,500,000	2,500,000	97,500,000	66,000,000	48,246,000	79,746,000	73,027,500	6,718,500
	60,000,000	20,000,000	80,000,000	20,000,000	75,000,000	59,360,000	15,640,000	2,500,000	97,500,000	81,860,000	60,801,024	76,441,024	73,027,500	3,413,524

1/ "Other assets" including bank accounts, insurance, and tangible personal property.

Gift Tax

The proposed initial estate tax is subject to the criticism that it discriminates in favor of appreciated capital assets other than real estate, stocks, and bonds. Personal property and collectors' items are cases in point; an appreciation in their value will remain untaxed. This inequity notwithstanding, the proposed arbitrary classification of assets is necessitated by the fact that any other procedure would require a dual valuation of every single item of property in an individual's estate--valuation at the time of death and valuation at the time of acquisition by the deceased. The task of providing data regarding valuation of property at the time of acquisition would in the first instance devolve upon the executors, who may or may not have been left in possession of the facts. In the event that no records were left behind, which would be likely in the case of personal property, the reconstruction of acquisition price would be an exceedingly difficult task. Since the dual valuation of every individual item of asset in an estate would create difficult administrative problems, it seems advisable to restrict the proposed capital gains tax to appreciation in the case of real estate, stocks, and bonds. These general categories present comparatively little difficulty with respect to valuation as of date of acquisition since the data are already required for income tax purposes.

V. Complementary Revisions in the Federal Gift Tax

In line with the revisions of the estate tax proposed above, certain changes should be made in the structure of the gift tax to maintain the complementary relationship between the two. No attempt is here made to discuss the adequacy of the present gift tax as a complement to the estate tax. That problem, involving primarily the coordination of the two taxes will be made the subject of a separate memorandum. The purpose of this section is more limited: To focus attention upon those changes in the gift tax which will automatically be called for by the above-recommended revisions of the estate tax.

1. It has been proposed in the preceding sections that the specific exemption of $40,000 provided by the estate tax be reduced to $20,000. A similar reduction from $40,000 to $20,000 should be made in the specific exemption provided by the gift tax.

2. The specific exemption afforded in the case of the gift tax should be of the same type as that employed in the estate tax. It has been pointed out in connection with the estate tax that the vanishing exemption is the most desirable of the three alternatives. If a vanishing

exemption is incorporated into the estate tax, it should also be employed in the gift tax. It has been urged that in the event the vanishing type of exemption is not incorporated into the estate tax, but if the present rate schedule is replaced by one on the totality plan, the constant exemption ought to be granted in terms of a constant tax credit rather than in the form of a deduction from the taxable base. By the same token, if the vanishing type of exemption is not incorporated into the gift tax, the constant exemption provided should be expressed in terms of a constant tax credit rather than as a deduction from the otherwise taxable base.

3. It has been recommended above in connection with the estate tax that the exemption of charitable bequests be eliminated and in its place a tax credit substituted, such tax credit to bear that ratio to the total tax liability which 50 percent of the charitable bequest bears to the net estate. Similar considerations point to the advisability of corresponding treatment of charitable gifts.

4. It has been suggested above in connection with the estate tax that the present bracket rate schedule should be replaced by one on the totality basis with rates ranging from 1 percent on taxable estates amounting to less than $100 to 75 percent on net estates amounting to $100,000,000 and over. In view of the complementary relationship of the two taxes, it follows that a totality rate structure should be incorporated into the gift tax, the effective rate at each step to be three-quarters of that proposed for the estate tax.

Gift-Estate Tax
Coordination

Part II. Coordination of the Federal Estate and the Federal Gift Tax.

A. Introduction

Sound fiscal practice requires that the complementary constituents of any tax system be properly coordinated. Such coordination need not necessarily imply uniformity in the tax burdens imposed. When, however, the differential in tax burdens imposed upon either of two complementary tax bases is greater or less than that calculated to express the preference which it is intended to bestow upon the one or the penalty which it is intended to impose upon the other, and more particularly, when the differential in tax burdens varies from case to case or is not uniform in all cases, coordination can be said to be lacking.

Estate and gift taxes comprise one phase of taxation in which coordination is especially important. Both are levied upon the right to transfer property; the one upon transfers at death, the other upon transfers during life. It follows that the treatment accorded these complementary tax bases by our tax laws should be harmonious. Public policy may properly justify the imposition of lighter or heavier burdens upon either of the two. If, for instance, it is desired to encourage the distribution of fortunes during the lifetime of their owners, preferential treatment accorded inter vivos gifts, as opposed to transfers at death, is readily reconcilable with coordination. When, however, the preferential treatment accorded inter vivos gifts is greater than that required by public policy and when the preferential treatment is not accorded uniformly to all donors, with the result that the benefits accruing to one individual are relatively greater or less than those accruing another, lack of coordination exists.

In this respect, the present Federal estate and the Federal gift taxes are in pressing need of coordination. The need for such coordination emanates from the following considerations:

(1) The gift tax has greatly reduced the effectiveness of the estate tax by affording substantial opportunity for reducing tax liability incident to property transfers.

(2) The opportunity for reducing tax liability in this manner is not uniformly available to all individuals but varies with their transferable wealth.

(3) The reduction in the tax liability incident to property transfers available through inter vivos gifts is greater than that required by public policy.

Lack of
Coordination

(4) The distribution of estates through inter vivos gifts encouraged by the preferential treatment accorded it for tax purposes and the consequent reduction of property transfers subject to the estate tax has reduced the amount of inheritance and estate tax revenue available to States.

B. <u>The existing lack of coordination</u>

The use of inter vivos gifts enables a conspicuous reduction in Federal transfer tax burden. The advantages accruing to the taxpayer inherent in the gift tax as opposed to the estate tax emanate from five major causes: (1) The gift tax rate schedule is three-quarters of the estate tax rate schedule; (2) the gift tax rate schedule applies to the amount of the transfer after deductions for taxes, while that for estate taxes applies to the amount of the transfer, including the amount of the tax; (3) the gift tax affords exemptions in addition to those afforded by the estate tax; (4) the use of inter vivos gifts enables a double use of the lower brackets for transfer tax purposes, thus defeating progression; and (5) the use of inter vivos gifts enables a reduction in income taxes by enabling the breaking up of large incomes into smaller units with the accompanying multiple use of exemptions and lower brackets.

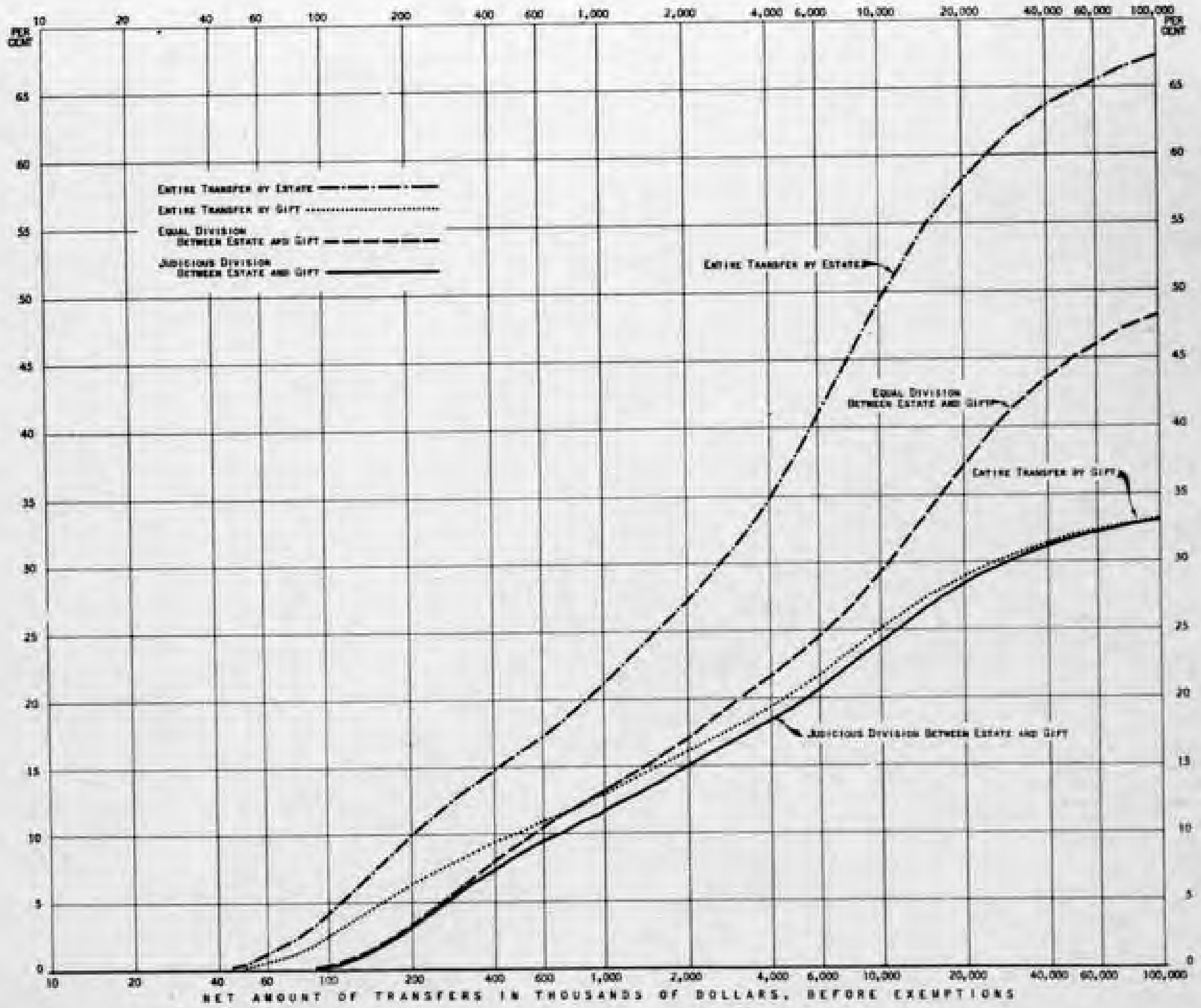
Because of the progressive character of both the income tax and property transfer tax rate structures, the tax advantage inherent in the gift tax from the above-enumerated considerations, is not uniformly available to all estates. The value of the double use of the transfer tax exemptions and lower brackets and the value of the multiple use of income tax exemptions and lower brackets grows more than proportionately greater with the increase in the size of the taxpayer's transferable fortune.

Ignoring the profitableness of inter vivos gifts which accrues from a reduction of income taxes, reference to the accompanying chart will reveal that in the case of a $5,000,000 estate, for instance, an estate tax liability of $1,901,400 can be reduced to $1,029,455 by making a gift of the entire estate and to $976,059 by making a judicious distribution of the estate between gifts and transfers at death. In these three alternatives, the effective rates of the transfer taxes are respectively 38.0 percent, 20.6 percent and 19.5 percent of the total estate. On a $100,000 estate, the transfer tax liability can be reduced from 4.2 percent to 2.5 percent by disposing of the entire estate through gifts and to 0.25 percent by a judicious allocation of the estate between gifts and transfers at death.

Furthermore, the transfer of property by gift serves to reduce income tax liability. For purposes of illustration, assume that a person with property valued at $10,000,000 and yielding 3 percent per annum

EFFECTIVE FEDERAL PROPERTY TRANSFER TAX RATES

Under Various Methods of Transfer



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Division of Research and Statistics

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disposes of $5,000,000 by gift. The annual income of $300,000 is now divided for income tax purposes between two taxpayers. The result is that the surtax liability on such income (the entire $300,000 assumed to be net income) is reduced from $151,360 to $116,840 (both parties assumed to be unmarried), largely as a result of the escape from the higher brackets of the income tax. Thus, income tax revenues from this particular property have been reduced by $34,520 per annum. Distribution to several donees, rather than to one alone, would enable substantially greater reductions.

Aside from inequity between taxpayers, it should be noted that the advantages afforded by the gift tax as opposed to the estate tax materially reduce the revenue significance of Federal transfer taxes. An estate of $220,000, including $40,000 of insurance, can be transferred by the owner to his wife and three children tax-free by gift distribution over a period of five years and a transfer of the remainder at death. For the Federal Government to provide the means for exempting estates of such size from transfer taxation seems inadvisable in the light of present Federal revenue needs.

Partly as a result of this lack of coordination of the estate and the gift tax and in part because of the structural defects of the present estate tax, previously discussed, transfer taxes occupy a relatively minor role in the American revenue structure. During recent years Federal and State taxes on property transfers accounted for little over 2 percent of all public revenues in the United States, in contrast with 4 percent in Australia, 7 percent in Great Britain, and 10 percent in New Zealand. These comparisons, let it be noted, are particularly significant because we are here concerned with one of the few constituents of the tax system capable of the application of the ability to pay principle.

In theory at least Congress has itself recognized the importance of an effective property transfer tax for it enacted the gift tax in order to defeat the transfer tax evasion made possible by the use of gifts inter vivos. Prior to the passage of the gift tax, it was possible to evade completely the estate tax by the distribution of property through gifts.

It is equally true that in spite of its enactment of the gift tax, Congress did not wish to destroy entirely the incentive for inter vivos gifts. On the contrary, it deliberately made inter vivos gifts attractive for it desired to encourage the distribution of estates during the lifetime of the owners. That is to be inferred from the fact that the gift tax rate structure, as enacted in 1932, 1934 and 1935, has consistently been three-quarters of that applicable to estates.

It is also possible, though not probable, that Congress was fully cognizant of some of the other advantages that go with inter vivos gifts in the present tax structure, and that it had intended to offer these as additional incentives. It is more probable, however, that the advantage accruing from the use of inter vivos gifts is greater than that contemplated by Congress. But whether that be the case or not, it must be maintained that the extent to which the use of inter vivos gifts unduly destroys transfer tax revenue and bestows a varying degree of advantage upon different taxpayers, the present arrangement is undesirable and should be amended. Furthermore, it is undesirable, insofar as it deprives States of that portion of estate tax revenue which they had been led to believe was earmarked for them under the crediting device of the 1926 Act and on the basis of which they have formulated their own inheritance and estate tax policies.

It will be recalled that when the crediting provision was incorporated in the 1926 Revenue Act the States were led to believe that Congress had intended 80 percent of the transfer tax revenue to be destined for State coffers, retaining only 20 percent for the Federal Treasury. Subsequently, the Federal estate tax rates were greatly increased without a corresponding expansion of the scope of the crediting provision. In consequence, the relative importance of credits for taxes paid to States, claimed against Federal estate taxes, declined from 76 percent of total Federal tax liability in 1931 to 18.3 percent of that in 1936. The dissatisfaction which has accompanied this gradual expulsion of the States from the death tax field has added greatly to the existing Federal-State conflict in taxation.

The situation has been aggravated further by the manner in which the Federal Government designed its gift tax. The fact that the existing relationship of the gift tax to the estate tax serves to encourage inter vivos gifts, automatically conspires to reduce State revenues, for it reduces the volume of property transfers taxable under State death taxes. In the case of the State of New York, for instance, State fiscal officials estimate this to involve an annual loss in revenue of approximately $40,000,000.

States in their quest for additional transfer tax revenues have countered Federal activity by imposing additional State death taxes frequently much in excess of 80 percent of the 1926 Federal estate tax, thereby undoing what remains of the benefits of the crediting device. In addition, to protect themselves against the loss of revenue through gifts, they have taken to the enactment of gift taxes. Wisconsin, Oregon, Virginia, Colorado, Minnesota, and North Carolina have enacted gift taxes since 1933.

Similar legislation is pending in New York, Connecticut, Delaware, Indiana, and Massachusetts. Thus, a new source of Federal-State conflict is rapidly developing, which can only be expected to gather momentum.

Proposed
Coordination

C. Proposal for the coordination of the Federal estate and gift tax

In view of the existing conflict between the Federal estate and and the Federal gift tax, a coordination of the two is urgently needed. Such coordination can be achieved by viewing inter vivos gifts as instalments of property transfers and viewing the taxes on such gifts as payments on account of transfer tax liability at death. The procedure is theoretically sound. Both taxes are levied on property transfers. Their objective is the taxation of property transfers at death. To prevent an evasion of death taxes through inter vivos gifts, the gift tax is imposed. If such gifts could properly be recorded and if there were an assurance of the adequacy of funds in the residual estate for the payment of taxes on all property transfers, including those made during the lifetime of the deceased, there would be no necessity for taxing gifts at the time of their occurrence. Because of the difficulties involved in complying with these conditions, the practical alternative of taxing gifts, when they take place was adopted. To view these gift taxes, collected by the Government because of expediency, as payments on account of ultimate estate taxes is the logical "next step." The concept is not new, but is already present in the gift tax and follows logically from the Congressional concept of transfer taxes. The existing gift tax statute views the taxes imposed on annual gifts as payments on account of final gift tax settlement. Additional future gifts create a tax liability calculated not only on the amount of the last unit of the gift but retroactively to the amount of the first gift; taxes paid on such foregoing gifts are considered mere prepayments to be credited against final gift tax liability. (Section 502, Revenue Act of 1932, amended.)

That Congress itself considered the two taxes inseparable is evidenced by the reports of the two committees which considered the gift tax in its first stages in 1932:

> "In short, the design is to impose a tax which measurably approaches the estate tax which would have been payable on the donor's death had the gifts not been made and the property given had constituted his estate at his death. The tax will reach gifts not reached, for one reason or another, by the estate tax.
>
> ".....Since the gift tax is an adjunct of the estate tax which is not restricted to transfers made within a single year, an effective gift tax must give consideration, so far as the rate of tax is concerned, to transfers made in prior years." (Committee on Ways and Means Report to accompany H.R. 10236, pp. 28-29, and Committee on Finance Report to accompany H.R. 10236, p. 40.)

A similar view was expressed by Justice Cardozo when he observed that "The tax upon gifts is closely related both in structure and in purpose to the tax upon those transfers that take effect at death. What is paid upon the one is in certain circumstances a credit to be applied in reduction of what will be due upon the other." Burnet v. Guggenheim, 288 U. S. 280, 286. (Underscoring supplied.)

Accordingly, it is concluded that the two taxes, those on gifts and those on estates, are mutually interdependent, deriving from identical origins and falling upon interchangeable transactions, and therefore may well be integrated in the interest of coordination.

The mechanical aspects of the integration here proposed are relatively simple. Let it be assumed that it is desired to encourage transfer by inter vivos gifts to the extent of continuing to grant a 25 percent tax advantage over that incident to property transfers at death. The task then is to design a mechanism which first, will give effect to precisely that tax advantage, not one greater or smaller; and second, which will afford a tax advantage uniformly available to all individuals irrespective of their transferable wealth. These requirements can be achieved by the following arrangement:

(1) Retain the 25 percent differential inherent in the existing gift tax and the estate tax rate structure;

(2) Change the existing net gift tax base to one determined by the amount of the transfer before deductions for taxes, comparable to that used in taxation of estates;

(3) Consider the taxes paid on inter vivos gifts as instalment payments on account of final estate taxes;

(4) Include in the taxable base at the time of death not only the residual estate remaining after gifts, but also the value of property previously reported for gift tax purposes;

(5) Compute a tentative estate tax liability upon all of the property disposed of by the decedent both during his lifetime and at his death;

(6) Credit against this tentative tax liability (a) gift taxes paid and (b) such premium upon these gift taxes as suffices to express the tax advantage the Government desires to afford inter vivos gifts.

Under the existing rate structure, the differential in favor of gift taxes is 25 percent; the estate tax rates are one-third higher than the gift tax rates. Accordingly, a $300 gift tax paid during life would entitle the estate to claim a $400 tax credit ($300 gift tax + 33-1/3 percent premium thereon) against the tentative estate tax liability at death.

D. <u>Operation of the proposed method of coordination</u>

The coordinating device here proposed introduces little departure from present taxation of property transfers and implies a tax computative task very similar to that now employed. A specific example showing the operation of both (1) the existing law and (2) the proposed device is here presented:

(1) Tax liability under the existing law:

Case (A)	John Doe has a fortune of $5,000,000. His estate at the time of his death will be subject to estate taxes amounting to	$1,901,400
Case (B)	If, however, he disposes of half of his estate by gift and retains only half of it in his estate, total estate and gift taxes	1,158,762
Case (C)	If, on the other hand, he makes a single gift of his entire property while he is alive, the gift tax will amount to	1,029,455
Case (D)	If he retains $640,000 in his estate and makes a gift of the rest, the combined gift and estate taxes will amount to	976,059

(2) The estate and gift tax liability under the coordination device here proposed and computed at existing estate and gift tax rates, will, in the four cases cited, be as follows:*

	Case A	Case B	Case C	Case D
Total value of property	$5,000,000	$5,000,000	$5,000,000	$5,000,000
Total value of gift	-	2,500,000	5,000,000	4,360,000
Gift tax exemption	-	40,000	40,000	40,000
Net taxable gift	-	2,460,000	4,960,000	4,320,000
Gift tax	-	549,300	1,426,050	1,175,700
Value of estate at death	5,000,000	2,500,000	-	640,000
Value of gift reported for tax purposes	-	2,500,000	5,000,000	4,360,000
Tentative estate tax base	5,000,000	5,000,000	5,000,000	5,000,000
Estate tax exemption	40,000	40,000	40,000	40,000
Tentative net estate tax base	4,960,000	4,960,000	4,960,000	4,960,000
Tentative estate tax liability	1,901,400	1,901,400	1,901,400	1,901,400
Credits:				
Gift taxes paid	-	549,300	1,426,050	1,175,700
Gift tax premium (1/3)	-	183,100	475,350	391,900
Total credit	-	732,400	1,901,400	1,567,600
Estate tax payable at death	1,901,400	1,169,000	-	333,800
Combined transfer tax liability:				
Gift tax	-	549,300	1,426,050	1,175,700
Estate tax	1,901,400	1,169,000	-	333,800
Total	1,901,400	1,718,300	1,426,050	1,509,500

The results of these computations are presented summarily in the following table. It is to be noted that Case C, rather than Case D receives the greatest advantage under the proposed method. Inasmuch as Case C is that of total distribution by gift, it can be readily seen that the proposed procedure is in conformity with the intent of public policy to provide an incentive to inter vivos gifts, the tax advantage depending on the extent to which property is distributed by gift. Of even greater significance, however, is the fact that the preferential treatment accorded inter vivos gifts is uniform throughout, namely, 33-1/3 percent on such amounts as are actually paid in gift taxes.

* These computations ignore the $5,000 annual gifts to any number of different individuals which are exempt from the present gift tax. See p. 50 below.

Objections
to Proposal

Comparison of effective transfer tax rates under existing and proposed treatment

Case	Present method		Proposed method	
	Tax	Effective rate	Tax	Effective rate
A	$1,901,400	38.03%	$1,901,400	38.03%
B	1,158,762	23.18	1,718,300	34.37
C	1,029,455	20.59	1,426,050	28.52
D	976,059	19.52	1,509,500	30.19

E. Consideration of possible objections to proposed method of coordination

The proposal here made for the coordination of estate and gift taxes may be criticized on grounds that it implies a stationary gift and estate tax rate structure; that in the event of future estate tax rate increases, the final tax liability incident to property transfers at death would be increased not only by the extent of the additional tax liability on the final instalment of the property distribution at death, but retroactively on all preceding inter vivos distributions; that under peculiar circumstance the tax liability may conceivably be greater than the value of the residual estate itself; and, conversely, that in the event of future rate reductions, a situation may arise where the tax computed on the final distribution of the deceased's property may be a negative quantity calling for a refund.

With respect to the above-anticipated criticism, it should be noted that the situation which may conceivably develop under the proposed plan does not differ from that already inherent in the existing gift tax, with its cumulative features. There, too, a change in gift tax rates could create the difficulties enumerated. For the purpose at hand, it will suffice to assume that there will be no reductions in the rate of property transfer taxes, or, at least, that before enacting such rate reductions, Congress will consider their implications. Such an assumption would have much theoretical strength, for not only is stability in transfer taxes desirable, but much may be said in defense of arriving once and for all at a satisfactory transfer tax rate schedule and retaining it at that level during periods of prosperity as well as economic inactivity. We are here concerned with one of the two constituents of the tax system susceptible to progressive treatment, and it may be good public policy to keep that tax at a fixed and optimum level, adding flexibility to the tax structure.

as required, through other taxes. At all events, the practice of allowing the rate structure in effect at the time of death to affect the tax burden on all previous property dispositions is valid. Both inter vivos gifts and estate taxes are imposed on the privilege of disposing of property accumulated during life. Since the enforced time of that disposition is time of death, it is valid to tax all such dispositions at rates in effect at time of death.

Coming to another point, it may be suggested that the cumulation of gifts for ultimate inclusion in the residual estate for estate tax purposes is of doubtful constitutionality first, because title to the property distributed through inter vivos gifts is not held by the decedent at the time of his death, and second, because property transfers during life must be taxed independently from those occurring at death.

With respect to the first of these legal objections, attention is called to the fact that the concept of cumulation implied in the proposed coordinating device is not new but is already employed in connection with the existing gift tax. The second involves more controversial problems the final evaluation of which may have to await judicial review. Specific judicial opinion to the contrary lacking, however, it is assumed that these gift taxes, more properly termed anticipatory estate taxes, may logically be considered prepayments on account of estate taxes.

Alternative Plan

In the event that the recommendation for including the value of inter vivos gifts, titles to which are no longer held by the decedent, in the final estate tax base, is found to be unconstitutional, consideration may be given to a reversal of the proposed coordinating device. More specifically, instead of considering inter vivos gifts as installments on ultimate estate distribution, the procedure may possibly be reversed by considering the property disposed at death as a final inter vivos gift subject to the gift tax under the present cumulative set-up.* Such a procedure would have the merit of eliminating the necessity of stretching the concept of property transfers at death. That advantage, however, is largely offset by several disadvantages, which may be briefly noted.

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* Section 502 of the Revenue Act of 1932, amended, provides: The tax for each calendar year shall be an amount equal to the excess of—

(1) a tax, computed in accordance with the Rate Schedule hereinafter set forth, on the aggregate sum of the net gifts for such calendar year and for each of the preceding calendar years, over

(2) a tax, computed in accordance with the Rate Schedule, on the aggregate sum of the net gifts for each of the preceding calendar years.

Advantages
of Proposal

First, it would involve the use of the principle of penalties in taxation which has many undesirable aspects and, from the point of view of public relations, might well be avoided. Second, it does not solve the difficulty inherent in the gift tax which would come with the downward revision of the rate structure discussed above and which exists both in the present gift tax structure and in the proposed transfer tax structure. Lastly, it would involve the substitution of the net base after deduction of the amount of the tax now inherent in the gift tax, for a base which includes the amount of the tax, used in the estate tax, unless the base used in conjunction with the gift tax itself is also revised.

Accordingly, it is concluded that if the suggestion to consider inter vivos gifts as instalments upon ultimate distribution of the estate, and if the suggestion to consider gift taxes merely as prepayment of ultimate estate taxes is constitutionally valid, then the initial proposal for the coordination of estate and gift taxes is preferable to the alternative proposal just discussed.

F. Advantages of the proposed plan

The imposition of a coordinated system of estate and gift taxation, as described on p. 44 above, would present no additional administrative problems. The record of inter vivos gifts is already being maintained currently for gift tax purposes and its use in connection with the final settlement of estate taxes would represent no additional burden.

The positive advantages of the proposed method of coordinating the estate and gift taxes may be summarized as follows:

(a) It will increase revenue from the estate and the gift tax by increasing the effective transfer tax rate.

(b) The Federal Government will be enabled to accord precisely that encouragement to inter vivos gifts which is required by public policy, and which at the same time will be equally available to all individuals, irrespective of their wealth.

(c) The proposed treatment of property transfers will be a logical corollary of the cumulative tax base and cumulative tax credit concept already employed in connection with gift taxes.

(d) It will make the bases of the estate tax and gift tax identical.

Gift Tax
Exemptions

(e) It will eliminate the double use of exemptions in connection with property transfer taxes.

(f) It will eliminate the double use of the lower brackets of the transfer tax rate structures.

(g) It will provide the machinery for eliminating the inequitable effect of gift taxes upon the estate and inheritance tax revenues of State governments without any reduction of Federal revenues, since the additional revenue obtained from the proposed coordination will be adequate to supply the additional funds diverted to the States. (See discussion under Part III.)

(h) It will forestall the present movement toward independent State gift taxes and thus will stifle a new and potent conflict which is arising between the Federal Government and the States.

Lastly, it will be observed that the device here proposed for the coordination of estate and gift taxes fulfills the requirements of a set of complementary taxes discussed in the introduction and at the same time eliminates all but one of the deficiencies now existing. The exception referred to is the unpredictable advantage inherent in inter vivos gifts which emanates from the multiple use of the lower brackets of the income tax.

G. Gift Tax Annual Exemption

The present practice of exempting from gift taxes \$5,000 gifts made annually to each of any number of individuals, as provided by Section 504 of the Revenue Act of 1932, amended, is excessively generous. It enables one individual to dispose of \$200,000 tax-free to four children in ten years, in addition to the specific exemptions provided in the gift and estate tax, and in addition to the \$40,000 of tax-exempt insurance payable to specified beneficiaries. The plea that an exemption of that amount is required to exclude from consideration small Christmas gifts, birthday gifts, etc., is hardly valid since a gift of \$5,000 is more than a mere expression of affection or good will. In this connection, it is of interest to note that the Ways and Means Committee Report on the 1932 gift tax proposed merely a \$3,000 exemption which was subsequently raised by the Senate Committee to \$5,000, and remained at that level even after the other exemptions were reduced. It is recommended that in line with the proposed reduction of the specific transfer tax exemption, and in line with the proposed use of the vanishing exemption, the present annual exemption be replaced by a maximum donor's annual exemption of \$5,000, irrespective of the number of donees.

Part III: Coordination of Federal and State Taxes on Property Transfers

1. Introduction

The simultaneous taxation of ostensibly identical tax bases by two separate and sovereign jurisdictions requires coordinate action. In the absence of coordination, undesirable economic and social consequences are inevitable. That in the United States such coordination is lacking and has of necessity produced "undesirable consequences" is apparent on all sides and requires no demonstration.

Speaking to the Conference of Mayors, meeting in Washington, D. C., on November 19, 1935, the President observed that Federal, State and local "taxes have grown up like Topsy in this country." Three years earlier Ogden Mills, then Secretary of the Treasury in an address before the City Bar Association of New York remarked that:

> * * * if we view our Federal, State and local taxes as a whole we do not find anything that faintly resembles a logical and coordinated plan, but rather a number of unrelated systems, frequently overlapping and existing in a state of confusion that gives rise to all manner of maladjustments, duplications and irregularities.
>
> There is a growing conviction, which I share, that the time has ceased when the Federal and State governments may safely chart separate and unrelated courses over the troubled financial waters which they must now all traverse. The time for drifting has passed. The time for considerate and conscious coordination has arrived. (New York Times, April 30, 1932.)

During recent years both the States and the Federal Government have passed through several years of fiscal stringency which brought in its wake a flood of new tax laws, adding to the existing incoordination. As a result Mr. Mills' indictment may have even more validity today than it had five years ago.

To be sure, the problem represented by conflicting Federal-State taxation is of more vital significance to the States than to the Federal Government, and the latter may conceivably direct its attention to more pressing matters. R. M. Haig puts the case well when he observes:

> It is obvious that despite the interest of national leaders, the movement for change in the existing arrangement is primarily a movement of and by the States. The Federal Government does not seek additional taxing power. Moreover

Federal-State
Conflict

it possesses a great tactical advantage in that, speaking generally, it can first formulate its tax program, and fold its hands, while the States struggle to conform their programs to it. At most there is some concern in Washington lest the nuisance and waste of the dual administration of certain types of taxation, which constitute important elements in the Federal system, may discredit these taxes and render them unavailable. (N. T. A. Proceedings, 1932, p. 223.)

If the Federal Government were content with pursuing a policy as narrow in its scope as that characterized above, the present discussion would obviously be out of order. However, the Federal Government should and, in fact, is seriously interested in sound fiscal practice in all levels of government and is thus eager to contribute to the elimination of Federal-State tax conflict. (Address of Henry Morgenthau, Jr., Secretary of the Treasury, before the Tax Revision Council in Washington, D. C., on June 7, 1935.)

2. The Existing Federal-State Conflict in Death Taxation

The problem insofar as it concerns Federal-State conflict in the field of death taxation is not new, although, as will be shown below, it emanates in part from the ineffectiveness, and in part from the narrowness of scope of the crediting provision initiated by the Federal Government in 1924 and modified in 1926.

The controversy surrounding Federal and State taxation of property transfers had its origin in 1907, at the time when President Theodore Roosevelt urged a heavy Federal tax on inheritances. His proposal was countered on the part of State officials with the plea that death duties be considered State rather than Federal sources of revenue, among other reasons because some States have relied upon this source of revenue for almost a century. The Federal Government's enactment of the estate tax in 1916 and, more particularly, its failure to repeal that levy after the war, rekindled State opposition to the Federal levy and culminated in two conferences on inheritance and estate taxation held in 1925 under the auspices of the National Tax Association. These conferences resolved that the Federal Government should withdraw from the field of death taxation within six years and in the interim should afford the taxpayer a maximum 80 percent credit against Federal tax liability for taxes paid to States. No doubt that resolution was in part instrumental in the reduction of Federal tax rates and in the increase of the scope of the crediting provision incorporated in the Revenue Act, which became law on February 26, 1926.

The crediting device incorporated in the 1924 Act and subsequently expanded in 1926, implied a willingness on the part of the Federal Government to share its transfer tax revenue with States, first in a ratio of 3 to 1 and later in the ratio of 1 to 4. On the strength of that implication some of the States have made an attempt to bring their death tax structures into conformity with that of the Federal Government. The post-1926 activities of the Federal Government, however, have been a steady swing away from that early pattern. In 1932, 1934, and 1935 Federal estate taxes were increased without a corresponding increase in the scope of the crediting provision, with the result that the States' share of total death tax revenues has been steadily diminishing. While the recent revisions of the Federal estate tax have reduced the specific exemption from $100,000 to $50,000 and later to $40,000, the crediting provision has remained unchanged. In consequence, no estate credit is at present permitted for taxes paid to States on the bulk of the estates--those amounting to less than $100,000. Furthermore, since the recent rate increases were more marked in the upper than in the lower brackets of the estate tax rate schedule, the relative share of death taxes subject to State credit steadily diminish as estates become larger. The result is that the States are deprived of the tax credit at both ends of the scale. Between 1931 and 1936 the percentage of Federal estate tax liability represented by credits claimed for taxes paid to States declined from 76 percent to 18.3 percent.

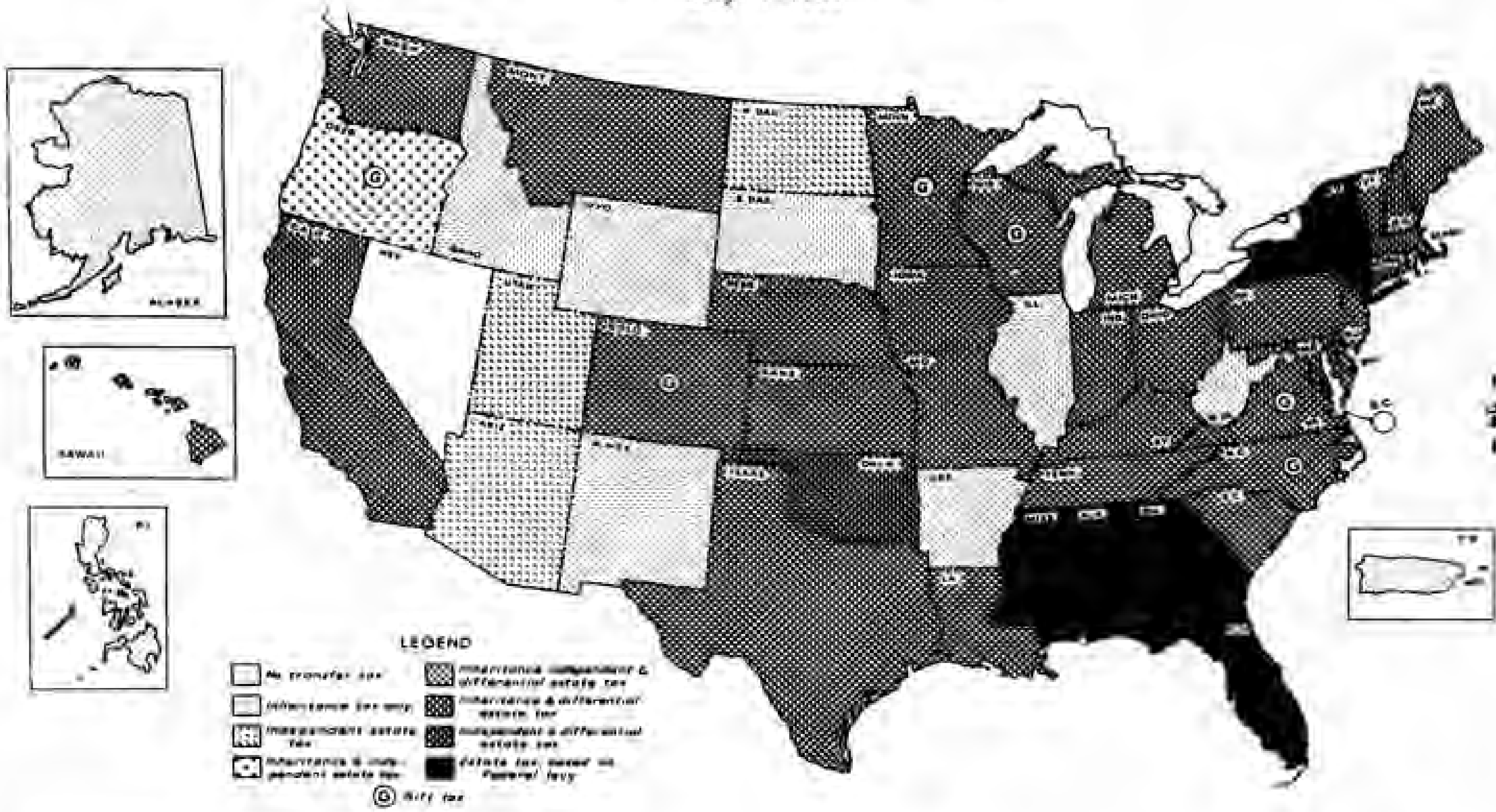
To add to the disturbance, the Federal Government enacted a gift tax in 1932 which is so constructed as to encourage the distribution of estates during the lifetime of the owners and thus reduce correspondingly the amount of the estate subject to Federal and, of course, State death taxes. This is apparent from the fact that between 1931 and 1936, the percentage of total Federal transfer tax liability, including both the estate and the gift tax, represented by credits claimed for taxes paid to States declined from 76 percent to 11 percent.

In their efforts to counteract the Federal Government's persistence to expel them from the field of property transfer taxation, States have resorted to the obvious - to the enactment of independent death and gift taxes - adding thereby to Federal-State conflict. That no attempt has previously been made by the Federal Government to rectify the situation is probably due in part to the fact that students of the problem have been inclined to exaggerate the remedial effects of the crediting device and to underestimate the extent of existing conflict. It is generally held by Shultz, Lutz, Walradt and others that the crediting device has served to bring death taxes in the various States in close conformity with each other and with those levied by the Federal Government, with the result that the total imposition upon any estate is largely limited to the amount computed under Federal rates. It may therefore be well to concern ourselves first with the extent of existing interstate variations with respect to the taxation of property transfers. An examination of the pertinent data will reveal that the optimistic generalizations of the type referred to are not substantiated by the facts.

Interstate
Variations

TYPES OF STATE TRANSFER TAXES

July 1, 1937



3. Interstate Variations in Death Taxation

The extent to which the crediting provision has failed to eliminate interstate variations in estate and inheritance taxation is remarkable, particularly in view of the widely accepted notion that it has fulfilled its function. In many respects there is probably as wide a diversity in State death duties today as prior to the adoption of the crediting provision by the Federal Government in 1924.

(A) Types of Death Taxes

In the first place, there is no uniformity in the types of death duties imposed by States (page 54). Despite the recommendation of the National Conference on Estate and Inheritance Taxation in 1925 that the States adopt the estate tax form of levy, progress in that direction has been comparatively slow. Seven States impose only inheritance taxes. Twenty-nine impose inheritance taxes together with differential estate taxes designed to absorb the maximum credit provided by the Federal Revenue Act of 1926. In some of these the differential levies are inoperative because the State inheritance taxes alone are in excess of 80 percent of the 1926 Federal schedule. Three States levy estate taxes entirely independent of, and in no way corresponding to, the Federal estate tax. Three follow the Federal estate tax in every detail, providing specifically that the amount of the State Tax shall be equal to 80 percent of the tax imposed by Title III of the Federal Revenue Act of 1926. Two States follow the Federal law except that variations therefrom are made in the specific exemption provided or in the rates imposed. One State combines an independent estate tax with a differential estate tax; another an inheritance tax with an independent estate tax, the latter apportioned among the beneficiaries; and a third combines an inheritance tax with both an independent and a differential estate tax. One State levies no death duty at all. Greater diversity is hardly conceivable.

(B) Definition of Gross Estate

Secondly, there remain wide variations among the States with respect to the definition of gross estate for tax purposes. Seven States follow the community property concept and, with minor variations, include in the gross estate at the time of the husband's death only half of his community property. The other forty States that levy death taxes include in the gross estate subject to the tax at the death of the husband all of the property acquired by him during marriage.

Further variations exist with respect to valuation of estates. Five States depend in the main upon the locally assessed values. Four give considerable weight to the locally assessed value, but use other standards of measurement as well. Four accept the valuation placed upon the property by the Federal Government. The remainder of the

States attempt to arrive at the "fair market value" of an estate by taking an average of a number of determinants such as bona fide sale, opinions of local real estate men, opinions of adjacent landholders, capitalization of the income from the property, purchase price, sales of similar property and value of property similarly situated. It may readily be appreciated, therefore, that the appraisal for tax purposes of two properties, located in neighboring States and having identical actual values, may be affixed at two widely divergent points.

A still further factor tending to increase interstate variation in valuation is the practice followed in the various States with respect to the date of valuation. Three States fix the date of valuation as of one year from the date of decedent's death, or at the date of distribution, should it occur before the expiration of one year. Two States follow the present Federal law in allowing the executor an option as to the date of valuation - fixing the value either as of the date of death or as of one year from the date of death. The remaining forty-two States levying death duties affix the value as of the date of death. This variance as to the date at which the value is fixed introduces the time factor as another variable in the determination of the gross estate, which acquires particular significance and makes for interstate variations in times of changing prices.

(C) Definition of Net Estate

The third variation is to be found in definitions attached to net estate in the various States. The deductions allowable from the gross estate in the determination of the net estate vary. Thus, the items generally allowed as deductions are funeral expenses, administration expenses, claims against the estate and an allowance for maintenance of the widow and children during the settlement. In some States limitations are placed upon the amount allowable as deductions. In others, a reasonable amount is allowed. In still others, the amount that may be claimed, if proved, is unlimited. An allowance for the value of the homestead is allowed in approximately ten States. Twenty-four States allow the amount of the estate tax paid to the Federal Government to be deducted. Twenty-four States allow no deduction for death duties paid to other States; twenty-three allow either a full or a partial deduction on that score. Eighteen States allow a deduction of property previously taxed from the gross estate in determining the net estate subject to tax. The pattern, to say the least, is heterogeneous.

(D) Treatment of Life Insurance

The Federal estate tax exempts the first $40,000 of insurance payable to specified beneficiaries other than the executor, under policies taken out by the decedent upon his own life. All other life insurance is taxable under the Federal law.

The treatment of life insurance in the death tax laws of the various States ranges from virtually complete exemption to complete taxation. At one extreme is Arkansas, which exempts all insurance payable directly or passing through the estate to direct descendants, ascendants and widows. At the other extreme is Wisconsin, which taxes all insurance. One group of twenty-seven States, including Massachusetts, New Jersey, and Pennsylvania, exempts insurance payable to named beneficiaries and taxes insurance payable to the estate of the decedent. Nine States tax insurance payable to the estate, exempting only limited amounts of insurance payable to specified beneficiaries. These limited amounts range from $10,000 in Kentucky to $75,000 in Colorado. New York and Tennessee combine the taxability of insurance payable to estates with a qualified exemption of insurance payable to named beneficiaries. Montana, Washington and the Carolinas restrict taxability to specified types of heirs. Kansas exempts insurance payable to named beneficiaries as well as insurance payable to the estate, except when such insurance is distributed from the proceeds of the estate to beneficiaries whose total share exceeds their respective specific exemption. Idaho and Vermont statutes do not touch upon the point, but the general indications are that insurance payable to the estate is taxable but insurance payable to the named beneficiaries is exempt.

Thus, it will be readily seen that the State death tax laws respecting insurance depart not only from the Federal practice but vary also from State to State. National uniformity is non-existent.

(E) Amount of Specific Exemptions

The fifth type of variation is that which concerns specific exemptions allowed in the various States. The type of the exemption, its amount, and the manner in which it is taken, have each their own complex patterns. In Maryland, Massachusetts, and to a limited extent in New Jersey, the exemption is conditional, disappearing entirely when the size of the legacy exceeds the amount of the exemption. Kentucky and West Virginia employ the vanishing type of exemption. The remainder of the States levying death duties use the constant type of exemption. As to the manner of taking the exemption, twenty States specifically provide that the exemption be deducted from the first bracket, twenty-one permit the exemption to be taken from the last or highest bracket. As to the amount of the exemption, that allowed a widow does not exceed $10,000 in twenty-two of the States, ranges from $10,000 to $25,000 in fourteen States, between $25,000 and $40,000 in two States, and in excess of $40,000 in seven States. With respect to other categories of heirs, the variations are no less marked.

(F) The Rate Structure

The sixth type of variation lies in the rate structures employed in the various States. Of the eleven States levying an estate tax type death duty, the rates of four (Alabama, Florida, Georgia, and Mississippi) are fixed at 80 percent of the rates imposed by Title III of the Federal Revenue Act of 1926. New York's rate structure is fixed at 100 percent (e.g., 25 percent above the maximum credit) of the 1926 Federal estate tax rate structure. North Dakota's rates range from 2 percent on net estates of less than $20,000 to 23 percent on net estates of more than $2,000,000. Oklahoma's rates range from 1 percent on the first $10,000 to 10 percent on estates above $10,000,000. Oregon's rates run from 1 percent on the first taxable $15,000 to 15 percent on estates in excess of $1,500,000. Arizona's rates range from 2 percent on the first $25,000 to 20 percent of the amount in excess of $5,000,000. Rhode Island levies a flat 1 percent rate on the value of the net estate in excess of $10,000, together with a graduated rate ranging from 1/4 percent on the value of the net estate in excess of $250,000 and not exceeding $300,000 to 14.92 percent on net estates in excess of $10,000,000. Utah's rates range from 3 percent on the first taxable $15,000 to 10 percent on estates in excess of $125,000. Thirty-eight States levy inheritance taxes either in addition to or in lieu of an estate tax. In each of these States the rates vary according to the relationship of the beneficiary to the decedent, and in all but three the rates are progressive. The lowest maximum rate applicable to the widow is Nebraska's 1 percent. The highest maximum rate applicable to the widow is 16 percent, levied by Kentucky on legacies of more than $2,000,000 and by New Jersey on legacies of more than $3,700,000. The maximum rates applicable to persons not relatives of the decedent range from but 6 percent in Wyoming to as much as 60 percent in Minnesota.

(G) Tax Burdens

As a result of all of the considerations noted above, wide interstate variations in tax burden still remain. The main purpose of the crediting provision of the Federal Revenue Act of 1926 was to equalize the tax burden of the death duties between the various States. It was desired that this be done in order to eliminate competition between States which, by reduction and even complete elimination of death duties, were bidding for wealthy residents. This competition was forcing State death duties into non-productivity at the time that the crediting provision was passed. Insofar as State-by-State variations in tax burden still remain, competition for wealthy residents has not been eliminated and the crediting provision has not achieved its ends.

To obtain comparable tax burden data for the entire country the Division of Research and Statistics of the Treasury Department submitted a questionnaire regarding twenty estates of varying size to the death tax administrators of the various States. Replies have thus far been tabulated from 28 States. These are summarized in the accompanying table. The questionnaire revealed that the effective rates of taxation range from zero to 1.5 percent on $10,000, $15,000 and $20,000 estates, from zero to 3.4 percent on $50,000 estates and from zero to 4.95 percent on $100,000 estates. In the case of estates in excess of $100,000, no less conspicuous variations remain, the crediting provision notwithstanding. Thus, the effective rates of taxation on $50,000, $5,000,000 and $50,000,000 estates range, respectively, from 1.38 percent to 8.89 percent, from 2.14 percent to 20.25 percent and from 2.16 percent to 22.73 percent. Data for the remaining twenty States are not likely to reveal lesser variations. Suffice it to observe that the crediting provision has far from equalized the death tax burdens imposed by the various States.

Effective rates of death taxes in selected States on estates of specified size
Computed on the basis of data secured by questionnaire to the several States
(Size of estates in thousands of dollars)

State	$10	$15	$20	$30	$40	$50	$65	$75	$100	$125	$150	$200	$250	$300	$400	$500	$1,000	$5,000	$10,000	$50,000
Alabama		-	-	-	-	-	-	-	-	.08	.19	.44	.72	.96	1.38	1.74	3.10	7.74	10.62	14.92
California	.28	.29	.30	.31	.31	.33	.38	.39	.47	.55	.66	.85	.98	1.09	1.26	1.38	2.45	4.71	5.26	8.52
Connecticut	.20	.34	.55	.75	.98	1.20	1.17	1.49	1.64	1.72	1.83	2.07	2.22	2.38	2.71	2.90	3.30	7.74	10.62	14.92
Delaware	.45	.52	.61	.72	.79	.83	.92	.98	1.07	1.13	1.22	1.40	1.52	1.65	1.89	2.06	3.10	7.74	10.62	14.92
Florida	-	-	-	-	-	-	-	-	-	.08	.19	.44	.72	.96	1.38	1.74	3.10	7.74	10.62	14.92
Georgia	-	-	-	-	-	-	-	-	-	.08	.19	.44	.72	.96	1.38	1.74	3.10	7.74	10.62	14.92
Illinois	.90	.93	.95	.97	.98	.98	1.17	1.25	1.49	1.69	1.86	2.20	2.52	2.76	3.15	3.52	5.42	12.14	13.51	13.81
Kentucky	.90	.90	.90	.98	1.25	1.53	1.90	2.09	2.69	3.15	3.61	4.28	4.75	5.17	5.80	6.30	7.90	11.80	13.51	15.48
Massachusetts	-	.88	.88	1.32	1.32	1.60	1.61	1.83	1.93	2.10	2.37	2.72	3.06	3.34	3.74	4.00	4.81	7.74	10.62	14.92
Michigan	.90	.90	.90	1.00	1.09	1.18	1.28	1.33	1.52	1.68	1.82	2.10	2.30	2.47	2.70	2.86	3.44	7.74	10.62	14.92
Mississippi	-	-	-	-	-	-	.10	.19	.32	.48	.71	.96	1.21	1.52	1.94	2.24	3.49	7.90	10.72	14.94
Missouri	.65	.70	.73	.83	.89	.97	1.02	1.05	1.09	1.16	1.19	1.32	1.58	1.76	2.29	2.62	3.48	7.74	10.62	14.92
Montana	1.10	1.33	1.50	1.67	1.75	1.90	2.14	2.33	2.65	2.94	3.27	3.73	4.12	4.72	5.51	6.11	8.01	10.56	10.88	14.92
Nebraska	.40	.40	.40	.40	.40	.45	.54	.58	.65	.77	.85	.97	1.08	1.15	1.38	1.74	3.10	7.74	10.62	14.92
New Hampshire	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.74	3.10	7.74	10.62	14.92
New Jersey	1.17	1.20	1.28	1.42	1.52	1.59	1.6[illegible]	1.69	1.74	1.77	1.82	1.93	2.02	2.12	2.31	2.53	3.40	7.74	10.62	14.92
New York	-	-	-	.15	.20	.25	.36	.43	.55	.62	.67	.88	1.16	1.42	1.89	2.29	3.88	9.68	13.27	18.65
North Carolina	1.08	1.08	1.12	1.23	1.38	1.46	1.60	1.71	1.93	2.16	2.35	2.67	2.93	3.37	3.53	3.72	4.90	7.74	10.62	14.92
North Dakota	.36	.30	.43	.61	.73	.80	1.17	1.49	2.28	2.90	3.43	4.37	5.12	5.93	6.95	7.77	11.05	20.25	21.63	22.73
Ohio	.61	.71	.81	1.10	1.28	1.38	1.48	1.53	1.99	1.80	1.90	2.03	2.14	2.23	2.14	2.58	3.15	7.74	10.62	14.92
Oklahoma	.08	.11	.13	.23	.55	.90	1.32	1.60	2.20	2.66	3.02	3.50	3.90	4.17	4.50	4.70	5.10	7.74	10.62	14.92
Oregon	.20	.70	.95	1.35	1.64	1.85	2.21	2.37	2.88	3.74	4.32	5.04	5.47	5.84	6.88	7.51	10.75	17.55	18.53	19.31
Rhode Island	-	.50	.75	1.00	1.13	1.20	1.28	1.33	1.43	1.51	1.59	1.71	1.82	1.89	2.00	2.07	3.10	7.74	10.62	14.92
Utah	-	1.00	1.50	2.33	3.00	3.40	3.85	3.93	4.95	5.56	6.30	7.23	7.78	8.15	8.61	8.89	9.45	9.89	9.94	9.99
Virginia	-	.14	.31	.58	.75	.87	.98	1.03	1.11	1.16	1.22	1.34	1.44	1.58	1.86	2.07	3.10	7.74	10.62	14.92
Washington	.50	.50	.50	.62	.73	.79	.87	.94	1.07	1.16	1.35	1.59	1.81	2.16	2.59	3.03	4.50	6.64	6.95	8.52
Wisconsin	1.02	1.28	1.46	1.77	1.78	1.98	2.20	2.39	2.69	2.97	3.29	3.75	4.14	4.73	5.52	6.12	8.01	11.56	10.62	14.92
Wyoming	.54	.54	.54	.54	.61	.79	1.00	1.10	1.30	1.47	1.59	1.73	1.82	1.87	1.95	1.99	2.07	2.14	2.15	2.16

(H) Dual Tax Administration

One of the serious deficiencies of the crediting device is its failure to eliminate dual administration. States are still required to maintain independent estate tax administrative organizations and taxpayers are still liable for the filing of both Federal and State death tax returns. Some degree of coordination has been achieved in eight States by requiring the filing of a duplicate of the Federal return. In three of these the State tax is computed on the basis of the Federal return and no additional State return is required. The remaining five require a duplicate of the Federal return in addition to the independent State return. Obviously the necessity for duplicate returns must remain as long as State taxes differ structurally from those imposed by the Federal Government.

(I) Further Interstate Variations

That the crediting device has not exerted as great an influence upon State taxation as is generally believed, may be deduced from a comparison of the amount of credits claimed for taxes paid to States against the Federal estate tax liability with the amount of inheritance and estate tax revenue collected by the States. If it is true that the crediting provision has had the effect of equalizing death taxes imposed by States, then the amount of credits claimed for taxes paid to States against the Federal estate tax liability under the 1926 Act should approximately equal 100 percent of State death tax collections. While the two series are not strictly comparable, they are sufficiently so to be of significance, particularly if the comparison is based on data for a number of years.

Ratio of State credit to State death tax collections, 1930-1936
Distribution of States by percentage intervals

Percentage intervals

Under 20		20 - 29.9		30 - 39.9		40 - 59.9		60 and over	
Utah	8.50	Wyoming	23.51	Arizona	30.14	Calif.	40.57	Maine	60.26
N. D.	10.53	N. H.	25.55	Oregon	30.73	Ky.	40.82	New York	63.87
Iowa	11.72	S. C.	25.63	Louisiana	33.15	Ohio	40.87	Michigan	64.49
S. D.	13.13	W. Va.	27.94	Pa.	33.86	Minn.	43.36	Miss.	73.85
Idaho	15.03	Wisc.	28.78	Ind.	34.22	N. C.	43.83	Georgia	74.59
N. M.	15.22	Tenn.	28.89	Washington	35.26	Delaware	45.49	Florida	91.34
Arkansas	17.55	Montana	29.22	Colorado	38.73	Ill.	45.64	Alabama	92.42
Kansas	17.56	Vermont	29.36	Missouri	39.10	Mass.	47.25		
				H. I.	39.30	Conn.	52.10		
				Nebraska	39.43	Md.	52.62		
						Okla.	54.31		
						Va.	54.37		
						N. J.	57.25		
						Texas	59.38		

A comparison of credits claimed against Federal taxes with State tax collections during the seven-year period 1930-1936 reveals a range from less than 10 percent in one State to 92 percent in another. In seven States credits claimed represent between 10 percent and 20 percent, in eight between 20 percent and 30 percent, in ten between 30 and 40 percent, in fourteen between 40 and 60 percent, and in seven over 60 percent of State death tax collections. For the nation as a whole, credits claimed represent less than 50 percent of State death tax collections. In other words, <u>States, instead of confining their taxes to 80 percent of the Federal schedule under the 1926 Federal Act, have in fact imposed taxes more than twice as high</u>.

A different approach to the evaluation of the present crediting provision is offered by an examination of the effectiveness of the differential estate taxes passed by the various States in order to take advantage of the available credit. Differential estate taxes, designed to absorb the difference between State death taxes and 80 percent of the Federal tax imposed under the 1926 Act are now on the statute books of thirty-one States. It has already been indicated that in no instance are these levies operative on net estates amounting to $100,000 or less. Detailed data available for nineteen of these thirty-one States reveal, furthermore, that the effectiveness of the differential levies is confined to comparatively few instances. In the case of two States, Kentucky and New York, they are never operative because the death taxes in these States amount to more than 80 percent of the Federal 1926 estate tax upon all estates including those amounting to $50,000,000. New York's rates are consistently 25 percent above the

Effective range of the differential estate tax in selected States computed on the basis of questionnaire submitted to the several States
(Value of estate in thousands of dollars)

State	Under 400	400	500	1,000	5,000	10,000	50,000
California							X
Connecticut					X	X	X
Delaware				X	X	X	X
Kentucky							
Massachusetts					X	X	X
Michigan					X	X	X
Missouri					X	X	X
Montana							X
Nebraska		X	X	X	X	X	X
New Hampshire			X	X	X	X	X
New Jersey					X	X	X
New York							
North Carolina					X	X	X
Ohio					X	X	X
Oklahoma					X	X	X
Rhode Island				X	X	X	X
Virginia				X	X	X	X
Washington					X	X	X
Wisconsin						X	X

maximum credit. Kentucky's rate structure begins with a $90 tax on $10,000 estates and reaches $3,931 on estates of $125,000, on which the State credit applicable to the Federal tax amounts to only $100. While the differential is gradually reduced as the size of the estate increases, Kentucky taxes are more than four times as large as the State credit on $400,000 estates and even on $50,000,000 estates amount to 104 percent of the State credit allowed against Federal tax liability under the 1926 Act. The crediting provision in this instance can thus be said to be wholly inoperative as an equalizer.

In the case of California and Montana, the differential levy becomes operative only on estates of $50,000,000; in nine States, on estates amounting to $5,000,000 or more; and in only one State on estates amounting to $400,000. In none of the nineteen States for which data are available is the differential levy operative on estates of less than $400,000. In other words, it is inoperative in the estate groups in which the majority of the estates fall. The net result is that tax burdens continue to vary between States. A field for interstate competition remains. The present crediting provision is not sufficiently broad in scope to promote interstate uniformity and equity.

Partly as a result of variations in tax burdens but primarily because of interstate variations in taxable wealth, the significance of death taxes in the revenue structures of the various States is in no sense uniform. In 1936 State death taxes, amounting to $113,793,000 accounted for 5.56 percent of all State tax collections.

State death tax collections as percentage of total
State tax collections, 1936
(Distribution of States by percentage intervals)

Under 1%		1% - 2%		2% - 3%		3% - 4%		4% - 9%		Over 9%	
Arizona	.30	N. Car.	1.01	Utah	2.16	Mich.	3.06	Vermont	4.01	Penn.	11.01
N. Mex.	.33	Ky.	1.04	Minn.	2.18	Ind.	3.08	N. Hamp.	4.23	Florida	11.37
Georgia	.38	Okla.	1.24	Va.	2.30	Iowa	3.21	Calif.	4.29	Mass.	12.41
Alabama	.43	Texas	1.26	Ohio	2.45	Oregon	3.30	Md.	5.25	N. J.	21.39
Ark.	.44	S. Car.	1.31	Kansas	2.55	Maine	3.69	Del.	5.86		
Idaho	.47	Wash.	1.63	Tenn.	2.96	Col.	3.78	Conn.	6.98		
Wyo.	.51	W. Va.	1.83	Ill.	2.97	Mo.	3.79	Wis.	7.90		
Miss.	.54							R. I.	8.11		
Montana	.71							N. Y.	8.29		
N. Dak.	.71										
S. Dak.	.72										
Nebraska	.76										
La.	.94										

In the case of individual States, their relative significance ranged from zero in Nevada and 0.30 percent in Arizona to 21.39 percent in New Jersey.* Death taxes produce less than 1 percent of the tax revenue in thirteen States, between 1 and 2 percent, 2 and 3 percent, 3 to 4 percent each in seven States, between 4 and 6 percent in five States, between 6 percent and 9 percent in four States, and over 9 percent in four States. They are of greatest relative significance in industrial States.#

In view of the existing variation in State taxation of property transfer, which, as has been observed above, permeates all aspects of State death taxes, the conclusion is inescapable that the crediting provision originally introduced in 1924 and subsequently expanded in 1926, is not in itself adequate for the elimination of interstate competition and Federal-State conflict in death taxation.

* It should be noted that New Jersey collections in 1936 were abnormally high as a result of the settlement of exceptionally large estates which approximately tripled normal annual death tax collections.

Florida's high position in 1936 is abnormal.

Coordination
Proposals

(4) Proposals for the Coordination of Federal and State Taxes on Property Transfers

The numerous proposals which have been advanced during the past few years for the elimination of the conflict between Federal and State taxation of property transfers, fall into three general categories: (A) Separation of revenue sources, (B) modification of the crediting device, and (C) Federal-State integration.

In examining the relative merits of the various proposals, certain objectives must be kept in mind: (a) That any change in Federal-State relations does not unduly reduce Federal revenues; (b) that it increase substantially, or at least moderately, State revenues; (c) that it not be coercive upon the States; (d) that it be of a type which can go into effect gradually and not be conditional upon the enactment of specific kind of legislation in all of the States; (e) that it disturb as little as possible the death tax legislation now on the books of the States, inspired in part by the Federal Government's crediting device; and (f) that it minimize as far as possible the need for dual administration on the part of fiscal authorities and dual compliance on the part of taxpayers.

(A) Separation of Sources

Those who advocate the separation of revenue sources between the Federal Government on the one hand and the States on the other, suggest two general plans: Either that the Federal Government or the States take over the entire death tax field, leaving the other similarly exclusive jurisdiction with reference to some other tax or that the death tax field itself be divided between the Federal Government and the States, the former taxing large estates and the latter small estates.

The "separation of revenue sources" proposal has been advocated by the President. On January 14, 1932, while Governor of New York, he spoke as follows at the New York City Democratic Victory Dinner:

> The time has come for the 48 sovereignties which have created the federal machinery of government to say to Washington: Let us follow the original principle established in the Constitution in 1787: That the states give to the federal government certain specific powers and reserve to themselves all other powers. Apply that to the great problem of taxation. We, the 48 sovereignties, must say to each other and to the federal government, let us counsel together; let us establish for times of peace a definite apportionment of the whole field of taxation. To the federal government we will give adequate sources of taxation to meet the administrative needs of the federal government as a government of definite delegated powers. All other sources of taxation we, the states, reserve unto ourselves. When that is accomplished it will be possible for the state sovereignties to scan this reserved field of tax sources

and to determine which elements in that field can with propriety and justice be allocated as tax sources to local government - to cities and counties and villages and towns.

Furthermore, and of equal importance, by dividing and clarifying the tax sources of government, we shall lift from the backs of legitimate enterprise burdens which in many cases are unfair and inequitably distributed. I have an example immediately at hand. This very week I have recommended to the legislature of this State four sources of additional revenue, each one of them an increase in existing taxes. Neither I nor the legislature has any knowledge of whether the federal government a month or two hence may or may not impose taxes on precisely these same sources. In the same way, neither the legislature nor I can, until this uncertainty is cleared up, take any practical steps to turn over any of our own tax sources to the local government units to help them out in the conduct of their local affairs. Even if the state were to allocate new tax sources to the cities or counties or towns, the whole system could be destroyed over night by a sudden taxing of those same sources by Washington.

The President's statement was, no doubt, provoked by practical difficulties encountered in raising State revenues during his gubernatorial experience. It may also be conceded that separation of sources would eliminate dual administration and dual compliance. There are, however, obstacles not revealed by the President which bulk large in the path of such a proposal. The cooperation of the States which such a procedure involves could not readily be obtained and would certainly be time consuming.

Even more serious is the difficulty which would be encountered in the correlation of the distribution of revenue sources with the allocation of governmental functions. On this point Haig stated:

> If the taxes were assigned to those jurisdictions which can best administer them with no provision for transfers of part of the yield, and if the functions of government in general were distributed by the same test of efficiency, it is almost inconceivable that the resulting patterns of costs and revenues would be even approximately identical. If, by some freak of fortune, they should chance to be so at a given moment, changes either in governmental functions or the conditions which govern efficiency in administration would immediately destroy the identity. As a practical matter, either efficiency in the administration of taxes or efficiency in the performance of other governmental functions would have to be sacrificed on the altar of the balanced budget. This difficulty is not an

imaginary one. The experience with the device of separation of sources in such states as California brilliantly illuminates the point. The task of making a federal-state plan of separation flexible and adaptable to constantly changing conditions is substantially more difficult than the corresponding task in the state and local sphere (N. T. A. Proceedings, 1932, page 229).

These considerations prompt the conclusion that the "separation of sources" idea in itself offers little opportunity for the solution of the problem of conflicting taxation. Accordingly, in the following section attention is directed to other possible methods of coordination.

(B) Modification of Crediting Device

The proposals for the modification of the present crediting provision have been generally prompted by the conviction that the amount of revenue currently derived by States from death taxes is insufficient. Accordingly, Walradt recommends that the amount of credit for State taxes be increased from 80 to 85 or 90 percent of the tax liability under the 1926 Act. Haig, on the other hand, recommended that the 80 percent credit for State death taxes be applied to the entire yield of the Federal estate tax, not merely to that portion of it collected under the 1926 Revenue Act. Others have urged an expansion of the crediting provision to the gift tax.

All of these proposals, it will be observed, would apply a flat credit against Federal estate tax liability on all estates irrespective of size. As an alternative the Commission on Conflicting Taxation suggests that administrative, economic and fiscal considerations point to the desirability of allotting to the States a larger share of the revenue from small estates than from large estates. The contention is supported by the fact that small estates can be more easily assessed by States, that large estates are in the main accumulated and invested in interstate enterprise making them national in character, and that State taxation of occasional large estates produces unpredictable fluctuations in revenues. Accordingly, it has been suggested that the crediting plan be graduated giving the States the greater part of the tax on estates under $200,000 and allow the Federal Government to retain most of the tax levied on that part of estates in excess of $1,000,000. A graduated scale of credits has also been urged by the New York State Commission for the Revision of Tax Laws, which recommended a scale of graduation with seven brackets, permitting a credit of 80 percent on estates up to $150,000 and declining to 20 percent on estates above $10,000,000. In the interest of simplicity, J. W. Martin, now Commissioner of Revenue for the State of Kentucky, suggests the use of three brackets, 75 percent credit on the first $100,000, 50 percent on that part of all estates between $100,000 and $1,000,000, and 25 percent on that part of estates above $1,000,000.

In reference to all of these proposals, it should be observed that no modification of the crediting provision can eliminate the necessity for dual administration and, in most cases, dual compliance on the part of taxpayers. In addition, any modification of the crediting provision would interfere with State legislation which was designed to secure advantage of the 80 percent credit now available under the 1926 act. This, it should be observed, is a significant consideration because twenty-two State laws designed to absorb the credit permitted against Federal taxes, are specifically stated in terms of 80 percent of the 1926 Federal levy. Thus, a change in the amount of the credit would automatically invalidate all of these State statutes and call forth a full complement of others. Furthermore, the extension of the crediting device to the gift tax would force upon the States the prompt enactment of State gift taxes, adding thereby to problems of administration and tax compliance. On the other hand, the probability of loss of Federal revenue need not unduly concern us here, since, as pointed out in the preceding Parts I and II, numerous opportunities are available for the revision of the Federal estate and gift tax which are adequate to compensate for any loss of Federal revenue that may result from a minor modification of the crediting device.

(C) Federal-State Integration

The third category of proposals would integrate Federal and State death taxes. These are of a wide variety. At one extreme is the proposal that death taxes be administered by the States and that the Federal Government be permitted to requisition these States for such funds as it requires. This, it will be recognized, is the discredited method of the old Confederation. More frequently, it is suggested that death taxes be administered by the Federal Government with one of the following conditions: (1) with State-sharing in the revenue, (2) with Federal grants-in-aid to the States, (3) with individual State additions to the Federal levy, both to be Federally administered, or (4) with the retention of all of the revenue by the Federal Government together with Federal assumption of responsibility for the financing of some function now financed by the States. With respect to these proposals, it should be observed that all but the one designated as (3) could become operative only after appropriate action has been taken by all States. They would be inoperative, in other words, so long as a single State stayed off the "band wagon." The coercion involved would be particularly distasteful because States have been inclined to view death taxation as their own rather than the Federal Government's prerogative. With respect to number (3), dealing with Federally-administered State additions to the Federal levy, it is concluded that the wide latitude it affords the several States, particularly in the event of its piecemeal adoption, is likely to enhance rather than reduce interstate conflict.

Recommended
Proposal

(5) Recommended Procedure for the Coordination of Federal and State Death Taxes

While none of the proposals considered above can individually solve the problem of Federal-State conflict in the field of death taxation, a combination of two of the methods appears workable. Specifically, it is suggested that an attempt be made to eliminate the existing conflict in death taxation by a combination of the present crediting device with a Federally-administered locally-shared system of death taxation. This can be achieved by providing an option as follows: Those States which continue to levy their own inheritance and estate taxes may continue to take advantage of the 80 percent credit allowed against Federal taxes under the 1926 Act. Those States, on the other hand, which will abolish their own death taxes may receive in lieu of the estate tax credit a fixed proportion, say 25 percent, of Federal estate and gift tax collections in their individual States. Since it is desired to encourage discontinuance of State taxes upon property transfers to eliminate dual administration and dual tax compliance, the revenue allocated the majority of the States under the second of the options should be substantially greater than that accruing to them under the operation of the crediting provision and should in fact be as great as that which they now derive from death taxes.

The adoption of this optional arrangement is believed to possess numerous advantages. In the first place, it provides a gradual transition from the existing situation and can therefore go into operation immediately and need not be postponed until such time as appropriate legislative action has been taken by all of the States. Secondly, the arrangement is in no sense coercive upon the States, but will obviously be attractive to the States. Thirdly, it will eliminate the necessity of separate State administration and dual estate tax compliance without loss of State revenue. Fourthly, it will necessitate no new State legislation, either in estate or gift taxation, but rather will produce a gradual repeal of existing legislation.

Furthermore, the proposed coordinating device would contribute to the solution of the problem of State jurisdiction with respect to death taxation. While the jurisdictional problems arising in connection with the administration of State death taxes have been greatly simplified during the past few years as a result of such Supreme Court decisions as that in the First National Bank of Boston vs. Maine, 284 U. S. 312, uncertainty and conflict still remain. In general, transfers of real estate are taxable by the State in which the property is located and tangible property is taxable at the place where it has an actual situs at the time of the owner's death. Intangible property is taxable by the State in which the decedent had his residence, unless it has acquired a business situs elsewhere. However, the question of business situs for intangibles is still unsettled. Furthermore, domicile with reference to intangibles is subject to State sovereignty. In consequence, variations exist producing undesirable double taxation. The Dorrance estate is a recent case in point. Because of the lack of coordination Pennsylvania and New Jersey, counter-claimants as to Dorrance's domicile, were able to collect, the one $17,000,000 and the other $15,620,800 from the same estate, both admitting at the same time that logically a man can be a domiciliary resident of but one State. Nevertheless, it appears that a man for tax purposes can be held to possess domicile in two or more States. This jurisdictional problem would be eliminated were the Federal Government the sole agency levying a death duty in the United States as is in fact here recommended. The problem would then resolve itself into one of distribution to be determined by fair and impartial rules of domicile, rules which would not be subject to interstate conflict but rather to the impartial scrutiny of the Federal Government.

Cognizance should also be taken of the fact that the coordination of the Federal and State taxes on property transfers as here proposed would greatly enhance general acceptability of the contemplated revisions of the Federal estate and gift taxes themselves. The realization that in revising these two Federal taxes provision has been made for the gradual elimination of the corresponding State levies with their added inconvenience and burden, and for their replacement by a diversion of some of the Federal revenue to the States, would be certain to result in wide public support.

Finally, the proposed arrangement will provide for a gradual simplification of the Federal estate tax structure itself. The computation of present Federal estate tax liability is excessively cumbersome involving two rate schedules, one enacted in 1926, the other in 1935. Since the first of these serves only the purpose of determining the maximum amount of credit which may be claimed for taxes paid to the States, the need for its existence will gradually diminish as the various States abolish their own death taxes in order to qualify for State sharing of Federal revenue.

From the point of view of the Federal Government, the disadvantage of the proposal lies in the fact that it will serve to transfer some revenue to the States which otherwise could be retained for Federal purposes. For that reason steps taken in the direction of Federal-State coordination must be accompanied with a structural revision of the estate tax and a coordination of the estate and the gift tax. In this connection it may be pointed out that the revisions recommended in the two foregoing sections will be more than adequate to compensate for the increase in the amount of revenue which would be diverted to the States.

States are now deriving approximately $100,000,000 a year from death taxes. Thus, the amounts diverted to them under the proposed arrangement would at least have to equal that amount. In reality it would have to be substantially higher, partly because it will have to be demonstrated that financially the States stand to benefit from the second option and partly because the amounts set aside for State sharing will have to be high enough to attract most of those States which now impose especially high taxes of their own. That will automatically increase the sums allocated to all of the other States. It should be observed, however, that the amount which will be diverted to the States under the proposed arrangement will not represent a net reduction from Federal revenue because part of it is already deducted in the form of credits against Federal taxes for taxes paid to States. In 1936 such deductions amounted to $44,000,000. In a sense, too, the funds transferred to the States will have been derived from those revisions of the Federal taxes themselves which were in part made possible by the fact that they will enable the elimination of overlapping State transfer taxes. Furthermore, whether the proportion of estate and gift tax collections diverted to the States should be placed at 25 percent, or at some other figure, cannot be determined until the exact revisions of both taxes are definitely decided upon and the revenue significance of those revisions fully analyzed.

It may be expected that there will be some reluctance on the part of the States to cede their prerogatives respecting property transfer taxation to the Federal Government. It will be recalled that the States are wont to look upon this field of taxation as their preempted field; a view which, by its enactment of the crediting device, the Federal Government has itself indirectly sanctioned.

There are other considerations, however, which are certain to weigh more heavily with the States than theoretical prerogatives. First of all, the States realize that the problem of conflicting Federal-State taxation is largely their problem; that it is of secondary revenue significance to the Federal Government. Accordingly, they are prepared to promote any equitable device leading to the elimination of conflict. Secondly, the proposed device will eliminate interstate competition which the States full well realize has on previous occasions greatly deprived their inheritance and estate taxes of productivity. Thirdly, the proposed device will add substantially to the transfer tax revenues of most of the States. This is particularly true with those States which, because of their smallness, are incapable of imposing an effective property transfer tax. In the case of the three or four extreme States, no attempt need be made to equal present revenues, partly because these are the States which are most eager to eliminate conflict and will therefore acquiesce to a minor revenue loss, and partly because the acceptance of the device by the other forty-four States will leave the remaining few little, if any, alternative. Furthermore, these extreme States are precisely those which are most sensitive to interstate competition and the possibilities of wealth migration.

On the other hand, the States will require some assurance that the proposed arrangement is moderately permanent. The Federal Government, however, should be prepared to give such assurance since it is here concerned with a tax ideally qualified for permanent and stable position in the Federal tax structure. Property transfer taxes affect accumulations spread over a lifetime and should therefore be stable. The estate of a person dying when rates are temporarily high is severely penalized in comparison with an estate taxable at some other time. The inequity is especially great because the property transfer tax is not levied annually but only once, at the time of death. Stable transfer tax rates not only promote equity but tend to encourage and enable property owners to protect their estates by providing readily liquid assets sufficient for the payment of transfer taxes. Fluctuating levies encourage individuals to postpone the planning of property transfers in the hope that taxes may be reduced. These considerations should enable the Federal Government to assure the States of the stability of the proposed coordinating device, which together with the above enumerated factors will render the proposed coordinating device more than acceptable to them.

In conclusion, too much emphasis cannot be placed upon the necessity of making a start in the direction of Federal-State tax coordination. That the entire problem cannot be solved with one clear sweep goes without saying. It follows that attempts at solution should proceed tax by tax. Death taxes offer a good starting point, partly because of their wide use as sources of State revenue but primarily because they present an opportunity for adding substantially to State revenues without a corresponding loss of Federal revenue. The resulting good will would contribute immeasurably to the solution of the Federal-State conflict in the other fields of taxation.

Tables

Table 1
Federal Estate Tax: Changes in Rates and Exemptions

1. Rate structure										
Individual brackets (000 omitted)	Cumulative value of brackets (000 omitted)	September 8, 1916	March 3, 1917	October 4, 1917	February 24, 1919	June 2, 1924 1/	February 26, 1926	June 6, 1932	May 11, 1934	August 31, 1935
First $ 10	$ 10	1%	1.5%	2%	1%	1%	1%	1%	1%	2%
Next 10	20	1	1.5	2	1	1	1	2	2	4
Next 10	30	1	1.5	2	1	1	1	3	3	6
Next 10	40	1	1.5	2	1	1	1	4	4	8
Next 10	50	1	1.5	2	1	1	1	5	5	10
Next 20	70	2	3	4	2	2	2	7	7	12
Next 30	100	2	3	4	2	2	2	7	9	14
Next 100	200	2 - 3	3 - 4.5	4 - 6	2 - 3	3 - 4	3	9	12	17
Next 200	400	3 - 4	4.5 - 6	6 - 8	3 - 4	4 - 6	4	11	16	20
Next 200	600	4 - 5	6 - 7.5	8 - 10	4 - 6	6 - 9	5	13	19	23
Next 200	800	5	7.5	10	6 - 8	9 - 12	6	15	22	26
Next 200	1,000	5	7.5	10	8	12	7	17	25	29
Next 500	1,500	6	9	12	10	15	8	19	28	32
Next 500	2,000	6	9	12	12	18	9	21	31	35
Next 500	2,500	7	10.5	14	14	21	10	23	34	38
Next 500	3,000	7	10.5	14	14	21	11	25	37	41
Next 500	3,500	8	12	16	16	24	12	27	40	44
Next 500	4,000	8	12	16	16	24	13	29	43	47
Next 500	4,500	9	13.5	18	18	27	14	31	46	50
Next 500	5,000	9	13.5	18	18	27	14	33	48	53
Next 1,000	6,000	10	15	20	20	30	15	35	50	56
Next 1,000	7,000	10	15	20	20	30	16	37	52	59
Next 1,000	8,000	10	15	20	20	30	17	39	54	61
Next 1,000	9,000	10	15	22	22	35	18	41	56	63
Next 1,000	10,000	10	15	22	22	35	19	43	58	65
Next 10,000	20,000	10	15	25	25	40	20	45	60	67
Next 30,000	50,000	10	15	25	25	40	20	45	60	69
Over 50,000		10	15	25	25	40	20	45	60	70
2. Exemptions		$50,000	$50,000	$50,000	$50,000	$50,000	$100,000	$50,000	$50,000	$40,000

1/ These rates were retroactively reduced by Revenue Act of 1926 to the level of 1919 rates.

Sources: Statistics of Income for 1934; Revenue Act of 1935.

Federal, State
Collections

Table 2

Federal and State death and gift tax collections, 1915-1938

(In thousands of dollars)

	Federal		State	
	Collections	Percent of total taxes and customs	Collections	Percent of total tax revenue
1915	-	-	28,784	7.9
1916	-	-	30,748	8.4
1917	6,077	0.6	40,038	9.8
1918	47,453	1.2	41,432	9.0
1919	82,030	2.0	47,889	9.0
1920	103,636	1.8	64,647	9.2
1921	154,043	3.1	65,703	9.0
1922	133,419	3.9	70,503	8.2
1923	126,705	4.0	75,193	8.2
1924	102,967	3.1	83,697	8.2
1925	108,940*	3.5	91,171	8.2
1926	119,216*	3.5	96,052	7.6
1927	100,340	2.9	112,191	8.3
1928	60,087	1.8	132,599	8.8
1929	61,897	1.7	148,592	9.2
1930	64,770	1.8	180,794	10.1
1931	48,078	1.7	182,653	10.3
1932	47,422	2.5	143,746	8.8
1933	34,310	1.8	126,359	8.4
1934	113,138	3.8	92,240	5.3
1935	212,112	5.8	100,783	-
1936	378,840	9.7		-
1937 (est.)	273,900	5.5		
1938 (est.)	383,200	5.7		

	Federal	
	Estate tax	Gift tax
1933	29,693	4,617
1934	103,985	9,153
1935	140,441	71,671
1936	218,781	160,059
1937 (est.)	249,000	24,900
1938 (est.)	358,200	25,000

* Includes gift tax collections amounting to $7,518,000 in 1925 and $3,175,000 in 1926.

Sources: (Secretary of the Treasury, Annual Report, 1936; Joint Committee on Internal Revenue Taxation, Federal and State Death Taxes, 1933; Dpt. of Commerce, Financial Statistics of States, 1931; National Industrial Conference Board, Cost of government in the United States, 1936; Treasury Dpt., Collections from Selected State-Imposed Taxes, 1936.

Table 3

The Federal estate tax: Summary data showing number of taxable returns, gross and net estate, and tax liability

(Amounts in thousands of dollars)

Year of filing	Taxable returns			Total tax before credit			Net tax after credit		
	Number	Gross estate	Net estate	Total	Under 1926 Act	Under 1932 Act as amended	Total	Under 1926 Act	Under 1932 Act as amended
1925	10,642	2,689,972	1,621,008	96,930			86,223		
1926	10,470	3,150,664	1,951,969	138,057			101,324		
1927	6,961	2,850,985	1,735,840	100,532	82,906		40,931	27,344	
1928	6,116	3,181,719	1,943,429	135,014	134,769		40,561	40,351	
1929	6,758	3,566,208	2,268,323	165,414	165,335		43,303	43,232	
1930	7,028	3,808,324	2,376,973	152,391	152,391		39,003	39,003	
1931	6,364	3,717,069	2,327,319	182,202	182,202		44,540	44,540	
1932	5,104	2,447,095	1,391,569	84,006	84,006		22,364	22,364	
1933	6,464	1,751,870	798,246	87,725	36,471	51,254	59,429	8,175	51,254
1934	7,981	2,025,412	882,712	129,150	43,693	85,457	95,228	9,771	85,457
1935	8,655	2,197,941	1,027,774	197,672	56,281	141,391	152,753	12,363	141,391

Source: United States Treasury Department, Statistics of Income, 1924-1934.

State
Exemptions

Table 4

Specific exemptions afforded by State death taxes 1/
(as of February 1, 1937)

$75,000 and over		$50,000 - $75,000		$25,000 - $50,000		Less than $25,000	
Alabama	$100,000	Illinois	$60,000	California	$41,000	Arizona	$14,000
Florida	100,000	Iowa	70,000	Colorado	40,000	Arkansas	12,000
Georgia	100,000	Mississippi	50,000	Delaware	26,000	Connecticut	10,000
Kansas	105,000*			Kentucky 2/	25,000	Idaho	24,000
New Hampshire	all*			Maine	30,000	Indiana	22,000
Rhode Island	75,000			Massachusetts 3/	30,000	Louisiana	15,000
Texas	75,000			Michigan	40,000	Maryland 3/	100
				Minnesota	30,000	Montana	21,500
				Missouri	30,000	New Jersey	15,000
				Nebraska	30,000	New Mexico	10,000
				New York	30,000	North Carolina	17,000
				North Dakota	27,000	Ohio	13,500
				South Dakota	30,000	Oklahoma	15,000
				Vermont	30,000	Oregon	10,000
				Washington	30,000	Pennsylvania	500
				West Virginia 2/	25,000	South Carolina	22,500
				Wyoming	30,000	Tennessee	10,000
						Utah	10,000
						Virginia	15,000
						Wisconsin	19,000

*These exemptions are in fact reduced to $100,000 through the operation of the differential estate tax designed to absorb the 80 percent credit for taxes paid to States provided by the 1926 Federal Estate Tax.

1/ It is assumed that there are three beneficiaries, a wife, a minor child, and an adult child.
2/ Vanishing exemption.
3/ Conditional exemption.

Source: Compiled on the basis of State statutes.

Table 5

Death tax exemptions in foreign countries 1/

Country	Type of tax	Amount of exemption 2/	Type of exemption
Canada			
Alberta	Succession duty	$ 1,000	Conditional
British Columbia	Succession duty	20,000	Continuous
Manitoba	Succession duty	25,000	Conditional
New Brunswick	Estate and succession duty	25,000	Conditional
Newfoundland	Estate duty	1,000	Conditional
Nova Scotia	Succession duty	25,000	Conditional
Ontario	Succession duty	25,000	Conditional
Prince Edward Island	Succession duty	5,000	Continuous
Quebec	Succession duty	15,000	Continuous
Saskatchewan	Succession duty	15,000	Conditional
Yukon	Succession duty	10,000	Conditional
Germany	Inheritance tax	12,000	Complete exemption in case children are living or have died in action during the World War or for National Socialist Cause
Australia	Estate duty	4,000	Continuous
Norway	Inheritance tax	1,233	Continuous
Great Britain	Estate duty	487	Conditional
Austria	Estate duty	468	Continuous
Denmark	Inheritance tax	438	Continuous
Italy	Succession duty	158	Complete exemption in case two or more children are living
France	Inheritance tax	None	-
Finland	Inheritance tax	None	-
Netherlands	Inheritance tax	None	-
Sweden	Inheritance tax	None	-
Spain	Inheritance tax	All	-
South Africa	Estate duty	All	-

1/ In case of inheritance taxes, it is assumed that the entire estate passes to the spouse.
2/ Converted at current rate of exchange.
Sources: Data for Canada compiled on the basis of CCH, Inheritance, Estate and gift tax service, 1937: Data for other countries compiled from foreign statutes, year books, commission reports and CCH, Tax Systems of the World, 1936.

Table 6

State death taxes: Method of taking exemptions
(As of February 1, 1937)

1. States in which continuous exemptions are deducted from the __first__ bracket:

Arizona	Louisiana	Ohio	Texas
California	Michigan	Oregon	Utah
Connecticut	Minnesota	Rhode Island	Vermont
Delaware	Montana	South Dakota	Virginia
Indiana	New Jersey	Tennessee	Wisconsin
	New York		

2. States in which continuous exemptions are deducted from the __last__ bracket:

Alabama	Idaho	Mississippi	North Dakota
Arkansas	Illinois	Missouri	Oklahoma
Colorado	Iowa	Nebraska	South Carolina
Florida	Kansas	New Mexico	Washington
Georgia	Maine	North Carolina	Wyoming

3. States which employ vanishing exemptions:

Kentucky
West Virginia

4. States which employ conditional exemptions:

Maryland
Massachusetts

5. New Hampshire allows full exemption to Class I beneficiaries but no exemption to Class II beneficiaries.

Pennsylvania allows partial exemption to widow or children and taxes the balance at a flat rate.

Source: Compiled on the basis of State statutes.

Table 7

Estate tax returns: Value of deductions on account of insurance

1931-1935
(Net estate classes and amounts in thousands of dollars)

Net estate classes	Year of filing					Total	Ratio of insurance exemption to gross estate 1/
	1931	1932	1933	1934	1935		
Not taxable under 1926 Act but taxable under subsequent acts	-	-	$11,094	$17,537	$18,017	$ 46,648	4.52%
Under $50	$ 9,601	$ 8,378	8,127	8,334	8,022	42,462	3.11
50 - 100	5,828	5,694	4,508	4,255	4,804	25,089	2.72
100 - 200	6,764	6,267	5,163	5,377	5,380	28,951	2.25
200 - 400	6,763	5,563	3,994	3,709	4,724	24,753	1.64
400 - 600	3,101	2,493	1,937	1,694	2,082	11,307	1.24
600 - 800	1,716	1,613	718	1,054	1,156	6,257	.97
800 - 1,000	1,819	802	722	416	638	4,397	.89
1,000 - 1,500	1,813	890	599	637	1,117	5,056	.62
1,500 - 2,000	767	377	252	248	387	2,031	.41
2,000 - 2,500	333	66	82	100	275	856	.23
2,500 - 3,000	439	250	80	120	41	930	.37
3,000 - 3,500	303	131	29	71	48	582	.29
3,500 - 4,000	161	74	-	101	117	453	.21
4,000 - 5,000	161	160	-	60	-	381	.16
5,000 - 6,000	101	25	7	-	40	173	.08
6,000 - 7,000	93	71	-	-	-	164	.10
7,000 - 8,000	80	-	40	32	37	189	.16
8,000 - 9,000	40	43	-	-	-	83	.07
9,000 - 10,000	-	-	-	-	-		
10,000 and over	182	40	-	-	25	247	.03
Total	40,065	32,937	37,352	43,745	46,910	201,009	1.66

1/ For statistics on gross estates see Table 3.

Source: Statistics of Income, 1930-1934.

Table 8

Estate tax returns: Value of deduction on account of charitable, public and similar bequests

1931 - 1935
(Net estate classes and amounts in thousands of dollars)

Net estate classes	Year of filing: 1931	1932	1933	1934	1935	Total	Ratio of charitable gifts to gross estate 1/
Not taxable under 1926 Act but taxable under subsequent acts	....	....	$ 9,862	$ 12,960	$16,825	$ 39,647	3.84%
Under $50	$ 13,863	$ 15,377	7,283	6,689	4,983	48,195	3.53
50 - 100	7,285	6,462	5,841	5,285	4,141	29,014	3.15
100 - 200	18,072	10,420	6,094	9,157	17,165	60,908	4.74
200 - 400	28,745	20,303	7,046	7,751	12,328	76,173	5.06
400 - 600	32,116	26,402	5,361	7,820	4,097	75,796	8.28
600 - 800	8,078	8,299	4,249	6,472	8,601	35,699	5.54
800 - 1,000	21,548	8,021	16,708	633	1,468	48,378	9.84
1,000 - 1,500	7,682	10,944	3,392	8,135	4,631	34,784	4.29
1,500 - 2,000	8,446	1,278	1,565	14,887	2,328	28,504	5.71
2,000 - 2,500	3,068	15,885	3,429	15,367	1,093	38,842	10.51
2,500 - 3,000	9,936	532	560	1,677	957	13,662	5.39
3,000 - 3,500	1,419	262	1,406	8,074	1,678	12,839	6.39
3,500 - 4,000	1,517	1,487	365	9,423	333	13,125	6.20
4,000 - 5,000	6,802	375	2,299	540	351	10,367	4.25
5,000 - 6,000	470	458	280	-	2,956	4,164	1.89
6,000 - 7,000	169	10,510	388	-	-	11,067	6.79
7,000 - 8,000	2,728	2,276	-	12,977	-	17,981	14.87
8,000 - 9,000	85	5,148	125	-	990	6,348	5.17
9,000 - 10,000	-	200	-	-	-	200	.62
10,000 and over	11,326	1,804	-	95	591	13,816	1.91
Total	183,355	146,443	76,253	127,942	85,516	619,509	5.10

1/ For statistics on gross estates, see Table 3.

Source: Statistics of Income, 1930-1934.

Table 7

Number of taxable estate tax returns filed, by net estate classes, for years 1927 to 1935

Net estate classes, before exemption (000 omitted)	Year filed								
	1927	1928	1929	1930	1931	1932	1933	1934	1935
Under $100	-	-	-	-	-	-	2,644	4,037	4,522
$100 - 150	2,690	2,184	2,288	2,258	2,154	1,869	1,485	1,567	1,624
150 - 200	1,232	1,026	1,189	1,236	1,112	893	729	714	696
200 - 300	1,259	1,067	1,132	1,235	1,100	899	688	686	713
300 - 500	837	884	998	1,006	908	701	467	450	534
500 - 700	350	326	414	425	353	267	172	198	201
700 - 900	181	167	221	257	198	147	83	109	112
900 - 1,100	105	110	137	132	110	86	63	53	63
1,100 - 1,600	135	136	149	190	178	99	57	86	86
1,600 - 2,100	55	67	79	98	86	49	29	26	33
2,100 - 2,600	26	44	41	57	43	22	18	19	16
2,600 - 3,100	19	23	29	35	26	17	6	8	15
3,100 - 3,600	15	19	12	13	19	10	5	5	11
3,600 - 4,100	16	11	14	16	14	9	2	12	8
4,100 - 5,100	8	16	14	28	18	9	8	5	5
5,100 - 6,100	12	12	10	8	13	7	4	1	7
6,100 - 7,100	8	7	7	7	8	7	1	-	3
7,100 - 8,100	1	3	3	7	4	2	1	3	2
8,100 - 9,100	2	4	3	4	2	4	2	-	2
9,100 - 10,100	3	2	2	1	1	1	-	-	-
10,100 and over	7	8	16	15	17	6	-	2	2
Total	6,961	6,116	6,758	7,028	6,364	5,104	6,464	7,981	8,655

Source: Compiled on the basis of Statistics of Income, 1926-1934.