

# Leveling the Playing Field between Inherited Income and Income from Work through an Inheritance Tax

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## Abstract

Despite our founding vision as a land of opportunity, the United States ranks at or near the bottom among high-income countries in economic equality and intergenerational mobility.<sup>1</sup> Our tax code plays a key role. Inherited income is taxed at less than one-seventh the average tax rate on income from work and savings. This chapter proposes a major step toward leveling the playing field by requiring wealthy heirs to pay income and payroll taxes on inheritances they receive above a large lifetime exemption. As part of this shift, the proposal would repeal the current estate and gift taxes and would tax accrued gains (beyond a threshold) on transferred assets at the time of transfer. It would also substantially reform the rules governing family-owned businesses, personal residences, and the timing and valuation of transfers through trusts and similar vehicles. The Urban-Brookings Tax Policy Center estimates the proposal would raise \$340 billion over the next decade if the lifetime exemption were \$2.5 million, and \$917 billion if it were \$1 million, relative to current law.

The proposal would almost exclusively burden the most affluent and most privileged heirs in society, while the additional revenues could be used to invest in those who are not as fortunate. As a result, the proposal would soften inequalities, strengthen mobility, and more equitably allocate taxes on inheritances among heirs. It would also enhance efficiency and growth by curtailing unproductive tax planning, increasing work among heirs, and reducing distortions to labor markets and capital allocation. Furthermore, the proposal is likely to increase public support for taxing inherited income. While the burdens of estate and inheritance taxes both largely fall on heirs, inheritance taxes are more self-evidently “silver spoon taxes” and appear to be more politically resilient as a result.

## Introduction

One of America's founding ideals is as a land of opportunity—a nation where one's financial success depends relatively little on the circumstances of one's birth. To be sure, we have had great failings in this regard. But equality of opportunity has remained a shared goal of liberals and conservatives alike.

Despite this founding vision, today the United States has one of the lowest levels of intergenerational economic mobility among high-income countries. While there are many drivers, our tax code plays a key role. Nowhere is this more evident than the taxation of wealth transfers. One child inheriting tens of millions of dollars while another inherits nothing is perhaps the paradigmatic example of unequal opportunities. But under current law recipients of large inheritances can exclude the entire amount they inherit from their tax returns. Meanwhile, those who live solely off their earnings rather than inheritances must pay both income and payroll taxes on everything they earn.

The estate tax and its cousins—the gift tax and the generation-skipping transfer tax—were meant to partially address this omission. But over time they have withered as Congress has repeatedly raised their exemptions and lowered their rates. In 2020 they are projected to raise \$16 billion, implying an average tax rate on inherited income of only 2 percent (appendix table 1, Urban-Brookings Tax Policy Center [TPC] 2018c; author's calculations). This is less than one-seventh the average tax rate on income from work and savings. Broadening economic opportunity will require many changes, but one vital reform is strengthening the taxation of inheritances.

This chapter proposes raising more revenues from large inheritances and fundamentally changing the way they are taxed. There would no longer be a separate wealth transfer tax system. Instead, taxation of inheritances would be integrated into the income and payroll taxes. A wealthy heir would simply pay income and payroll taxes on their large inheritances, just as a police officer or teacher does on their wages. The focal point for assigning tax burdens would shift from the amount the donor transfers to the amount heirs receive.

Specifically, the proposal would require heirs to include any inheritances they receive above a large lifetime exemption as ordinary income on their income tax returns. They would also have to pay payroll taxes (disregarding the Social Security maximum earnings threshold) on inheritances above this threshold, for which they would accumulate Social Security benefits up to the maximum benefit amount.

In addition, the proposal would partially repeal two provisions in the income tax—carryover basis and stepped-up basis—that, respectively, substantially reduce the tax due on accrued gains on gifted assets and completely eliminate it for bequeathed assets. Instead, such gains would be taxed at the time of transfer to the extent they are especially large. To address concerns about family-owned and -operated businesses and primary residences, the proposal would allow heirs to indefinitely defer any inheritance tax they owe (with interest) to the extent it could require them to sell such assets. Finally, the proposal would curtail tax avoidance through a suite of reforms to the rules governing the timing and valuation of transfers through trusts and similar vehicles.

The proposal would raise a large amount of revenue based on estimates by the Urban-Brookings Tax Policy Center (TPC). If the lifetime exemption were \$2.5 million, it would raise \$340 billion over the next decade. If the lifetime exemption were \$1 million, it would raise \$917 billion, and if it was \$500,000, the proposal would raise about \$1.4 trillion. These lifetime exemptions would limit the proposal's reach to those receiving exceptionally large inheritances—the top 0.02 percent, 0.08 percent, and 0.18 percent, respectively, when ranked by inheritance size. Moreover, the proposal would probably raise even more because TPC was not able to model several of its revenue-raising features. These funds could be used to invest in Americans who are less privileged, further mitigating unequal opportunities.

The proposal would take a large step toward leveling the playing field between income from inherited wealth and income from work, while also taxing similar inheritances in a more similar way. In doing so, it would soften inequalities and strengthen mobility. It would also enhance efficiency and growth by curtailing unproductive tax planning, increasing work among heirs, and reducing distortions to labor markets and capital allocation.

A further benefit of the proposal is that it would also more equitably allocate taxes on inheritances among heirs. At an aggregate level, the economic burden of revenue-equivalent estate taxes and inheritance taxes is not very different. Both are largely borne by the most affluent and privileged heirs in society. This occurs because both have sharply progressive rate structures, and, on average, heirs of large estates receive large inheritances and are relatively high-income themselves. But this is not always the case: Some heirs of very large estates receive small inheritances and are not that well off. Some heirs of smaller estates have inherited a great deal over time and are very affluent. As a result, the inheritance tax proposed here would

allocate tax burdens much more precisely based on heirs' economic status than our current wealth transfer taxes do.

Finally, and perhaps most importantly, shifting to an inheritance tax is likely to increase public support for taxing inherited income because it would better align the public's understanding of wealth transfer taxes with their actual economic effects. Experts on both sides of the aisle agree that wealth transfer taxes are largely borne by heirs, and not by their benefactors, regardless of whether they are structured as estate or inheritance taxes (Batchelder and Khitatrakun 2008; Mankiw 2003). But the structure of an estate tax makes it easier for opponents to characterize it as a double tax on frugal, generous entrepreneurs who just want to take care of their families—even though nothing could be farther from the truth. Instead, the estate tax is the only tax that ensures wealthy heirs pay at least some tax on large amounts of inherited income, even if at much lower average rates than apply to income from good, old hard work. Nevertheless, inheritance taxes are more self-evidently “silver spoon taxes” and, as a result, appear to be more politically resilient.

## The Challenge: Why Reform the Taxation of Inheritances?

In 2020 Americans are projected to inherit about \$765 billion in gifts and bequests (appendix table 1). This represents roughly 4 percent of annual household income (appendix table 1, TPC 2018a; author's calculations). This estimate excludes wealth transfers to spouses and transfers that support minor children. Beyond this annual flow, a large share of existing wealth was derived from inheritances. Inheritances represent about 40 percent of all wealth (Davies and Shorrocks 2000; Piketty and Zucman 2015; Wolff and Gittleman 2014).

The estate tax and its cousins—the gift tax and the generation-skipping transfer tax—are the only federal taxes that apply directly to inherited income. But those taxes are projected to raise only \$16 billion in 2020, implying an effective tax rate of 2 percent (appendix table 1; TPC 2018c; author's calculations). Expanding and reforming the taxation of inheritances would improve the fairness and efficiency of the fiscal system, spur growth, and reduce tax complexity and associated tax planning.

### **FAIRNESS**

The United States faces two related challenges that call for increasing the progressivity of our fiscal system overall, and specifically for

taxing inheritances more heavily: high economic inequality and low intergenerational mobility. Among high-income countries, the United States has the second-highest level of income inequality after taxes and transfers and the highest level of wealth inequality (Balestra and Tonkin 2018; Batchelder and Kamin 2019; Organisation for Economic Co-operation and Development [OECD] 2019a, 2019b). As a group, the top 1 percent receives more income than the bottom 40 percent and owns more wealth than the bottom 95 percent (Wolff 2017). Both income and wealth inequality are heavily skewed by race (Wolff 2018).

Despite our national mythos as a land of opportunity, the United States also has one of the lowest levels of intergenerational economic mobility. That is, relative to other countries, financial success in the United States depends heavily on the circumstances of one's birth. On average, a father in the United States passes on roughly one-half of his economic advantage or disadvantage to his son (Corak 2013).<sup>2</sup> Among other high-income countries, the comparable figure is typically about one-third, and in several countries it is one-fifth. There are even larger mobility barriers among some communities of color. Black men in particular have far less upward mobility and greater downward mobility than others, and to such a large extent that the current black–white income gap is not projected to change at all if these mobility dynamics persist (Chetty et al. 2018).

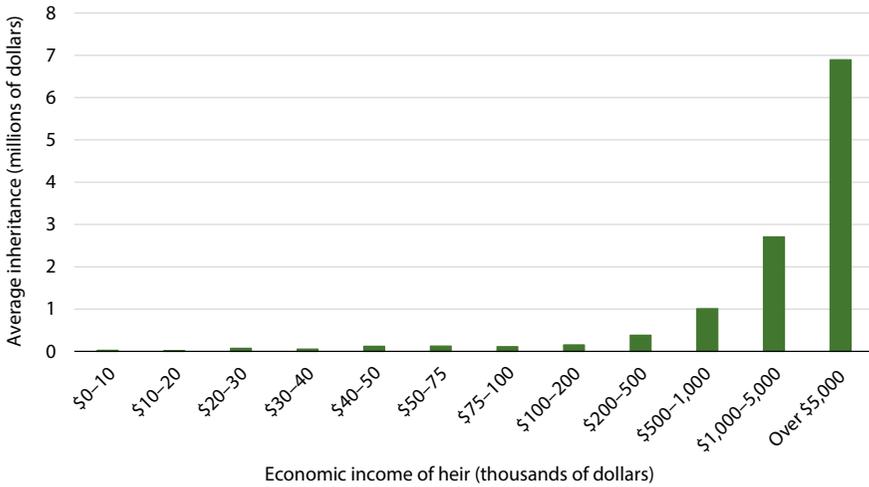
Inheritances exacerbate both these challenges. Among households receiving an inheritance in 2020, those with economic income over \$1 million are, on average, expected to inherit \$3 million, while those with economic income under \$50,000 are expected to inherit only \$62,000 (see figure 1; for further data, see appendix table 2).<sup>3</sup> Inheritances thus increase within-generation inequality on an absolute basis, conferring much larger benefits on high-income families than on low-income families.<sup>4</sup>

Inheritances also magnify wealth disparities by race. White households are twice as likely as black households to receive an inheritance. Moreover, receipt of an inheritance is associated with a \$104,000 increase in median wealth among white families, but only a \$4,000 increase among black families (Thompson and Suarez 2015).

Inheritances have even-more-dramatic effects on intergenerational mobility, substantially increasing the degree to which a child's economic future is determined by the luck of their birth. Indeed, by some estimates, financial inheritances are a more important predictor of a child's future earnings than are the child's IQ, personality, and education *combined* (Bowles, Gintis, and Groves 2005).

FIGURE 1.

## Average Inheritance Received by Economic Income Group among 2020 Heirs



Source: Appendix table 2.

Note: Economic income is expanded cash income plus one-fifth of gifts and bequests received.

THE HAMILTON  
PROJECT  
BROOKINGS

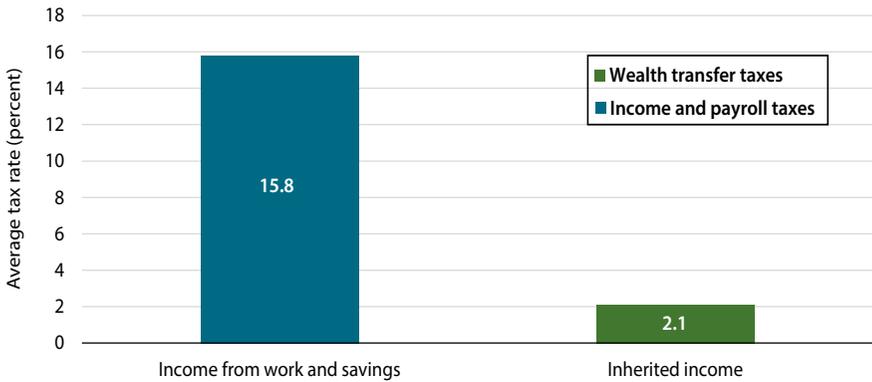
Given the degree to which inheritances drive inequality in economic opportunities, one would think tax policy would try to ameliorate their effects. But current law does very little in this regard. For example, if a wealthy individual bequeaths assets with \$10 million in unrealized gains, neither the donor nor the heir ever has to pay income or payroll tax on that \$10 million gain because of a provision called stepped-up basis. In addition, inherited income is excluded from the income and payroll tax bases. That is, beneficiaries of large inheritances are never liable for income or payroll tax on the value of inheritances they receive—regardless of whether the inheritances are attributable to unrealized gains.<sup>5</sup>

Some argue that any income or payroll tax previously paid by a wealthy donor on assets they gift or bequeath should count as taxes paid by the heir. But the donor and heir are two separate people. When a wealthy individual pays their personal assistant's wages out of after-tax funds, we do not think the assistant has therefore paid tax on their own wages. Likewise, a wealthy heir has not paid tax on their inherited income just because their benefactor paid tax on their income that was used to fund the inheritance.

Others argue that only money earned in exchange for goods and services should be subject to income tax. But the income tax does, and should, be levied on all forms of income that increase one's ability to pay, like winning the lottery (which is, after all, not so different from inheriting wealth).

FIGURE 2.

## Average Tax Rates on Income from Work and Savings vs. Inherited Income



Sources: Appendix table 1; TPC 2018b, 2018c; author's calculations.

Note: Estimate for inherited income is for 2020. Estimate for income from work and savings is for 2019. Both estimates include the individual income tax, the employee and employer shares of the payroll tax, and wealth transfer taxes (the estate tax, gift tax, and generation-skipping transfer taxes). However, inherited income is not currently subject to income and payroll taxes, and income from work and savings is not subject to wealth transfer taxes.



The estate tax and its cousins were meant to partially address these inadequacies of the income and payroll taxes, which would otherwise leave inherited income to be effectively taxed at a zero rate. Importantly, bipartisan experts agree that the heirs of large estates, and not their benefactors, largely bear the burden of wealth transfer taxes (Batchelder and Khitatrakun 2008; Mankiw 2003).<sup>6</sup> As such, those are the only taxes on inherited income.

But the exemptions in our current wealth transfer taxes are so large (\$23.2 million per couple in 2020) and the base so porous that income in the form of inheritances is taxed at an average rate of only 2 percent, as illustrated in figure 2. This rate is less than one-seventh of the average tax rate—levied in the form of income and payroll taxes—on income from work and savings.

In a fairer system, income from large inheritances would actually be taxed at a higher rate than income from work. Recipients of large inheritances are better off than people who earn the same amount of money by working because heirs incur no opportunity cost: They have not had to give up any leisure or earning opportunities in order to receive their inheritance. All else equal, therefore, fairness demands that heirs pay more taxes on the same amount of income, not less.

But all else is not equal. Recipients of large inheritances also typically benefit from a huge leg up in life in other ways that mean they can earn relatively more if they choose to work. Wealthy heirs generally have access to the best education, valuable social networks, easy and inexpensive access to credit, and a safety net that protects them if they take risks that do not pan out. These advantages further strengthen the case for taxing inheritances at a higher rate than income from work.

Increasing the progressivity of income and payroll taxes could substantially reduce inequality and broaden opportunity. Indeed, cross-country analysis finds that within-generation income and wealth inequality are associated with less economic mobility across generations (Corak 2013). Yet this approach would be insufficient without stronger taxes on inheritances specifically. More progressive income and payroll taxes cannot ensure that large inheritances are taxed at similar or higher rates than wage income as long as inheritances are excluded from their tax bases.

## **EFFICIENCY AND ECONOMIC GROWTH**

The relatively light taxation of income in the form of inheritances compared to income from work and savings also reduces the efficiency of the tax system and impedes growth. Indeed, several studies estimate that, when one combines efficiency and fairness concerns, the optimal tax rate on large inheritances is far higher than current law—on the order of 60 to 80 percent (Batchelder 2009; Piketty and Saez 2013a).<sup>7</sup> The optimal top tax rate on other forms of income is also much higher than current law (for a review, see Piketty and Saez 2013b). But increasing taxes on large inheritances may nevertheless be more efficient than comparably progressive increases to income taxes.<sup>8</sup>

To understand why, it is important to distinguish the different reasons why people with very large estates might have saved. It is an article of faith among estate tax opponents that wealth transfer taxes harm the economy because they sharply reduce working and saving among very wealthy individuals. But for this harm to occur, the working and saving decisions of wealthy donors must be heavily influenced by the amount their heirs will receive after tax. In fact, a large body of empirical research finds this is not the case. Instead, the amount that the affluent accumulate for wealth transfers is relatively unresponsive to the wealth transfer tax rate (for reviews, see Batchelder 2009 and Kopczuk 2013).

People with very large estates typically have multiple reasons for saving: They might enjoy being wealthy relative to other people, with the prestige and power that it confers while they are alive (egoistic saving). They

could have saved to meet their projected needs in retirement, including unanticipated health expenses (life-cycle saving). They may have saved to be able to give to their children or others they care about (altruistic saving). And they might have saved to compensate the heir for services, such as taking care of them in old age (exchange-motivated saving). The empirical evidence to date suggests the first two motivations (and especially the first) are so strong among the very wealthy that they reduce their saving very little in response to high wealth transfer tax rates (for reviews, see Batchelder 2009, Joulfaian 2019, and Kopczuk 2013). Put differently, a lot of the reason why the wealthy save is to be wealthy while they are alive, which wealth transfer taxes do not affect. As a result, taxing large wealth transfers generates fewer economic distortions than many other kinds of comparably progressive taxes.

Moreover, there are several other efficiency- and growth-related reasons to tax large inheritances more heavily—and at rates comparable to or higher than tax rates on income from work and savings—that existing estimates of the optimal tax rate do not incorporate.

For one, any negative effects of wealth transfer taxes on the working and saving decisions of wealthy donors are at least partially offset by their positive effects on such decisions for the next generation. There is extensive evidence that wealth transfer taxes induce heirs to work and save more because they do not have as large an inheritance to live off (Brown, Coile, and Weisbenner 2010; Holtz-Eakin, Joulfaian, and Rosen 1993). This is what economists call an income effect. More working and saving by heirs grows the economy.

Wealth transfer taxes also tend to improve business productivity and therefore economic efficiency. Several studies have found that businesses run by heirs tend to perform worse because nepotism limits labor market competition for the best manager (e.g., Pérez-González 2006).

Furthermore, higher taxes on large inheritances can reduce labor market distortions in much broader ways. In earlier times, we missed out on the talents of many Americans by prohibiting them from pursuing careers in which they would excel, whether by law or intimidation. Today we continue to miss out on many Americans' talents because of typically less blatant but still powerful barriers to upward mobility. One reason is the uneven playing field that large inheritances create.

In addition, the current tax treatment of accrued gains on gifted or bequeathed assets distorts capital allocation decisions throughout the economy in a phenomenon called lock-in. Currently, when an asset is

bequeathed, all income taxes due on the accrued gains on the asset are wiped out because of stepped-up basis. This provision creates an enormous incentive for prospective donors to hold on to underperforming assets until death, purely for tax reasons. Assets transferred to charities typically benefit from the same tax advantage. When assets are gifted to individuals (i.e., given during a donor's life rather than at their death), the lock-in effect is smaller but still substantial.<sup>9</sup> If gains on gifted or bequeathed assets were taxed more like labor income—which is taxed as soon as it accrues—these distortions to capital allocation decisions would diminish.

## COMPLEXITY AND TAX PLANNING

The final drawback of our current approach to taxing large inheritances is its extraordinary complexity and the tax-planning opportunities it creates, which privilege those who can afford the best tax advice. Any tax on wealthy individuals will entail a number of complex rules, if only to counter the avoidance strategies that their tax advisers develop. But current law entails far more complexity than is necessary, especially by taxing similar types of transfers at very different effective rates.

One example of this needless complexity is stepped-up basis for bequests and carryover basis for gifts. As just discussed, these provisions inefficiently distort capital allocation, creating incentives to hold on to underperforming assets. But they also generate transactional complexity, meaning incentives for taxpayers to spend time and money on tax planning that they could more productively spend elsewhere.

Another example of unnecessary complexity is the differential treatment of gifts and bequests more generally. Current wealth transfer taxes generally tax bequests more heavily than they tax gifts made during life because the former are taxed on a pretax (tax-inclusive) basis and the latter on an after-tax (tax-exclusive) basis. For example, suppose a donor wants to transfer \$1 million above and beyond their lifetime exemption. If they do so through a bequest, the 40 percent estate tax rate will apply to the pretax transfer (i.e., the full \$1 million), leaving their heir with \$600,000. But if they do so through a gift, the 40 percent gift tax rate will apply to the posttax transfer, allowing their heir to inherit \$714,286 for the same cost to the donor.<sup>10</sup> Thus, comparing apples to apples, the gift tax rate is actually only 29 percent. Cutting against this favorable tax treatment for gifts is stepped-up basis, which results in lower income tax rates on bequests to the extent they include appreciated assets. These cross-cutting incentives create traps for the unwary and incentives for wealthy donors to spend substantial resources on tax planning to minimize their tax liability, which is a deadweight loss to the economy.

Further complicating matters are the rules governing valuations and transfers through trusts or other entities. For example, family limited partnerships (FLPs) are often used to hold assets in order to obtain nonliquidity discounts. Once the moment for valuing and taxing the transfer has passed, heirs often dissolve the FLP so they can sell the underlying assets at will. The Internal Revenue Service (IRS) estimates the valuation discounts for FLPs range from 30 to 65 percent (Dodge 2016; Eller 2005). These valuation discounts are often unreasonably large when the FLP owns a closely held business. But they are even more egregious when the FLP holds investment assets with a clear market value, such as portfolio interests in publicly traded stock. As another example, donors often use trusts or other devices under which they retain the ability to receive some portion of their property back, in order to deflate the value of the transferred assets. Grantor retained annuity trusts (GRATs) are the most common approach. According to one estimate, they have reduced the amount of revenue raised by estate and gift taxes by one-third (Midar 2013).

In sum, wealth transfer taxes currently play a critical role in addressing the undertaxation of inherited income, but they are insufficient. The entire approach to taxing inheritances—including their income and payroll tax treatment—needs to be reformed in order to level the playing field between income from inherited wealth and income from work. Doing so can soften inequalities, strengthen mobility, and enhance efficiency and growth by reducing unproductive tax planning and distortions to labor markets and capital allocation. Before turning to the details of the proposal, some further background on current law is necessary.

## Background: Overview of Current Law

There are currently several components to the taxation of wealth transfers: the estate tax, gift tax, and generation-skipping transfer tax (collectively referred to as wealth transfer taxes), the basic income tax and payroll tax treatment of gifts and bequests, and the income tax treatment of accrued gains on assets that are gifted or bequeathed. These elements are summarized in table 1.

### **WEALTH TRANSFER TAXES**

The *estate tax* was enacted in 1916 and has been part of the law ever since, with the exception of 2010 when it was repealed for one year. As of 2020 the estate tax is applied at a 40 percent rate to the sum of lifetime gifts and bequests transferred in excess of \$11.58 million. Effectively, this means that a married couple can transfer \$23.16 million over their lifetimes to

TABLE 1.

## Major Features of Current Law Treatment of Inheritances

	Wealth transfer taxes			Income and payroll taxes		
	Rate	Donor lifetime exemption	Donor additional annual exemption	Donor	Heir	Accrued gains
Gifts	40%	\$11.58M (\$23.16M per couple)	\$15K per heir	No deduction	No tax	Carryover basis
Bequests			\$0			Stepped-up basis
Generation-skipping transfers	Additional 40%		Same as other gifts/bequests			Same as other gifts/bequests

Note: Transfers to spouses and charities, and gifts for education, medical expenses, and support expenses for minors, are tax exempt. Parameters are for 2020.



their children or other beneficiaries tax free. The \$11.58 million per donor exemption is scheduled to fall by half after 2025 due to the expiration of some provisions in the 2017 tax bill.

The *gift tax* has been a part of the tax code since its enactment in 1932. Gifts are subject to the same unified lifetime exemption as the estate tax, and gifts above that exemption are also subject to a 40 percent rate. However, as previously noted, the effective gift tax rate is lower than the estate tax because it applies to posttax, not pretax, gifts. In addition, each year a donor can completely disregard gifts totaling up to \$15,000 to a given heir (effectively \$30,000 for a married donor couple), meaning these gifts do not count toward the lifetime exemption. All wealth transfer tax exemptions are indexed for inflation.

The *generation-skipping transfer (GST) tax* was enacted in 1986 in response to concern that transfers directly to a donor's grandchildren were taxed only once under the estate and gift taxes, whereas transfers to a donor's grandchildren through their children were taxed twice.<sup>11</sup> The GST tax imposes a second (but only a second) layer of tax on transfers to recipients who are two or more generations younger than the donor. Its exemptions and rates mirror those of the estate tax.

Under all three wealth transfer taxes, a large portion of gifts and bequests are tax exempt. Transfers to spouses and charities are not taxed. Similarly, amounts paid during life for education and medical expenses and for basic support expenses for minors are tax exempt. There are also special

provisions for transfers of closely held businesses to address concerns that the tax might otherwise force the sale of the business. For example, any tax due on bequests of many closely held businesses can be paid in installments over a period as long as 15 years at a below-market interest rate.

Over time the share of federal revenue raised from these wealth transfer taxes has declined precipitously due to Congress raising the lifetime exemptions and lowering the rates. In 1973 wealth transfer taxes accounted for 2.1 percent of federal revenues; in 2020 they are projected to account for only 0.5 percent (Office of Management and Budget [OMB] 2019). Over that same period, the share of estates subject to the estate tax fell from 6.5 percent to a projected 0.1 percent (JCT 2015; TPC 2018c).

## **INCOME AND PAYROLL TAX TREATMENT**

Although a great deal of attention is typically paid to wealth transfer taxes, and to the estate tax specifically, the income and payroll tax treatment of gifts and bequests is equally important. Donors do not receive an income tax deduction for gifts and bequests (other than those to charitable organizations). But recipients of gifts and bequests can exclude amounts they inherit from their income for income or payroll tax purposes. In addition, assets gifted during life receive a carryover basis, while bequests receive a fair market value basis. This means that the tax due on accrued gains on gifted assets can be deferred until the heir sells the assets, at which point they will pay tax on gains that accrued both before and after they received it. The tax due on accrued gains on bequeathed assets is forgiven entirely; the heir pays tax only on gains that accrued after they inherited the asset.

## The Proposal

### **MAJOR FEATURES**

The inheritance tax proposed here represents a fundamental shift in the way wealth transfers are taxed. Under the proposal, there would no longer be any separate wealth transfer tax system; the estate, gift, and GST taxes would be repealed. Instead, taxation of inheritances would be integrated into the income and payroll taxes. The focal point for taxation would shift from the amount transferred to the amount heirs receive.

The proposal can be scaled to different revenue targets. Revenue estimates for three different lifetime exemptions are provided below. For purposes of describing the mechanics of the proposal, I will focus on the highest exemption of \$2.5 million. At this level, the proposal would raise about the

same amount of revenue as the 2009 estate and gift taxes if their lifetime exemptions at the time (\$3.5 million) were indexed for inflation. The proposal has four major features.

First, if a taxpayer inherits more than \$2.5 million over the course of their lifetime from any combination of donors, they would be required to pay income and payroll taxes on gifts and bequests they receive above this threshold. To state the obvious, \$2.5 million is a lot of money. Less than 1 percent of heirs inherit that much (see appendix table 1). An individual who inherits \$2.5 million at age 21 can live off their inheritance for the rest of their life without anyone in their household ever working, and their annual household income will still be higher than that of three-quarters of American families.<sup>12</sup>

Heirs would include any inheritances above this threshold (taxable inheritances) as ordinary income on their income tax Form 1040. Currently, the top rate on ordinary income is 37 percent, though it is scheduled to revert to 39.6 percent after 2025. Heirs would also have to pay Social Security and Medicare taxes (disregarding the Social Security maximum earnings threshold) on their taxable inheritances on their 1040. The combined rate for those taxes is 15.3 percent. Heirs would accumulate Social Security benefits on their Social Security tax payments up to the maximum benefit amount. Excess payroll tax revenues collected would go to the Social Security and Medicare trust funds.

Taxable inheritances could be spread out over the current year and the previous four years to smooth out income spikes that might trigger higher income tax rates, while minimizing work disincentives. The income tax rate would be calculated without regard to net operating losses in order to limit the ability of heirs to obtain lower income tax rates by artificially concentrating business losses in years when they receive inheritances.

In addition, each year heirs could entirely disregard \$15,000 in gifts and bequests, meaning they would not count toward the \$2.5 million lifetime exemption. If a taxpayer received gifts from a given donor over the course of the year that totaled less than \$2,000, that donor's gifts would not count toward this additional annual exemption, even if the annual sum of such gifts from multiple donors exceeded \$15,000. These annual exemptions would help ensure that the vast majority of gifts and bequests would not have to be reported, thus limiting compliance costs. They would also ensure that individuals would not have to report the receipt of a large number of relatively small gifts from family and friends, for example after a wedding. All exemptions and the amount of prior inheritances would be adjusted for inflation.

The existing rules governing what transfers are taxable would remain largely unchanged. Transfers to spouses and charities, as well as gifts for education, medical expenses, and support expenses for minors, would still be tax exempt.<sup>13</sup> Thus, similar to current law, the proposal would not tax a large portion of wealth transfers even after accounting for the lifetime exemption.

Aside from appreciated assets, which are discussed below, the income tax treatment of donors would remain unaltered. Donors would not receive an income tax deduction for gifts and bequests unless the transfer was to a charitable organization.

To understand how the proposal works, imagine an heir receives a bequest of \$3 million above the \$15,000 annual exemption, and has not received reportable inheritances (i.e., exceeding the annual exemption) in any prior year. Their taxable inheritance would be  $\$3,000,000 - \$2,500,000 = \$500,000$ . They would have to pay tax on this amount under the same rate structure as their other ordinary income plus the 15.3 percent payroll tax. Because the income tax brackets rise with income, this might mean that part of their taxable inheritance would fall within a higher tax bracket than, for example, their income from work, because they received the inheritance all in one year. To limit this effect, they could elect to file as if their taxable inheritance was only \$100,000 in the current year and in each of the previous four years. If this heir was in the top income tax bracket, their marginal tax rate on their inherited income would be 49.5 percent and their average tax rate on their inheritance would be 8.2 percent.<sup>14</sup>

The second feature of the proposal would apply constructive realization for income tax purposes to large accrued gains on gifts and bequests, repealing carryover basis and stepped-up basis for large accrued gains in the process. Specifically, the proposal would follow President Obama's proposal by maintaining current law for the first \$100,000 in accrued gains (\$200,000 per couple) plus \$250,000 for personal residences (\$500,000 per couple) (U.S. Department of the Treasury [Treasury] 2015).<sup>15</sup> Gains above these exemptions would be treated as realized when transferred. Unlike President Obama's proposal, however, this proposal would apply to charitable transfers.

The income tax due on any constructively realized gains would be paid by the donor or their estate, and therefore would effectively be deductible when calculating heirs' taxable inheritances.<sup>16</sup> For example, suppose a donor gives \$3 million in publicly traded stock to their child, who has not previously received any reportable inheritances (i.e., exceeding the annual exemption) and who has used up their current-year \$15,000 annual exemption with

an inheritance from a different source. The donor's basis in the stock is \$2.7 million. The donor would have to pay income tax on \$200,000 of the \$300,000 accrued gains. The heir would receive a basis of \$2.9 million in the \$3 million of stock they inherit, and would owe income and payroll tax on a taxable inheritance of \$500,000, as explained above.<sup>17</sup>

This feature of the proposal would ensure that almost all capital income used to fund large inheritances is taxed once, regardless of how well-advised the donor and their heirs are. It would also substantially reduce incentives for investors to hold on to underperforming assets purely for tax reasons.

The third feature of the proposal would address the politically sensitive issue of family-owned businesses and primary residences through a special provision. To be clear, the liquidity issues associated with such assets have been greatly exaggerated in the public debate. Estate tax repeal lobbyists have repeatedly invoked the trope of the estate tax forcing the sale of family farms, even though neither the American Farm Bureau nor *The New York Times* has been able to identify a single instance of this occurring (Graetz and Shapiro 2011; Johnston 2001). More generally, business assets can create liquidity problems only if there are insufficient liquid assets in the estate to pay any tax due plus any mortgages and liens outstanding. But this is true for only about 3 percent of estate tax returns, many of which currently elect to defer the estate tax due for up to 15 years at a below-market rate of return (IRS 2014; JCT 2015).<sup>18</sup> Nevertheless, rhetoric may matter more than reality. Some argue that the failure of estate tax supporters to adequately address this issue was a prime reason for the brief repeal of the estate tax in 2010 (Graetz and Shapiro 2011).

To address these concerns, the proposal would allow heirs to indefinitely defer the tax they owe on taxable inheritances to the extent it exceeds the liquid assets they inherit, minus a cushion of \$500,000. During the deferral period, they would only have to pay a market rate of interest on the tax due, and not the underlying tax liability itself. Liquid assets would be defined as all assets other than family-owned and -operated businesses, and primary residences. To qualify as a family-owned and -operated business, the donor or their relatives must have majority owned and materially participated in the business during the 10-year period prior to the transfer. The deferral period would end when the heir or their relatives no longer majority own or materially participate in the business, or to the extent they dispose of their interest in the business, or otherwise cash it out.<sup>19</sup> To qualify as a primary residence, the donor or their relatives must have continually used the house as their primary residence for the 10-year period prior to the transfer. The deferral period would end when the heir no longer uses it as their primary

residence. Current provisions allowing deferral, exemptions, or valuation discounts for certain closely held businesses and personal residences would be repealed.<sup>20</sup>

To illustrate how this feature of the proposal would work, suppose an heir who is otherwise in the highest income tax bracket receives a reportable bequest of \$12.5 million and has received no prior inheritances. Four-fifths of the bequest (\$10 million) is a closely held business, and one-fifth (\$2.5 million) is liquid assets, such as publicly traded stock. In this case, the heir's total tax liability would be \$4.95 million.<sup>21</sup> Because this tax liability exceeds the liquid assets they are inheriting minus the \$500,000 cushion, they could elect to defer the excess (\$2.95 million) as long as they or their relatives continue to majority own and operate the business.

This provision would therefore eliminate the possibility that an heir would ever need to sell a family business or primary residence at the time of inheritance in order to pay the associated tax liability. It would also eliminate the possibility that they would ever need to sell such assets over time if they earn at least a market interest rate of return. Unlike current law, however, this provision would limit the preference to those who actually face liquidity constraints and would charge heirs a market interest rate. As a result, it would entail far weaker incentives for donors to shift wealth into closely held businesses and real estate purely for tax reasons.

Finally, the fourth feature of the proposal would limit tax avoidance through a number of reforms to the rules governing the timing and valuation of transfers through trusts and other devices, as described in more detail in box 1. The proposal would also substantially simplify and narrow the reach of the generation-skipping transfer tax, limiting it to generation-skipping transfers through dynastic trusts, which are increasingly used to provide for an unlimited number of future generations.<sup>22</sup>

The four major features of the proposal are summarized in table 2.

TABLE 2.

## Major Features of Proposed Treatment of Inheritances

	Wealth transfer taxes	Income and payroll taxes				
		Donor	Heir lifetime exemption	Heir additional annual exemption	Rate	Accrued gains
Gifts	None	No deduction	\$2.5M or \$1M or \$500K*	\$15K**	Ordinary income + payroll tax***	Realization upon transfer w/ exemptions
Bequests					Add'l tax at top rate if in trust	
Generation-skipping transfers						

\* Transfers to spouses and charities, and gifts for education, medical expenses, and support expenses for minors, are tax exempt.

\*\* Gifts of less than \$2,000 received from a given donor are excluded from both exemptions.

\*\*\* The heir could elect to spread taxable inheritances over the current year and the previous four years. There would be no maximum earnings threshold for purposes of the payroll tax.



## REPORTING, WITHHOLDING, AND TRANSITION RULES

As with any tax reform, the proposal would require a number of reporting, withholding, and transition rules so that the IRS could effectively administer it. These rules are critical because moving from no information reporting to substantial information reporting, on average, increases individual income tax compliance from 37 to 93 percent (IRS 2016). When coupled with tax withholding, the compliance rate rises to 99 percent (IRS 2016).<sup>23</sup>

To facilitate compliance, the proposal would require donors or their estates to report all gifts or bequests above the \$15,000 annual reporting exemption to the recipient and to the IRS. Donors would also have to report their basis in all transferred assets to the heir and the IRS. Heirs would have to annually report the amount of any gifts and bequests they receive in excess of the \$15,000 annual reporting exemption (and the \$2,000 per donor annual exemption) to the IRS so the IRS can track their cumulative reportable inheritances.

Donors or their estates would be required to remit a withholding tax on all transfers above the \$15,000 annual reporting exemption at the highest income and payroll tax rate (currently 49.5 percent). However, the heir could immediately claim a refund for the withholding tax if they had not yet reached their lifetime exemption, or to the extent that their income and

payroll tax rate was lower than the withholding rate.<sup>24</sup> Box 1 describes how the withholding tax would work in the case of beneficiaries of trusts and similar devices.

Finally, the proposal would not be phased in, but would be effective immediately.<sup>25</sup> It would apply to all post-effective-date inheritances. Previous inheritances would not count toward the lifetime exemption and heirs could not claim a credit for wealth transfer taxes paid on such previous inheritances. The proposal would also apply to all post-effective-date distributions from trusts, regardless of when the trust was created.

These transition rules would be reasonably precise because heirs tend to receive only one substantial inheritance over their lifetime. For example, among heirs who are projected to inherit more than \$2.5 million in 2020, their inheritance in that year will represent an estimated 96 percent of their lifetime inheritances (appendix table 1; author's calculations).

#### BOX 1.

### How would the proposal address concerns about tax avoidance through trusts, business entities, and similar devices?

Under current law, taxpayers use a number of strategies to avoid the estate, gift, and generation-skipping transfer taxes.

Donors may transfer assets through family-owned entities, such as FLPs and LLCs, in order to claim large nonliquidity discounts.<sup>26</sup> For example, a donor might contribute assets to an FLP and then transfer a quarter interest in the FLP to each of their four children. The children could then claim that each of their interests are worth less than a quarter of the assets' value because none of them has a controlling interest in the FLP. Such valuation discounts are often excessive when the FLP owns one or more closely held businesses. But they are even more egregious when the FLP holds investment assets that have a clear market value and are completely liquid, such as portfolio interests in publicly traded stock. The IRS estimates that valuation discounts for FLPs range from 30 to 65 percent (Dodge 2016; Eller 2005). Donors also use other entities or devices to obtain nonliquidity discounts. Overall, such discounts range from 15 to 60 percent or higher (JCT 2012).

Donors may also undervalue wealth transfers by using trusts or similar devices to create string or hybrid transfers, where the donor gifts property to their heirs but retains the possibility of receiving some portion of the property back. GRATs are the most common approach. Under a GRAT, the trust pays the donor a set amount for several years, and then distributes the remaining assets to their heirs. The donor is typically allowed to undervalue the taxable gift (and overvalue their retained interest) at the time of transfer because the IRS-prescribed interest rate is unreasonably low. Then, their retained interest is valued at its actual (and much lower) value when it is later included in their taxable estate. In the process, a large portion of the value of the transferred assets simply disappears for wealth transfer tax purposes. According to one estimate, GRATs have reduced the amount of revenue raised by the estate and gift taxes by one-third (Midar 2013), and they are just one form of this type of tax-planning strategy.<sup>27</sup> Moreover, the amount of disappearing wealth is magnified when such retained interests are coupled with valuation discounts, such as those obtained through FLPs.

Donors often adopt similar strategies when making charitable contributions. They may create trusts that are directed to distribute part of their assets to charities and part to taxable beneficiaries. By taking advantage of the current rules used to project the share of the trust assets that will go to charities (which typically allow the donor to assume a below-market interest rate), they can undervalue the portion of the transfer that is subject to the estate and gift taxes.

In addition, donors can use grantor trusts to reduce the size of taxable gifts. A grantor trust is one over which the donor retains some powers. In practice, these powers can be negligible, making grantor trust status effectively elective, even when the creation of the trust is treated as a taxable gift (Ascher 2010). Once a trust is a grantor trust, the donor is responsible for paying income tax on the trust's income; otherwise the trust itself owes the tax. Because the donor paying income tax on the trust's behalf is not treated as a taxable gift, the effective gift tax rate on inheritances from grantor trusts is typically substantially lower than it is for non-grantor trusts.

Furthermore, donors may value transferred assets at different amounts in different contexts, often without penalty. While legislation passed in 2015 cut down on some of these abuses, opportunities for inconsistent valuations remain.

To address these avoidance strategies, the proposal includes a suite of reforms designed to more accurately value wealth transfers, drawing on proposals by the Treasury (1984), Cunningham (2000), Crawford (2011), Caron and Repetti (2014), Dodge (2016), and others. These reforms could generally be adopted on their own or as part of the proposal, but several would be easier to implement in the context of an inheritance tax (Batchelder 2009; Crawford 2016).

First, investment assets, such as publicly traded stock, that are held in family-owned entities would no longer be eligible for nonliquidity discounts. The owners of such entities would be treated as pro rata owners of the entity's investment assets.<sup>28</sup> In addition, the proposal would limit the availability of nonliquidity discounts for operating business assets held by family-owned entities. Minority discounts would be disregarded to the extent they were created by spousal property law or through a gift or bequest.

Second, retained interests, including those created through string or hybrid transfers, would be taxed under a hard-to-complete rule.<sup>29</sup> This means the heir's final tax liability would not be set until the donor's retained interest ends or the donor's death, whichever comes earlier. For example, in a GRAT, the value of the heirs' taxable inheritance would not be based on a rough projection of future events, but rather would be determined once the donor's retained annuity expires. In the meantime, a withholding tax would apply at the highest rate (currently 49.5 percent).

The hard-to-complete rule and withholding tax would also apply to trusts and other vehicles in which the donor retains no interest themselves if the precise beneficiaries or the amount they will receive is unclear because no single heir immediately has full and permanent control over the assets.<sup>30</sup> For example, if the trustee is authorized to distribute its assets among the donor's descendants according to their needs, the trust would pay a withholding tax when it receives assets and, upon distribution, the beneficiary could claim a credit for that withholding tax (which would accrue

interest at a market rate) against their income and payroll tax liability on the inheritance. If the distribution was only of part of the trust's assets, the beneficiary could claim only their pro rata share of the credit.

Third, in the case of grantor trusts, income tax payments by the grantor on behalf of the trust would be treated as additional gifts, and would be subject to the withholding tax.<sup>31</sup> The grantor trust rules should also be substantially reformed.<sup>32</sup>

Finally, building on the 2015 legislation, the proposal would require donors and heirs to assign basis and value transferred assets consistently in more circumstances. When gains are realized under the new constructive realization rule, heirs would have to adopt the same value for inheritance tax purposes, and vice versa. This consistency rule would also apply to charitable contributions and transfers to spouses, unlike current law. Furthermore, donors would have to report to both the IRS and their heirs any valuations of transferred assets procured for insurance, financial reporting, or banking purposes. The IRS could use these outside valuations as evidence of undervaluations by taxpayers.

Together, these reforms would substantially curtail the ability of taxpayers to temporarily and artificially deflate the value of inheritances at the time the tax liability is assessed, only to subsequently resolve any valuation uncertainties in ways that demonstrate that the tax liability should have been much higher.

## REVENUE EFFECTS

TPC has estimated the revenue effects of this proposal relative to current law. TPC based these estimates on their estate tax microsimulation model, which was adapted to estimate the amount that individual heirs inherit and each heir's other income. The estimates are rough because of data limitations that require multiple levels of imputation, and because they rely in part on IRS data on the distribution of estates among heirs from 1992, which is the last year the IRS conducted such a study.<sup>33</sup>

The estimates are restricted to the core features of the proposal and, as a result, probably substantially underestimate the revenue raised by the

proposal as a whole. Specifically, they do not include the proposed reforms to the rules governing closely held businesses, primary residences, and generation-skipping transfers described above, or the reforms to transfers through trusts and similar vehicles described in box 1. They also do not include revenue raised from applying constructive realization to charitable transfers, or from taxing post-effective-date distributions from pre-effective-date trusts.

As summarized in table 3, TPC estimates the proposal would raise \$337 billion over the next decade relative to current law if the lifetime exemption were \$2.5 million. It would raise even more at lower lifetime exemption levels: \$917 billion if the lifetime exemption were \$1 million, and \$1.393 trillion if it were \$500,000. Table 3 also illustrates the extent to which the proposal would raise less if the reforms to stepped-up basis and carryover basis were not included. These lifetime exemptions would limit the proposal's reach to those receiving exceptionally large inheritances—the top 0.02 percent, 0.08 percent, and 0.18 percent, respectively, when ranked by inheritance size (appendix tables 1 and 2; author's calculations).<sup>34</sup>

At the \$2.5 million exemption level, the proposal would raise about as much in steady state as the 2009 estate and gift taxes (which applied a 45 percent rate to transfers above a lifetime exemption of \$3.5 million, or \$7 million per couple) if their exemptions were indexed for inflation and if one disregards the revenue raised from constructive realization.<sup>35</sup>

TABLE 3.

## Revenue Raised by the Proposal

	Revenue raised, 2020-30
<b>Inheritance tax and constructive realization on gifts and bequests</b>	
\$2.5 million	\$337 billion
\$1 million	\$917 billion
\$500,000	\$1,393 billion
<b>Inheritance tax</b>	
\$2.5 million	\$168 billion
\$1 million	\$790 billion
\$500,000	\$1,298 billion

Source: TPC calculations.

Note: Estimates are for fiscal years and include the revenue effects of repealing the current estate and gift taxes (\$284 billion in revenue lost over the period). Exemption amounts are for 2020 and indexed for inflation thereafter. Estimates do not include the proposals to (1) reform rules regarding valuations, closely held businesses, primary residences, generation-skipping transfers, and transfers through trusts or similar vehicles; (2) apply the inheritance tax to distributions from pre-effective-date trusts; or (3) apply constructive realization to charitable transfers.

## BENEFITS OF THE PROPOSAL

### *Fairness*

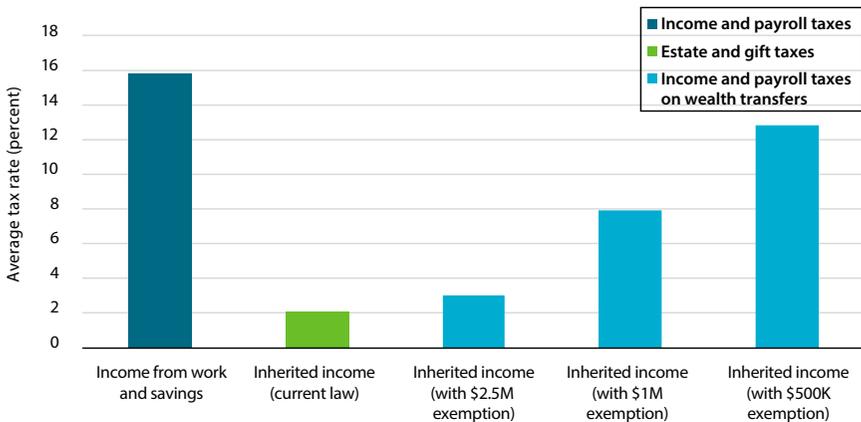
There are a number of ways the proposal would strengthen the fairness of the fiscal system as a whole. First, by taxing large wealth transfers more heavily, it would soften inequality and broaden opportunity. As illustrated in figure 3, the average tax rate on inherited income overall would still be far lower than the average rate on income from work and savings, largely because of the proposal's large lifetime exemptions. But the gap would narrow—and among heirs receiving the very largest inheritances, it would close or reverse.<sup>36</sup>

The revenue raised could be used to invest in those not fortunate enough to receive a massive inheritance, or the other advantages that typically accompany one—further improving intergenerational mobility. For example, it could fund expanded access to child care, universal preschool, increased Pell Grants, or expansions to the Earned Income Tax Credit to ensure no worker is taxed into poverty.

Second, the proposal is likely to increase public support for taxing inherited income because it would better align the public's understanding of wealth transfer taxes with their actual economic effects. Experts on both sides of the aisle agree that wealth transfer taxes are largely borne by heirs, not by

FIGURE 3.

### Average Tax Rate on Inheritances vs. Income from Work and Savings



Sources: TPC 2018b, 2018c; TPC calculations.

Note: The light blue bars represent the proposal for different lifetime exemption levels. Estimate for inherited income is for 2020 and assumes the proposal is fully phased in. Estimate for income from work and savings is for 2019. All estimates include the individual income tax, the employee and employer shares of the payroll tax, the estate tax, the gift tax, and the generation-skipping transfer tax.

their benefactors, regardless of whether they are structured as estate or inheritance taxes (Batchelder and Khitatrakun 2008; Mankiw 2003). But the structure of an estate tax makes it easier for opponents to characterize it as a double tax on frugal, generous entrepreneurs who just want to take care of their families—even though nothing could be farther from the truth. Instead, the estate tax is the only tax that ensures wealthy heirs pay at least some tax on large amounts of inherited income, even if at much lower rates than their personal assistants pay on their wages. Nevertheless, this imagery is powerful.

Perhaps as a result, inheritance taxes are much more common around the world. Most countries that historically had estate taxes have repealed them, while those with inheritance taxes typically have not (Batchelder 2009).<sup>37</sup> Inheritance taxes are potentially more politically resilient because they make clearer the inequities of low rates on inherited income. This should be even truer of the type of inheritance tax proposed here because, unlike most other inheritance taxes, it would include large inheritances directly in the heir's income and payroll tax base.<sup>38</sup>

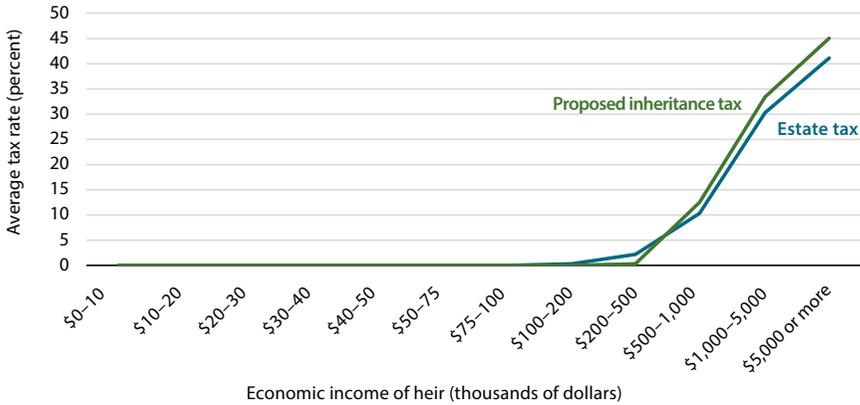
Third, the proposal would more equitably allocate wealth transfer taxes among heirs. The core reason why is that some small inheritances come from relatively large estates, and some heirs to large fortunes received their inheritances from multiple, smaller estates. In addition, the proposal would apply different rates to heirs based on their total income, unlike the estate and gift taxes. As a result, the distribution of tax burdens among heirs would be somewhat different under the proposal than under our current system, even if both raised the same amount of revenue.

In aggregate, the distributional effects of revenue-equivalent inheritance taxes and estate taxes are not very different. To illustrate, figure 4 compares the burdens of an estate tax and inheritance tax by heirs' economic income if both raised the same amount of revenue in 2009. (It assumes a lifetime exemption of \$3.5 million under the estate tax and \$1.9 million under the inheritance tax.) While the inheritance tax is slightly more progressive, both are highly progressive and the difference is relatively small.

But if one focuses on the individual level, the difference between the two approaches become more pronounced. Figures 5 and 6 continue the comparison of an inheritance tax and an estate tax that raise the same amount of revenue in 2009. They show that, among heirs burdened by at least one tax, only 30 percent (7,972 out of 26,519 heirs) would be burdened by both tax systems. A full 63 percent of heirs who fall under the inheritance tax lifetime exemption—and therefore owe no inheritance tax—nevertheless face estate tax burdens.

FIGURE 4.

## Average Tax Rate on Inheritances by Heirs' Economic Income, 2009



Sources: Batchelder 2009; Batchelder and Khitatrakun 2008.

Note: Economic income is expanded cash income plus one-fifth of gifts and bequests received. The estate tax rate is 45 percent on cumulative transfers above \$3.5 million. The inheritance tax rate is the heir's ordinary income tax rate plus 15 percentage points on cumulative inheritances above \$1.9 million. Both estimates assume no change to the taxation of accrued gains on gifts and bequests.

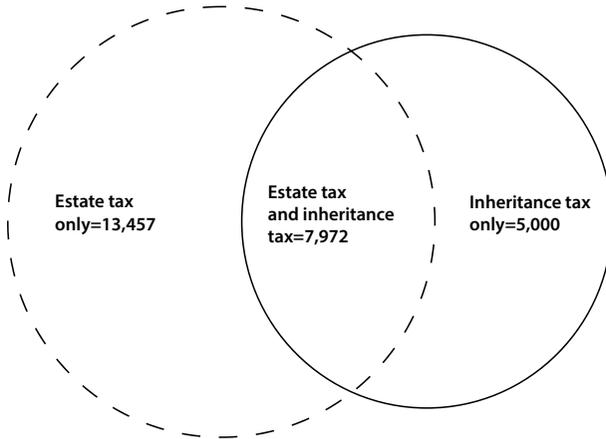


On a dollar-weighted basis, these individual-level differences shrink. The 7,972 heirs who are burdened by both taxes account for the lion's share (about 90 percent) of revenue raised by each tax (Batchelder 2009; Batchelder and Khitatrakun 2008). But even among this group, individual-level differences persist. While on average the estate tax rate rises with the inheritance tax rate among heirs who are burdened by both taxes, many inheritances are subject to a much higher estate tax rate than inheritance tax rate, or vice versa. As a result, figure 6 shows that about 30 percent of the dollar-weighted burden of revenue-equivalent estate and inheritance taxes would fall on different heirs. Overall, when weighted by inheritance size, only half of the inheritance tax rate of individual heirs is directly accounted for by factors that determine the heir's estate tax rate, and vice versa (Batchelder 2009).

These individual-level differences should not be construed as a fundamental criticism of the estate tax, which is overwhelmingly borne by the recipients of large inheritances. Even when the estate tax exemption was \$7 million per couple (rather than \$23 million, as it is today), less than 4 percent of the revenue came from heirs inheriting less than \$1 million. But its burdens are allocated less precisely based on heirs' ability to pay than they would be under the proposal.

FIGURE 5.

### Number of Heirs Burdened by 2009 Estate Tax and Revenue-Equivalent Inheritance Tax



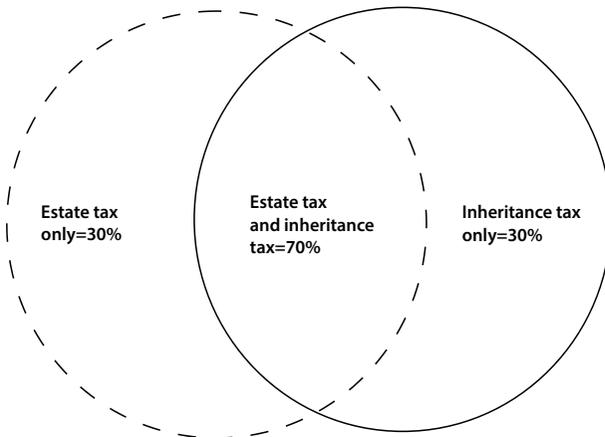
Sources: Batchelder 2009; Batchelder and Khitatrakun 2008.

Note: The estate tax rate is 45 percent on cumulative transfers above \$3.5 million. The inheritance tax rate is the heir's ordinary income tax rate plus 15 percentage points on cumulative inheritances above \$1.9 million. Both estimates assume no change to the taxation of accrued gains on gifts and bequests.



FIGURE 6.

### Dollar-Weighted Share of Revenue Raised from Heirs Burdened by 2009 Estate Tax and Revenue-Equivalent Inheritance Tax



Sources: Batchelder 2009; Batchelder and Khitatrakun 2008.

Note: The estate tax rate is 45 percent on cumulative transfers above \$3.5 million. The inheritance tax rate is the heir's ordinary income tax rate plus 15 percentage points on cumulative inheritances above \$1.9 million. Both estimates assume no change to the taxation of accrued gains on gifts and bequests.



The previous discussion focuses on the benefits of shifting to an inheritance tax. But the other features of the proposal would also strengthen the fairness of the tax system.

Applying constructive realization to large gains on assets that are gifted or bequeathed would be highly progressive. Under President Obama's similar proposal, the Treasury estimated that the top 1 percent of taxpayers would bear 99 percent of the burden, and the top 0.1 percent would bear 80 percent (Executive Office of the President and U.S. Treasury Department 2015). Part of the reason is that accrued but unrealized gains represent a larger share of the largest estates (Huang and Cho 2017). For example, unrealized gains represent 6 percent of the value of estates under \$2 million, but 46 percent of the value of estates over \$50 million (Avery, Grodzicki, and Moore 2015).

The proposed reforms to limit tax avoidance through trusts, business entities, and similar vehicles would be highly progressive as well. Although there is a large degree of uncertainty around how much wealth is currently held in trusts, they likely hold trillions of dollars in assets (Crawford 2019).<sup>39</sup> Many of these trusts were established to exist in perpetuity, potentially benefitting wealthy heirs in the same family for hundreds of years.

Moreover, a large share of the value of such trusts was never subject to income or wealth transfer taxes at all. For example, the donor may have established the trust before the generation-skipping transfer tax was enacted in 1986 and may have taken advantage of stepped-up basis and vehicles like those described in box 1 to avoid almost all income, estate, and gift taxes. The proposal would ensure that heirs of dynastic trusts are at least required to pay income and payroll taxes on amounts they inherit.

### *Efficiency and Effects on Growth*

The fact that the proposal would reduce the extent to which inherited income is taxed more lightly than income from work and savings should also improve the efficiency of the tax system and spur growth, as explained in more detail above. While donors may modestly reduce their saving, the effects should be relatively small. At the same time, heirs should respond by increasing their labor force participation and earnings substantially. Greater economic mobility should improve labor market efficiency as a whole. And constructive realization and curtailing avoidance opportunities would reduce distortions to capital allocation decisions, ensuring that more capital went to its most productive use.

The proposal would shift not only the average tax rate on inherited income closer to the optimum, but also change the form of taxation. Traditionally,

there are three ways of taxing wealth transfers. One is an estate and gift tax paid by the donor, where the rate and exemption turns on the amount the donor transfers. The second is an accessions tax, which taxes the heir and bases their rate and exemption solely on the amount they receive. The third is an inclusion tax, which also taxes the heir, but by requiring them to include inherited income in their income tax base. Over time, there have been a variety of proposals to replace the U.S. estate and gift taxes with an accessions or inclusion tax, both of which are inheritance taxes (e.g., Alstott 2007; Andrews 1967; Batchelder 2007, 2009; Becker 2005; Cunningham and Cunningham 2009; Dodge 1978; Duff 1993, 2016; Perry Fleischer 2016; Roosevelt 1938; Seligman 1916; Simons 1938). All three approaches have been implemented at some point in the United States and are presently in place in other jurisdictions (Batchelder 2009; Drometer et al. 2018).

The proposal here is largely an inclusion tax, but it differs from existing and proposed inclusion taxes in two ways. First, it includes inheritances not just in the income tax base, but in the payroll tax base as well. And second, it includes a large exemption for inherited income that is separate from other exemptions in the income and payroll tax systems.

The optimal form of taxes on inheritances depends on the prevalence of the four potential reasons why people with very large estates may have saved, which were described above. In the case of altruistic and exchange-motivated saving, the efficient approach is to base any exemption on the amount received, not on the amount transferred, and for the tax rate to rise with the heir's income.<sup>40</sup> In the case of life-cycle and egoistic saving, the efficient tax is essentially confiscatory, akin to a 100 percent accessions or estate tax.

As discussed, the empirical evidence to date finds that the vast majority of large wealth transfers stem from egoistic saving and, to a lesser extent, life-cycle saving, implying a high optimal tax rate on inherited income (for reviews, see Batchelder 2009 and Kopczuk 2013). But a meaningful minority stems from altruistic and exchange-motivated saving, implying that the optimal rate should be below 100 percent and should rise with the heir's income. Put together, this implies the optimal form of taxation is an inclusion tax, potentially at higher rates than those applied to other forms of income—similar to the unique form of tax proposed here.

The efficiency case for shifting from an estate and gift tax to an inheritance tax is even stronger when we consider that the nominal payor shifts from the donor to the heir. If all taxpayers were rational and farsighted, this would not matter. A rational donor would respond to any given wealth transfer tax liability in the same way, regardless of whether they, their

estate, or their heirs nominally pay the tax. But taxpayers are not rational and tend to be influenced by salient features of taxes, such as the nominal rate or payor, rather than the actual rate or who bears the economic burden (Chetty, Looney, and Kroft 2009; Eckel and Grossman 2003; Finkelstein 2007; Goldin and Homonoff 2013; Schenk 2011). Because any efficiency losses from taxing wealth transfers arise from the impact on donors' and not heirs' behavior, this implies that any economic distortions created by taxing wealth transfers will be smaller under an inheritance tax than they are under a comparable estate tax.

### *Simplification and Horizontal Equity*

Finally, the proposal would simplify the tax system by reducing incentives for taxpayers to spend time and money on tax planning that could more productively be spent elsewhere. It would also strengthen horizontal equity by reducing the extent to which the most aggressive tax planners are rewarded, while those who dutifully follow the letter and spirit of the law are penalized.

Unlike current law, gifts and bequests would generally be taxed at the same effective rates. The inheritance tax would apply to both on a pretax basis, in contrast to current law, which applies a different and lower effective rate to gifts. Large accrued gains on gifted or bequeathed assets would both be taxed at the time of the transfer (after a generous lifetime exemption), substantially reducing the differences under current law created by carryover basis for gifts and stepped-up basis for bequests. Prior gifts would be indexed for inflation when calculating whether an heir had met the lifetime exemption, reducing another incentive under current law to transfer wealth earlier in time through gifts.

Constructive realization for accrued gains would also reduce the current incentives for donors to carefully consider the tax consequences of selling assets they may gift or bequeath, rather than basing their investment decisions purely on nontax factors.

Finally, the proposed reforms to the taxation of transfers through trusts and other devices should dramatically reduce tax planning incentives. By adopting hard-to-complete rules and curtailing noneconomic valuation discounts, the proposal would eliminate the most lucrative and egregious avoidance strategies that the wealthy use today.

## Questions and Concerns

### *1. Would the proposal privilege larger families?*

One potential concern about the proposal is that, controlling for the total amount transferred, it will impose lower tax burdens on larger families. While true, this is fair because each individual heir will inherit less. The economic burden of both current wealth transfer taxes and the proposal largely falls on the recipients of large inheritances, not on their benefactors. If ten siblings each inherit \$1 million from their parents, each child is less privileged and has less ability to pay than does a child without siblings who inherits \$10 million from their parents. Thus, the children from the large family should collectively pay less on their inherited income than the child who inherits ten times as much.

### *2. How would the proposal affect charitable giving?*

The empirical evidence to date suggests that the amount of charitable giving is highly responsive to wealth transfer tax incentives (Batchelder 2009; Joulfaian 2019). The Congressional Budget Office (CBO) estimates that repealing the estate tax would reduce charitable giving by 16 to 28 percent, while other research and experience from the temporary repeal of the estate tax in 2010 suggests the reduction may be even larger (CBO 2004; Robbins, West, and Boteach 2017). Thus, the effect on charitable giving has been an important part of the debate about changes to the estate tax.

The proposal would strengthen incentives to give to charity in some respects and reduce them in others. Most notably, it would apply a higher top rate to inheritances (49.5 percent) than the estate tax (40 percent). This would increase the implicit subsidy for giving to charities instead of taxable heirs by a substantial 24 percent.

In other circumstances, though, the proposal reduces incentives to give to charities rather than individual heirs. Currently, once a donor has exceeded the lifetime exemption for wealth transfers, the only way they can straightforwardly avoid paying any estate or gift tax is by transferring funds to their spouse or charity. (They can also, of course, use an array of less-straightforward avoidance strategies, such as those described in box 1.) Under the proposal, there is a third option: The donor can make gifts or bequests to a broader array of heirs, such as grandchildren, siblings, or friends, to ensure that all their individual heirs remain below the lifetime inheritance exemption. Which effect dominates depends on the relative elasticity of giving to charities versus a wider set of heirs. Unfortunately, there do not appear to be any studies on this issue.

Other features of the proposal would also create cross-cutting incentives for charitable giving. For example, the proposal would tax contributions to noncharitable nonprofits (such as 501(c)(4)s and 501(c)(6)s), which are currently subject to the estate tax but not the gift tax. On the margin, this increases the incentive to give to charitable rather than noncharitable nonprofits. On the other hand, the proposal should reduce donors' responsiveness to taxes on wealth transfers in general by shifting the nominal payor from the donor to the heir. This implies donors may also respond less to the large incentive to give to charity under the proposal than they would to the same incentive under an estate and gift tax.

The likely effect of the proposal on charitable contributions of appreciated assets is even more complex. Currently, the effective income tax rate on such appreciation is typically lower for charitable gifts than it is for gifts to individuals, but is the same (i.e., none) for charitable bequests versus bequests to individuals. The proposal would apply constructive realization in all four circumstances, but there would be a \$100,000 exemption for accrued gains on assets transferred to individuals. As a result, this feature of the proposal should shift the form of charitable contributions during life toward unappreciated assets. If donors are unwilling or unable to engage in such shifting, it could also reduce charitable contributions on the margin.

Thus, overall the proposal simultaneously creates larger and smaller incentives to give to charity relative to current law. Which effect dominates for a particular donor depends on how responsive the donor is to charitable giving incentives overall, which tax bracket their current planned heirs would be in, how much they value transferring funds to additional heirs versus charities, how much they value transferring funds to noncharitable organizations versus charities, and how able they are to shift the types of assets they give to charities.

In the face of such conflicting incentives and empirical evidence, it is difficult to draw meaningful conclusions. A reasonable guess is that the proposal would slightly increase charitable giving overall, while changing the form of such giving toward relatively more contributions of cash and unappreciated property.

### *3. How would the proposal affect the states?*

Historically, the federal estate tax offered a dollar-for-dollar credit for state wealth transfer taxes up to a limit, which allowed states to receive part of the revenue from federal wealth transfer taxes without actually imposing any new economic burden on their residents. Although this credit was part of the law for more than 80 years, it was repealed effective in 2005 and

replaced with a deduction. Since then, the number of states with an estate or inheritance tax has plummeted from 50 to 17 (McNichol 2019).<sup>41</sup>

If one thinks such revenue sharing should be reinstated, it would be easy to do. For example, the proposal could include a credit for state inheritance taxes and each heir's share of state estate taxes. States would likely act to conform their wealth transfer tax systems to the inheritance tax model in order to piggyback on the new federal reporting requirements, as they did under the federal estate tax credit (even when they had an inheritance tax).

A further benefit of the proposal is that it would increase the ability of states to enact or retain wealth transfer taxes if they so wish. Shifting to a federal inheritance tax would facilitate state adoption of inheritance taxes, with their attendant political resiliency advantages described above. Moreover, state inheritance taxes would suffer from less base erosion through tax competition. Currently, states may compete to attract wealthy, elderly residents by eliminating or reducing their estate taxes. While such tax competition may increase state income tax revenue, it loses estate tax revenue and, on net, states typically raise less revenue overall (Moretti and Wilson 2019). Under an inheritance tax, states might also compete in this way, but their incentive to do so would be reduced. Each heir would have a smaller tax incentive to move, and heirs may find it more difficult to move than donors, who are typically retired, for employment reasons.

#### *4. How would the proposal work in the cross-border context?*

The proposal would apply to all inheritances if either the donor or the heir is a U.S. citizen or resident. This is consistent with existing jurisdictional principles governing cross-border transactions, which permit countries to tax income of their citizens and residents, or income sourced to the country. If the heir is a foreign resident, the donor or their estate would be required to collect a withholding tax on the inheritance to the extent it exceeds the annual reporting exemption. The heir could claim credit for the withholding tax once they report and pay tax on their inheritance. If the donor is a foreign resident, the heir could claim a foreign tax credit for any foreign wealth transfer tax paid on the inheritance.

#### *5. Does the proposal eliminate the need for a wealth tax or an accrual tax?*

Recently, there have been several prominent proposals for a wealth tax or an accrual tax. Batchelder and Kamin (2019) summarize the benefits and challenges associated with these proposals. To the extent one believes that, on balance, either regime should be adopted, the proposal offered here is a complement rather than a substitute for these reforms.

The rationale for a wealth tax or an accrual tax largely stems from our current low effective tax rates on capital income and the unfairness these low rates create because the highest-income taxpayers tend to report a very large share of their income in the form of capital income. In contrast, all other taxpayers tend to report the lion's share of their income as labor compensation. This inequity is a separate issue from whether and how inheritances should be taxed. One could believe that tax rates on capital income should generally be low and nevertheless support including large inheritances in the heir's income and payroll tax base.

An accrual tax has the further benefit of largely eliminating the lock-in effect created by deferral incentives in the tax code. The proposal here would eliminate two of those incentives: stepped-up basis for bequests and carryover basis for gifts. But it would not address the third and potentially largest incentive: the realization rule. If one believes that tax rates on capital gains should be raised substantially, it is critical to reduce or eliminate the lock-in effect. Otherwise, large increases to the capital gains rate could lose revenue as investors respond by holding on to underperforming assets even longer. The constructive realization approach proposed here would raise the revenue-maximizing capital gains rate substantially—by some estimates from about 30 to 50 percent (Rubin 2019). But an accrual tax, coupled with the constructive realization rule proposed here, would raise the revenue-maximizing capital gains rate far higher.

A wealth tax potentially has some political economy advantages over an accrual tax as a way to tax the wealthy more heavily. It is easier to explain and may have a broader base because it would be writing on a blank slate. Enacting the proposal here would not change those dynamics. If anything, it could improve the IRS's ability to administer a wealth tax by establishing a set of valuation rules for assets held in trusts and other entities that better reflects economic realities.

Another rationale for a wealth tax is that it would arguably increase the fairness of the tax system as a whole if wealth provides additional information about well-being beyond the taxpayer's income. The proposal here would partially address these concerns because inheritances are one source of wealth. But it would not apply to many other forms of wealth that arguably should be counted in determining taxpayers' relative affluence, such as assets earned and consumed during life.

## Conclusion

Wealth transfer taxes are a vital part of efforts to mitigate economic disparities, and especially inequality of opportunity. The proposal offered here would diminish the relative advantages enjoyed by those born at the very top, while leaving those who do not receive extraordinarily large inheritances unaffected.

At the same time, the proposal would raise a large amount of revenue that could be used for investments that enhance economic mobility of children from low- and middle-income families. For example, it could fund expanded access to child care, universal preschool, increased Pell Grants, or expansions to the Earned Income Tax Credit to ensure no worker is taxed into poverty. These proposals are estimated to significantly improve infant health, heighten academic achievement, boost labor force participation, and increase lifetime earnings for children from relatively disadvantaged backgrounds (Executive Office of the President and U.S. Treasury Department 2014; Marr et al. 2015).

President Franklin Delano Roosevelt once said, “Inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government” (Roosevelt 1938). The same could be said today. Rather than falling near the bottom among high-income countries on this score, we should recommit to a vision of America as a land of opportunity where one’s financial success depends relatively little on the circumstances of one’s birth. A first step is to start taxing extraordinarily large inheritances the same way we tax good old hard work.

# Appendix

APPENDIX TABLE 1.

## Distribution of Current-Year and Lifetime Inheritances by Current-Year Inheritance Size

Current inheritance level	Tax units receiving current inheritances		Total current inheritances		Lifetime inheritances of tax units receiving current inheritances	
	Number	Share of tax units	Amount (in millions)	Share of current inheritances	Amount (in millions)	Share of lifetime inheritances
\$0–\$100K	2,874,479	69.6%	\$72,671	9.5%	\$139,573	14.6%
\$100K–\$500K	940,215	22.8%	\$204,351	26.7%	\$270,596	28.4%
\$500K–\$1M	169,022	4.1%	\$119,451	15.6%	\$135,047	14.2%
\$1M–\$2.5M	114,260	2.8%	\$200,356	26.2%	\$234,425	24.6%
\$2.5M–\$5M	19,870	0.5%	\$68,270	8.9%	\$74,797	7.8%
\$5M–\$10M	7,397	0.2%	\$44,772	5.9%	\$45,092	4.7%
\$10M–\$20M	2,199	0.1%	\$29,651	3.9%	\$29,912	3.1%
\$20M–\$50M	732	0.0%	\$17,463	2.3%	\$17,503	1.8%
More than \$50M	70	0.0%	\$7,248	0.9%	\$7,248	0.8%
All	4,128,243	100%	\$764,233	100%	\$954,193	100%

Source: TPC calculations.

Note: Estimates are for 2020. Includes filing and non-filing units but excludes those that are dependents of other tax units.

APPENDIX TABLE 2.

## Distribution of Current-Year and Lifetime Inheritances by Heir's Economic Income

Heir economic income	All tax units	Tax units receiving current inheritances				
	Number	Number	Average current inheritance	Average lifetime inheritance	Share of current inheritances	Share of lifetime inheritances
\$0–\$10K	11,449,386	94,215	\$23,802	\$26,974	0.3%	0.3%
\$10K–\$20K	20,992,776	339,638	\$17,442	\$27,315	0.8%	1.0%
\$20K–\$30K	19,464,062	365,792	\$70,285	\$97,114	3.4%	3.7%
\$30K–\$40K	15,867,046	288,649	\$53,172	\$100,715	2.0%	3.0%
\$40K–\$50K	13,263,684	334,711	\$118,392	\$148,038	5.2%	5.2%
\$50K–\$75K	25,054,272	675,873	\$124,894	\$181,834	11.0%	12.9%
\$75K–\$100K	16,975,536	416,450	\$107,992	\$140,731	5.9%	6.1%
\$100K–\$200K	32,524,126	977,820	\$151,840	\$195,540	19.4%	20.0%
\$200K–\$500K	16,038,559	487,794	\$379,737	\$465,296	24.2%	23.8%
\$500K–\$1M	2,065,668	82,610	\$1,009,075	\$1,161,363	10.9%	10.1%
\$1M–\$5M	827,883	34,511	\$2,707,537	\$2,771,184	12.2%	10.0%
More than \$5M	79,655	2,465	\$6,893,587	\$7,022,544	2.2%	1.8%
All	175,863,553	4,128,243	\$185,123	231,138	100%	100%

Source: TPC calculations.

Note: Estimates are for 2020. Includes filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but included in the totals. Economic income is expanded cash income plus one-fifth of gifts and bequests received.

APPENDIX TABLE 3.

## Distribution of Current-Year and Lifetime Inheritances by Heir's Income Excluding Inheritances

Heir income excluding inheritances	All tax units	Tax units receiving current inheritances				
	Number	Number	Average current inheritance	Average lifetime inheritance	Share of current inheritances	Share of lifetime inheritances
\$0–\$10K	11,664,491	309,320	\$127,745	\$146,765	5.2%	4.8%
\$10K– \$20K	21,189,508	536,369	\$127,391	\$148,124	8.9%	8.3%
\$20K– \$30K	19,554,620	456,350	\$149,009	\$199,402	8.9%	9.5%
\$30K– \$40K	15,871,693	293,297	\$122,950	\$156,840	4.7%	4.8%
\$40K– \$50K	13,273,734	344,761	\$225,765	\$251,563	10.2%	9.1%
\$50K– \$75K	24,944,690	566,291	\$214,909	\$280,607	15.9%	16.7%
\$75K– \$100K	16,971,269	412,183	\$172,276	\$230,005	9.3%	9.9%
\$100K– \$200K	32,326,819	780,514	\$175,164	\$224,506	17.9%	18.4%
\$200K– \$500K	15,881,095	330,330	\$264,468	\$344,077	11.4%	11.9%
\$500K– \$1M	2,031,158	48,100	\$405,547	\$457,535	2.6%	2.3%
\$1M– \$5M	814,335	20,963	\$801,780	\$866,395	2.2%	1.9%
More than \$5M	79,236	2,046	\$1,403,547	\$1,546,826	0.4%	0.3%
All	175,863,553	4,128,243	\$185,123	\$231,138	100%	100%

Source: TPC calculations.

Note: Estimates are for 2020. Includes filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but included in the total.

## Acknowledgements

I owe special thanks to Surachai Khitatrakun, Eric Toder, and the Urban-Brookings Tax Policy Center for their work on modeling the revenue effects of the proposal. For helpful comments and discussions, I am grateful to Noël Cunningham, Bill Gale, Seth Hanlon, Chye-Ching Huang, David Kamin, Beth Kaufman, Greg Leiserson, Ryan Nunn, Jimmy O'Donnell, Jay Shambaugh, and participants in The Hamilton Project author's workshop. Jay Cullen provided outstanding research assistance.

## Endnotes

1. This article draws extensively on my prior work on wealth transfer taxes, including Batchelder (2007, 2008, 2009, 2016, 2017) and Batchelder and Khitatrakun (2008).
2. Intergenerational mobility estimates typically look only at the correlation between fathers' and sons' incomes, excluding mothers' and daughters' incomes, because of large changes in labor force participation among women over the past several decades.
3. Economic income is defined here as expanded cash income (following the TPC definition) plus one-fifth of any gift or bequest received in the current year, in order to smooth inherited income over time. This distribution of inheritances would appear even more skewed if economic income were defined to include heirs' entire inheritance in the year of receipt, which would be more consistent with TPC's definition of expanded cash income in other contexts, such as including all accrued gains only when they are realized (Rosenberg 2013). Tax units with negative income are omitted from the three appendix tables. If they are included in the category of economic income under \$50,000, that group's estimated average inheritance is \$74,000.
4. They do not increase within-generation inequality on a relative basis, however, because of regression to the mean (Batchelder 2009; Wolff 2002).
5. If an heir saves their inheritance, the earnings on those savings will be taxed, but the amount inherited will not.
6. The Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO) do not include the estate, gift, and generation-skipping transfer taxes in their distributional analyses. The Treasury has only done so intermittently, but in those cases has distributed the burden to the donor. I have seen no public justification for this assumption and privately have been told it does not reflect a theoretical or empirical judgment, but rather the practical difficulty in linking estate and gift tax returns to heirs. For further discussion, see Batchelder (2009) and TPC (2018d, 2019). Experts who question whether wealth transfer taxes largely burden heirs generally assume their enactment is accompanied by changes to income tax rates that perfectly offset their revenue or distributional effects (e.g., Hines 2009). But such perfect offsets are impossible if one believes the distributional measure should include inherited income; it would require simultaneously enacting and repealing the same changes to the taxation of inherited income.
7. To the extent that donors with large estates have saved for altruistic reasons and receiving bequests is not a tag for well-being, the optimal tax on inheritances is negative (Batchelder 2009; Farhi and Werning 2010; Kaplow 1995; Piketty and Saez 2013a). But neither of these assumptions holds in reality. Receiving large inheritances does increase the heir's well-being, and the vast majority of large wealth transfers stem from other saving motives, especially egoistic saving, for which the optimal tax rate is 100 percent (Batchelder 2009; Gale and Slemrod 2001).
8. The empirical evidence on this point is far from conclusive. But to provide a rough sense, a review of the literature on the elasticity of taxable income with respect to the net-of-tax income tax rate concluded that the best available estimates range from 0.12 to 0.40 (Saez, Slemrod, and Giertz 2012). In contrast, a review of the literature on the elasticity of estates to the net-of-tax estate tax rate concluded, "All these papers estimate a similar baseline elasticity of between 0.1 and 0.2" (Kopczuk 2013, 365). Several caveats are in order. First, these estimates are not strictly apples to apples

because one is a stock and one is a flow, and because the taxable income elasticities include both capital and labor income and are not limited to the top of the income distribution. These elasticities also include avoidance responses in addition to real behavioral changes. Nevertheless, they suggest that, as a first pass, wealth transfer taxes may be more efficient than comparably progressive income and wealth taxes.

9. Specifically, the accrued gain on the asset at the time of the gift is not taxed until the recipient disposes of the asset due to a provision called carryover basis.
10. In other words, \$1 million = \$714,286 + \$714,286 \* 0.4.
11. Technically the GST tax was first enacted in 1976, but that version was retroactively repealed in 1986.
12. For example, \$2.5 million would produce an inflation-adjusted income of about \$122,000 to age 98, assuming a 5 percent real rate of return. In 2018 the 70th percentile of household income was \$100,000 and the 80th percentile was \$130,000 (U.S. Census Bureau 2019). This example considers the expected, not guaranteed, consumption potential of such an heir. In order to guarantee income exceeding the 75th percentile in every year, the heir would need to purchase a life annuity, which may entail a lower rate of return.
13. However, transfers to noncharitable nonprofit organizations (such as 501(c)(4), (c)(5), and (c)(6) organizations) would be taxable at the highest income and payroll tax rates.
14. The heir's marginal tax rate on their taxable inheritance would be lower than the sum of their marginal income and payroll tax rates because individuals can deduct or exclude half of payroll taxes on their income tax return. Thus, the top marginal tax rate on inheritances would be  $0.37 + 0.153 - (0.37 * 0.0765) = 0.4947$ . This heir's average tax rate would be 8.2 percent because this marginal tax rate applies to only one-sixth of their inheritance.
15. It also would maintain current law for transfers of tangible personal property, such as furniture and small family heirlooms, but not collectibles.
16. There are interactions between this proposal and the proposed changes to the rules governing transfers through trusts and similar devices described in box 1. Generally, constructive realization should apply to the donor in the same circumstances as the withholding tax on wealth transfers. In addition, constructive realization should apply to the heir when their final inheritance tax liability is determined. For example, suppose a donor contributes appreciated assets to a GRAT, of which 60 percent is expected to go to the donor and 40 percent to their heir. The donor would then pay tax on 40 percent of the accrued gains at the time of the contribution, and the basis in the GRAT's asset would be adjusted accordingly. When the heir ultimately receives the remaining assets, they would pay tax on any accrued gains above and beyond those constructively realized by the donor, including gains that accrued in the intervening years. A number of complex issues that might otherwise arise would be mitigated or resolved by the facts that constructive realization would apply to transfers to charities, and the rate applicable to gains constructively realized when assets are contributed to a trust would be the donor's, not the heir's. For further discussion of some of these issues, see American College of Trust and Estate Counsel (ACTEC 2019).
17. The heir would receive a carryover basis to the extent the accrued gain is exempt from constructive realization because this is a gift. If the transfer instead was a bequest, the heir would receive a stepped-up basis for the exempt portion of the accrued gain (i.e., their basis in the stock would be \$3 million).
18. For these purposes, liquid assets include cash, cash management accounts, state and local bonds, federal government bonds, publicly traded stock, and life insurance on the life of the decedent that is payable to the estate. It does not include proceeds from insurance on the life of the donor that is payable to the heirs (JCT 2015).
19. This would include circumstances in which the business sells some of its assets and distributes the proceeds to the heir, or when the heir and/or related parties incur nonrecourse debt secured by the business or its assets.
20. Specifically, the proposal would repeal § 6166, which allows estates to defer paying the estate tax due on certain closely held businesses for up to 15 years at a below-market interest rate; § 2032A, which permits valuation discounts for real property used in a trade or business; and § 2702, which allows donors to undervalue personal residences for gift tax purposes in certain circumstances (JCT 2015; Miller and Maine 2011).

21. Their taxable inheritance would be \$10 million and their marginal tax rate would be 49.5 percent.
22. Specifically, contributions to dynastic trusts would be subject to a withholding tax at the top income and payroll tax rate (currently 49.5 percent). Distributions from such trusts to skip heirs (two more generations younger than the donor) would be taxed at the heir's ordinary income tax rate and the payroll tax rate (disregarding the taxable maximum) to the extent they exceed the heir's lifetime exemption. Skip heirs would not receive a credit for their portion of the withholding tax, which is the GST tax, except to the extent of any unused portion of their own lifetime exemption or that of their parents. If the donor directly transfers assets to a skip heir, rather than through a dynastic trust, the GST tax would not apply. The rationale for exempting direct transfers to skip heirs is that it is far less likely in such circumstances that the intervening generations had access to the assets the skip heir inherits and chose to forgo such access.
23. Comparable estimates for the estate and gift tax are not available.
24. The withholding tax would apply to the tax-inclusive gift or bequest, as would the heir's income and payroll tax liability. For example, suppose a donor wants to transfer \$1 million after tax to their heir. They would need to set aside \$1,980,198 for the transfer and would remit a withholding tax of 49.5 percent, or \$980,198, on that amount, with the remaining \$1 million going to the heir. The heir would report an inheritance of \$1,980,198 on their Form 1040. If the heir had already used up their annual and lifetime exemptions and was in the highest tax bracket, they would owe no additional tax and would receive no refund. However, if these conditions did not hold, the heir would receive a credit for the excess withholding tax paid.
25. The effective date should be a date earlier than the date of enactment, such as the date of introduction, in order to limit tax planning in anticipation of the reform. This is a common practice in tax legislation.
26. These include discounts for lack-of-marketability, lack-of-control, and minority interests (Cunningham and Cunningham 2018).
27. Another example is an installment sale by a donor to their grantor trust, which the trust pays for with an installment note bearing a low rate of interest (U.S. Senate Committee on Finance 2017).
28. This treatment would apply even if state law or the governing documents limit the heir's ability to sell, redeem, or liquidate their interest.
29. Following Dodge (2016), retained interests would be defined broadly to include the possibility of the donor receiving trust income or assets under another person's power, even if that power is limited by standards such as support.
30. This treatment would apply to charitable lead annuity trusts, irrevocable life insurance trusts, insurance dedicated funds, and Crummey trusts, just to name a few examples.
31. This treatment should apply to income tax payments by the donor after the effective date, whether on behalf of new or existing grantor trusts.
32. For proposals, see Schmolka (2000), Soled (2001), Ascher (2010), and Cunningham and Cunningham (2012). If the grantor trust rules were largely repealed, this proposal would be less necessary.
33. The IRS has conducted more limited studies since then and, controlling for estate size, the distribution of estates among heirs does not appear to have changed in any dramatic ways (Joulfaian 2019).
34. If one excludes households that do not receive an inheritance in the current year, the corresponding percentages are 0.8 percent, 3.6 percent, and 7.7 percent. Arguably, the best approach would be to rank households by lifetime inheritances received and include those that never receive an inheritance. In this case, the share of households burdened by the proposal would also be very small because only a small minority ever receive an inheritance (Thompson and Suarez 2015).
35. Specifically, TPC estimates the estate and gift taxes at the 2009 parameters (indexed) would raise \$518 billion over calendar years 2020 to 2029, relative to a baseline of no wealth transfer taxes. The estate and gift tax lifetime exemption in 2020 would be \$4.14 million after indexing (\$8.28 million per couple). Disregarding constructive realization, TPC estimates the proposed inheritance tax would raise \$511 billion over the same period in steady state relative to a baseline of no wealth transfer taxes. While TPC assumes the proposal is effective immediately (i.e., that it applies to gifts and bequests received after December 31, 2019), some of the revenue raised from transfers in 2028 to 2030 would not be collected until after 2030, and thus are not included in table 3. In addition, the

- proposal raises less in table 3 than it would in steady state because only inheritances received after December 31, 2019, count toward the lifetime exemption in table 3.
36. Heirs with inheritances far above the lifetime exemption could pay a higher average tax rate on their inherited income than their income from work because the Social Security tax applies only to labor earnings up to \$137,700 in 2020. However, this would not be the case for heirs who are not far above the lifetime exemption because it would substantially lower their average tax rate on inherited income.
  37. The U.S. states also have been less likely to repeal inheritance taxes than estate taxes (Cammenga 2019; McNichol 2019).
  38. Most inheritance taxes in the U.S. states and around the world are accessions taxes, which provide an exemption for each heir and then apply a flat, low rate above that exemption that is unrelated to the heir's income or payroll tax rate (Batchelder 2009).
  39. Banks and trust companies acting as trustees must report the amount of trust assets they manage, which was \$918 billion in 2018 (Sitkoff and Dukeminier 2017). But when a private individual serves as the trustee, there is no similar reporting requirement. Moreover, many trust assets, including real estate and closely held business interests, cannot be held in a trust maintained by a bank or trust company (Crawford 2019).
  40. As explained in Batchelder (2009), because exchange-motivated transfers are essentially compensation, they should be taxed like all other labor income and included in the income and payroll tax bases. Altruistic transfers should be subsidized to account for positive externalities, with the subsidy rate gradually declining to zero as the heir's ability to pay rises.
  41. The District of Columbia also has an estate tax.

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