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Considering Alternatives: Are There Methods Other Than the Estate and Gift Tax That Could Better Address Problems Associated with Wealth Concentration?

Ray D. Madoff
Boston College Law School, madoffer@bc.edu

CONSIDERING ALTERNATIVES: ARE THERE METHODS OTHER THAN THE ESTATE AND GIFT TAX THAT COULD BETTER ADDRESS PROBLEMS ASSOCIATED WITH WEALTH CONCENTRATION?

RAY D. MADOFF[*]

Abstract: This Commentary analyzes three articles generated from the Symposium "The Centennial of the Estate and Gift Tax: Perspectives and Recommendations," held on October 2, 2015 at Boston College Law School. This Commentary explores the underlying purpose of the estate and gift tax: eliminating wealth inequality. It then considers the three articles' proposed alternative tax systems—namely an accession tax and a wealth tax—that could more adequately address the problem of wealth concentration, and evaluates the merits of each.

INTRODUCTION

The estate and gift tax is in a precarious position. Once a well-accepted part of our country's overall tax system imposing significant levels of tax on large swaths of the population, today it applies only to the smallest percentage of the public, and at relatively modest rates. And still it is met with general antipathy, not just by Republican politicians who have long held estate tax repeal as one of their core platform positions, but even by some Democrats who treat it like Voldemort, the villain from the *Harry Potter* series whose name must not be spoken.[1]

One might conjecture that a diminished need for the estate tax has caused its unpopularity. But this is far from the case. Congress enacted the original estate tax to address wealth inequality, which by all accounts is at

[*] Professor of Law, Boston College Law School. She is the author of IMMORTALITY AND THE LAW: THE RISING POWER OF THE AMERICAN DEAD (2010).

[1] *See* Peter Baker, *House Votes to Repeal Estate Tax*, N.Y. TIMES (Apr. 16, 2015), http://www.nytimes.com/2015/04/17/us/politics/house-votes-to-repeal-estate-tax.html?_r=0 [https://perma.cc/7SPF-3BCH] (discussing the house vote to repeal what Republicans call the "death tax"); Siobhan Hughes, *Plan to Raise Estate Tax Divides Democrats*, WALL ST. J. (Nov. 30, 2012), http://www.wsj.com/articles/SB10001424127887324020804578151430887301890 [https://perma.cc/T2RU-TGSV] (calling the estate tax a "thorny issue" for some Democrats).

an all-time high today.[2] Moreover, the notion of wealth inequality as a societal problem has received broad acceptance across political and socioeconomic spectra.[3]

This leaves us with a great contemporary conundrum: why are estate and gift taxes so reviled when the problem that the taxes were designed to address is so prevalent and so widely recognized? Regardless of the answer to this conundrum, a more promising way forward may involve abandoning the estate and gift tax in favor of an alternative, raising the question: are there methods other than the estate and gift tax that could better address problems associated with wealth concentration?

The accompanying series of articles by Professors David Duff, Miranda Perry Fleischer, and David Shakow provides a strong analytic structure to explore: (1) the underlying purposes for the current estate and gift tax;[4] (2) possible alternative tax systems that could best fulfill these purposes;[5] and (3) what these systems would look like in detail.[6]

I. WHAT IS THE UNDERLYING PURPOSE OF THE ESTATE AND GIFT TAX?

The starting point for any inquiry about competing tax systems is to determine what problem we are trying to solve; only then can we consider which alternatives most effectively solve the problem.

For most tax systems, the answer is relatively straightforward: the purpose of a tax is to generate revenue for the government. Nevertheless, the estate tax is unlike other taxes because it fulfills multiple purposes and because it has generally done a fairly poor job in terms of generating revenue. As Professor Duff points out in *Alternatives to the Gift and Estate Tax*, since the end of World War II, income, consumption, and social security taxes have become the dominant means of raising revenue in most developed countries.[7] Indeed, in the United States, the percentage of revenue raised by estate and gift taxes has always been under 5%, and in 2015 it is expected to be under 1%.[8] Moreover, even if Congress could revise the estate and gift tax in such a way as to generate greater revenue (by increasing

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[2] *See, e.g.*, Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capital Income Tax Data* 1 (Nat'l Bureau of Econ. Research Paper, Working Paper No. 20,625, 2014), http://gabriel-zucman.eu/files/SaezZucman2014.pdf [https://perma.cc/RP5L-8Q9N].

[3] Michael I. Norton & Dan Ariely, *Building a Better America—One Wealth Quintile at a Time*, 6 PERSP. ON PSYCHOL. SCI. 9, 9 (2011), http://www.people.hbs.edu/mnorton/norton%20ariely.pdf [https://perma.cc/26LL-PJRC] (noting that most agree that wealth inequality is high).

[4] *See infra* notes 7−17 and accompanying text.

[5] *See infra* notes 18−21 and accompanying text.

[6] *See infra* notes 22−53 and accompanying text.

[7] David G. Duff, *Alternatives to the Gift and Estate Tax*, 57 B.C. L. REV. 893, 896 (2016).

[8] *Id.*

rates and/or decreasing exemption amounts), these same results could be more efficiently accomplished through adjustments to other taxes.

Professor Duff explores—and ultimately rejects—other possible justifications for the current estate tax system.[9] These include the estate tax's role in contributing to the overall progressivity of the tax system by imposing a larger burden on those with greater ability to pay (promoting "vertical equity"), increasing the fairness of the system by capturing an ability to pay that is not otherwise captured by the existing system (promoting horizontal equity), and curbing overall concentrations of wealth.[10] Professor Duff finds each of these rationales inadequate for purposes of justifying the estate tax, and this author generally agrees with his analysis.[11] There is, however, an additional purpose of the estate tax that should be added to Professor Duff's list: the estate tax promotes fairness by providing an essential counterweight to the extraordinary benefits conferred on inherited wealth under our income tax system.

Our current income tax system favors inherited wealth in two significant ways. First, it entirely excludes inherited wealth from taxable income. No matter how much wealth an individual inherits, whether it is $100, $100,000, or $100 million, the income tax system treats that individual the same as a person who inherits nothing.[12] The failure to tax inherited wealth is particularly glaring in light of the substantial taxes imposed on wages of working Americans, who are subject to income taxes of up to 39.6%[13] and self-employment taxes of up to 15.3%.[14] This decision to exclude inheritance from the income tax base while taxing wages at the highest rates effectively shifts the tax burden from heirs to wage earners.

Second, those with inherited wealth enjoy special benefits with respect to taxation from sales of property. Normally, when an individual sells property, he or she is subject to tax on the difference between the amount he or she receives from the sale and the original purchase price. If the property is passed on by gift, the recipient has the same basis in the property that the donor had, thus passing on any built-in gains to the recipient. There is a special basis rule, however, that applies to property passed on at death: in

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[9] *See id.* at 900−06.

[10] *See id.* at 900−04.

[11] *See id.*

[12] *See* I.R.C. § 102 (2012). This rule also applies to property received by gift and through life insurance. *See id.*

[13] *See Percentage Method Tables for Income Tax Withholding*, INTERNAL REVENUE SERV., https://www.irs.gov/publications/p15/ar02.html#en_US_2016_publink1000254686 [https://perma.cc/U39T-ZULS].

[14] *See Self-Employment Tax*, INTERNAL REVENUE SERV., https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Self-Employment-Tax-Social-Security-and-Medicare-Taxes#1 [https://perma.cc/B96A-UMVW].

that case, the heir receives the property with a basis equal to the fair market value of the property at the time of the decedent's death ("stepped-up basis"). The effect of stepped-up basis is that an heir can sell inherited property and pay no capital gains taxes, even if the decedent had significant untaxed, built-in gains at the time of death.

These factors reinforce Professor Duff's conclusion that "the unique virtue of a wealth transfer tax is to target unearned sources of wealth that not only contribute to wealth inequality, but do so in a way that perpetuates dynastic concentrations of wealth and power and undermines fair equality of opportunity."[15]

The problems of unearned wealth and dynastic power also motivate Professor Fleischer's article, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*.[16] She argues that the problem with large transfers at death is that they bestow "unearned power and influence over others."[17] This problem is distinctly different from the problems raised by inequality caused by other factors, such as earned (as opposed to inherited) wealth, and relatively modest inheritance: that which does not rise to the level of granting power and influence over others. As she notes, a couple hundred-thousand or even a million dollars might make someone's life better off, but wouldn't afford the ability to exert power and influence over others.

Having reached some modicum of agreement on the fundamental purpose of the estate tax—as a way of countering problems raised by large amounts of inherited wealth—we still must consider and evaluate alternative methods for accomplishing this result.

II. Considering Alternative Methods

We think of the estate tax as the only (or at least the most natural) way of imposing taxes on inheritances, but in fact there are several different systems that can be used. Although the estate and gift tax is imposed on the donor on the basis of the donor's accumulated lifetime and death time transfers, other possibilities exist that shift the focus to the recipient's finances. These include an "accessions tax," which imposes taxes on the recipient on the basis of the amount of gratuitous receipts received during the recipient's lifetime, or an inheritance tax which imposes taxes on the recipient on the amount of gratuitous transfers made, calculated on an annual basis. Still other alternatives involve modifications to the income tax system: either

[15] Duff, *supra* note 7, at 912.
[16] Miranda Perry Fleischer, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*, 57 B.C. L. Rev. 913 (2016).
[17] *Id.* at 914.

making the transfer of property a realization event for the donor (resulting in capital gains taxes on the gain), or treating gifts and bequests as taxable income to the recipient.[18]

The challenge in considering alternatives to our current tax system is that they need to succeed on many levels in order to be effective.[19] For example, a successful tax system must be: fair (or appear to be fair) to the public at large; manageable for those taxpayers who are subject to it; enforceable by those charged with its enforcement; administrable by those charged with its administration; and consistent with the country's broader societal values.

The tax systems that we currently have—the income tax system and the estate and gift tax system—may not meet all of these ideals, but their sheer familiarity often makes us more accepting of their limitations. Nevertheless, when considering new tax systems—like an accessions tax and a wealth tax—their unfamiliarity makes us more wary and less accepting of their flaws.

This skepticism makes the work of Professors Fleischer and Shakow all the more challenging. They must consider how their proposed systems—the accessions tax and the wealth tax, respectively—would function on all levels and how they would handle novel issues, like new types of valuation problems, as well as more familiar ones, such as how to handle family businesses and charitable giving. Section A of this Part explores Professor Fleischer's proposed accessions tax.[20] Section B examines Professor Shakow's wealth tax.[21]

A. Considering an Accessions Tax

It is not surprising that having identified a similar purpose of the estate tax, both Professors Duff and Fleischer also find that an accessions tax best addresses their shared concerns. The strength of the accessions tax is that it focuses on the recipient of property (who, after all, is the potential power holder) instead of the donor. By imposing taxes based on the recipient, it

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[18] Unfortunately the authors did not have time to consider the value of extending the income tax to include gifts and inheritances. Although this might be over-inclusive in terms of handling dynastic wealth, it is probably more politically viable, as many Americans already assume that inherited wealth is subject to income taxes.

[19] In this way, it is similar to Tolstoy's famous line: "Happy families are all alike; every unhappy family is unhappy in its own way." LEO TOLSTOY, ANNA KARENINA 1 (Joel Carmichael trans., Bantam Books 1960) (1877). What this seemingly enigmatic statement means is that a happy family must satisfy myriad criteria; failure to satisfy a single one can create an unhappy family. Similarly, a successful tax system (like a happy family) must satisfy many different criteria.

[20] *See infra* notes 22−39 and accompanying text.

[21] *See infra* notes 40−55 and accompanying text.

encourages the donor to break up his or her estate into smaller shares, as that will result in an overall lower tax liability, as each recipient will have his or her own exemption level and rate ladder.[22]

Professor Fleischer's article in particular makes an important contribution to the literature by articulating the details and challenges of her proposed accessions tax.[23] These various examples illustrate that when evaluating a proposed tax system, the devil is in the details. Still, Professor Fleischer threads the needle in such a way that allows her conclusions about what constitutes an accession to make sense.[24] Nevertheless, she knows that she will be unable to make rules that adequately capture all situations in which a person has achieved greater influence and power.[25] To address that problem, she also recommends imposing a special estate tax whenever assets are transferred to a trust whose beneficiaries are somehow able to exercise substantial influence over those assets, even if the rules would not impute an accession until a later point.[26]

In the end, Professor Fleischer has done much of the heavy lifting for a legislative body with the vision, integrity, and political acumen needed to forge a new solution to an ongoing and pernicious problem. Her proposal addresses the issues of exemption amounts, annual exclusions, distinctions based on relationships, trusts and powers of appointment, charitable donations, and family farms and businesses.[27]

1. Exemption Amounts

The critical task of any tax designed to curb large concentrations of wealth is to delineate an appropriate cut-off for "large." Those interested in addressing solely the issue of inequality might impose taxes even when the inequality is minimal. But because Professor Fleischer is primarily concerned with curbing power that results from extreme inequality, she chooses a per-recipient exemption amount that is actually higher than that which we have seen in the estate tax world: each individual would be able to inherit \$10–20 million before being subject to tax.[28]

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[22] *See* Fleischer, *supra* note 16, at 922. Professor Fleischer notes how poorly the current estate tax system works from this perspective because it draws no distinction based on whether the wealth is being broken up or not. *See id.* Alternatively, Professor Shakow argues for an annual wealth tax imposed on living taxpayers. David J. Shakow, *A Wealth Tax: Taxing the Estates of the Living*, 57 B.C. L. REV. 947 (2016); *see infra* note 40 and accompanying text (discussing Professor Shakow's article).

[23] *See* Fleischer, *supra* note 16, at 927−46.

[24] *See id.*

[25] *See id.* at 927.

[26] *See id.* at 939−41.

[27] *See id.* at 928−29, 937−44.

[28] *See id.* at 928.

2. Annual Exclusions

Gifts are a regular part of human life, and in order to reduce the intrusiveness and administrative burdens of a gift tax, it is useful to set an amount under which no reporting is required. Professor Fleischer adopts the current annual exclusion of $14,000 for lifetime gifts and includes an additional annual exclusion of $100,000 for bequests received.[29] Transfers within these amounts would not only avoid taxation, but would also not be subject to reporting requirements.[30]

3. Distinctions Based on Relationships

Under our current estate tax system, unless the transfer is to a spouse, all recipients are treated the same regardless of the particular relationship between the donor and the recipient. Professor Fleischer, however, proposes to tax receipts from close relatives more heavily than other gratuitous transfers.[31] Initially this seems peculiar, as most inheritance taxes impose lighter taxes on transfers to closer family members and heavier taxes on transfers to more distant relatives.[32] Under Professor Fleischer's system, transfers between spouses would remain tax free, but transfers to immediate relatives (defined as lineal ascendants and descendants and siblings of the decedent and their spouses) would be taxed at roughly twice the rate of transfers to other individuals (cousins, nieces, nephews, and friends).[33] Her goal is to encourage donors to spread their wealth more widely than they otherwise might.[34]

4. Trusts and Powers of Appointment

The treatment of trusts is a challenging one for an accessions tax. Professor Fleischer does an admirable job of exploring whether the tax should be imposed on creation, vesting, or distribution from the trust.[35] She recognizes that in keeping with the goal of her accessions tax, the taxable moment should ideally be at the time that the trust interest enhances the holder's influence and power.[36] But given the huge variety of trust interests, this

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[29] *See id.* at 929.
[30] *See id.*
[31] *See id.* at 930.
[32] This is presumably based on some notion that there is a greater right of inheritance from closer relatives, and inheritances from more distant relatives results in more of a windfall to the recipient.
[33] *See* Fleischer, *supra* note 16, at 930.
[34] *See id.*
[35] *See id.* at 933–41.
[36] *See id.* at 934.

precise moment is not self-evident. Moreover, the ability to exert control also depends upon whether or not the beneficiary is also a trustee, and further, about the trustee's particular powers. Powers of appointment raise a similar challenging issue. General powers of appointment clearly afford this power, but what about broadly granted non-general powers? One thing we know from the estate and gift tax world is that non-general powers of appointment can still confer great power on the holder.

5. Charitable Donations

The issue of transfers to charities raises a more interesting question. Our current income tax and estate and gift tax tend to grant favorable tax treatment for transfers to all § 501(c)(3) organizations, regardless of their degree of control.[37] Professor Fleischer recognizes how an individual can be granted significant control and influence even through a charitable entity.[38] For that reason, she wisely recommends that transfers to charities controlled by a family member should be taxed, though at a lower rate than that imposed on property controlled outright.

6. Family Farms and Businesses

Any tax on wealth is likely to raise issues for farms and family businesses. This has been the bugaboo of the estate and gift tax system: opponents have used the specter of forced liquidation of small businesses and farms to argue against the estate tax. An accessions tax arguably raises the same concern. Professor Fleischer addresses this concern in two ways: first, the large $20 million exemption will cover the vast majority of family farms and businesses; and second, in cases in which the exemption does not apply, she provides relief for those taxpayers whose tax liability exceeds the liquid assets received.[39]

B. Considering a Wealth Tax

As an alternative to an accessions tax, Professor Shakow considers the viability of an annual wealth tax in his article, *A Wealth Tax: Taxing the Estates of the Living*.[40] He argues that a wealth tax could serve as a substitute

[37] The deduction for contributions to private foundations are in some ways less favorable than to public charities.
[38] *See* Fleischer, *supra* note 16, at 942–43.
[39] *See id.* at 943–44 & n.143.
[40] *See generally* Shakow, *supra* note 22.

not just for the estate tax, but for the income tax as well.[41] It is in this last role that Professor Shakow focuses his attention.[42]

As a historical matter, Professor Shakow notes that the purpose of the estate tax was to impose the tax burden on "those deriving the most benefit and protection from the Government."[43] He suggests that based on this standard, however, Congress likely proposed the estate tax as a "surrogate" for a wealth tax.[44] Congress likely declined a wealth tax because an annual property valuation seemed more daunting than simply measuring income. But after more than a century of the income tax system, Professor Shakow asks whether it is time to re-examine this issue.[45] His article's goal is to do just that: take seriously the concerns of enacting a wealth tax.[46]

A wealth tax depends on accurate valuations of property. Indeed, one of the consistent arguments brought against a wealth tax is the difficulty in valuation. Although the values of some types of wealth are readily measurable, others are not. Professor Shakow notes that critics have listed a range of assets as particularly difficult to value: real estate, closely held stock, non-corporate business assets, farm assets, private equity and hedge funds, and other limited partnerships.[47] Nevertheless, Professor Shakow considers each of these categories and shows how valuation might not be as difficult as it first seems.[48] For example, real estate (which comprises twenty-two percent of all assets) is already subject to regular valuation by local property taxes as well as private valuation services like Zillow.[49]

Where valuation of assets remains a problem—such as in closely held businesses—Professor Shakow points out that determining income can also be problematic.[50] In support of this, he cites a 2007 report from the U.S. Government Accountability Office, estimating that only forty-three percent of income from sole proprietorships was being accurately reported.[51] The accuracy of the valuation can be affected by the taxpayer's interest in avoiding the taxes. This in turn is affected by the tax rates, as higher tax rates presumably give greater incentive for taxpayers to reduce valuation.

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41 *See id.* at 951.
42 *See generally id.*
43 *Id.* at 948 (quoting H.R. REP. NO. 64-922 (1916), *reprinted in* 1939-1 C.B. (pt. 2) 22, 23).
44 *Id.*
45 *See id.* at 949.
46 *See id.* at 949−50.
47 *See id.* at 953.
48 *See id.* at 952−58.
49 *Id.* at 953−54.
50 *See id.* at 955.
51 *Id.* at 955 & n.52 (citing U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1014, TAX GAP: A STRATEGY FOR REDUCING THE GAP SHOULD INCLUDE OPTIONS FOR ADDRESSING SOLE PROPRIETOR NONCOMPLIANCE 1 (2007), http://www.gao.gov/assets/270/265399.pdf [https://perma.cc/8SNB-SDJ5] (estimating that sole proprietors misreported 57% of their income in 2001)).

Professor Shakow's plan works to ameliorate this dilemma. He designed it to operate as a substitute for the individual and corporate income tax.[52] As such, it can use a relatively low rate of taxation: approximately 1.6%. He argues that this low rate provides less of an incentive to undervalue property.[53] Yet this argument fails to take into account the fact that although a single tax of 1.6% might seem low, an annual tax at that rate quickly adds up. As such, taxpayers may not be so sanguine regarding the issue of valuation.

Moreover, Professor Shakow chose the 1.6% rate as a way for the wealth tax to approximate the same amount of taxes raised by the current income tax system.[54] It also leaves the burden on both wages and capital roughly the same as under current law. But to fulfill the purpose of the estate tax—to impose higher taxes on those deriving the most benefit and protection from government—then the tax rate would need to be significantly increased. There would also likely be a greater emphasis on taxes on capital as opposed to taxes on wages. This paradigm would increase incentives for taxpayers to focus on questions of valuation.

Professor Shakow has provided a valuable service in answering the concerns raised by the estate tax.[55] Still, it seems unlikely to me that Congress will impose a wealth tax as a substitute for the income tax. In this age of growing awareness of wealth inequality, however, it seems increasingly probable that Congress may adopt a wealth tax as a supplement to the income tax as a way of promoting vertical equity. When legislatures turn to this issue, Professor Shakow's analysis will serve them well.

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[52] *See id.* at 951.

[53] As Professor Shakow notes, "[T]o the extent that the wealth tax described in this Article leads to a flat tax rate on wealth that is around 1.6%, valuation issues must be quite great for taxpayers to pursue them very far." *Id.*

[54] *See id.* at 971.

[55] *See id.*