The Contemporary Tax Journal

Volume 5
Issue 2 *Winter 2016*

Article 13

2-12-2016

Analysis of the Federal Estate Tax

Rachita Kothari
San Jose State University

Recommended Citation

Kothari, Rachita (2016) "Analysis of the Federal Estate Tax," *The Contemporary Tax Journal*: Vol. 5 : Iss. 2 , Article 13.
https://doi.org/10.31979/2381-3679.2016.050213 https://scholarworks.sjsu.edu/sjsumstjournal/vol5/iss2/13

ANALYSIS OF THE FEDERAL ESTATE TAX
By Rachita Kothari, MST student

Introduction

The federal estate tax, in varying forms, has served as a source of funding the government of the United States for more than two centuries. The current federal tax system on the transfer of wealth has three major parts: the estate tax, gift tax and generation skipping transfer tax. Per section 2001(a) of the Internal Revenue Code, property transferred by a deceased person is subject to the estate tax. Normally it is the estate of the decedent that has to pay the tax and not the heirs who inherit the estate. As the estate tax, if applicable, is normally paid to the state prior to final distributions to the heirs, the estate tax indirectly reduces the amount of estate the heirs can inherit.

The estate tax is one of the most progressive taxes levied by the federal tax system because it taxes the wealthy taxpayers. Typically only the wealthy multi-millionaire and billionaire Americans pay estate tax on their property exceeding the exemption limits. For single individuals the exemption limits for 2015 are $5.43 million.[52] In case of married couples the potential unused exemption amount of the deceased spouse may be passed to a surviving spouse under certain circumstances provided an election is made on the federal estate tax return filed by the deceased spouse. This is known as exemption portability, according to which a surviving spouse is eligible for a total exemption amount of up to $10.86 million. To elaborate, if a deceased spouse does not use the exemption amount at all and makes an election in the estate tax return filed, then the surviving spouse would have a total exemption limit of $10.86 million, which would be $5.43 million of the surviving spouse and $5.43 million from the deceased spouse.[53]

While computing the estate tax, certain deductions and exemptions are available to compute the "Taxable Estate." One of the deductions is marital deduction, wherein any amount of estate transferred by a deceased to a spouse is normally exempt from estate tax.[54] Another deduction is bequests to charitable organizations – including religious and public use organizations. [55] Charitable contributions made by the estates are allowed as a deduction without any limits to compute the taxable estates, unlike in case of individual returns where the deduction may be limited

The estate tax rate is a progressive structure, with a maximum rate of 40 percent. A Federal Estate Tax Return (Form 706) has to be filed within nine months following the day of death, if the sum of the taxable estate and prior taxable gifts cumulatively exceed the exemption limits mentioned above. In 2015, gifts to individuals up to a total amount of $14,000 (per recipient) are generally exempt

[52] Internal Revenue Service, In 2015, Various Tax Benefit Increase Due to Inflation Adjustments, October 23, 2014; http://www.irs.gov/uac/Newsroom/In-2015,-Various-Tax-Benefits-Increase-Due-to-Inflation-Adjustments

[53] Internal Revenue Code, § 2010(c)(4) - Deceased Spousal Unused Exclusion Amount

[54] Internal Revenue Code, § 2056(a) - Allowance of marital deduction

[55] Internal Revenue Code, § 2055 - Transfers to Public, Charitable, and Religious Uses

from gift tax.[56] Form 4768 is filed for an automatic extension of 6 months to file the federal estate tax return.

The estate tax applies to a small number of estates due to the high exemption limits and various deductions. According to the Joint Committee on Taxation, 99.8 percent of estates do not owe any estate tax.[57]

The revenue generated from the estate tax is a small fraction of the total federal tax revenues, but it is a consistent source of federal revenue. The estate tax is expected to raise approximately $20 billion in the year 2015.[58] According to the Joint Committee of Taxation, under the current law, the estate tax will generate approximately $270 billion over the next ten years.[59]

In April 2015, the proposal H.R. 1105 (114th Congress) passed in the House Ways and Means Committee and the full House to completely repeal the estate tax and generation skipping transfer tax for decedents dying after the date of enactment of the proposal.[60] The proposal is pending the Senate Finance Committee's review.

---

[56] Internal Revenue Code, § 2503(b) - Exclusion from Gifts

[57] Committee for a Responsible Federal Budget, Ways & Means Committee Adds $270 Billion to Deficits by Repealing Estate Tax, March 26, 2015; http://eww.budgetreform.org/blogs/ways-means-committee-adds-270-billion-deficits-repealing-estate-tax

[58] Office of Management and Budget, *Table 2.5, Composition of Other Receipts*; http://www.whitehouse.gov/omb/budget/Historicals.

[59] Joint Committee on Taxation, "Description of HR. 1105, The "Death Tax Repeal Act of 2015"," March 25, 2015, Pg 13; https://www.jct.gov/publications.html?func=startdown&id=4760

[60] Congress.Gov, H.R. 1105 - Death Tax Repeal Act of 2015, April 16, 2015; https://www.congress.gov/bill/114th-congress/house-bill/1105?q={%22search%22%3A[%22\%22hr1105\%22%22]}&resultIndex=1

DOI: 10.31979/2381-3679.2016.050213

Application of Principles of Good Tax Policy

The following section will briefly analyze the existing Estate Tax law using the ten principles of good tax policy outlined in the AICPA Tax Policy Concept Statement No. 1: Guiding Principles of Good Tax Policy: A Framework for Evaluating a Tax Proposal.[61]

Criteria	Does The Proposal Satisfy the Criteria?	+/-
Equity and Fairness – Similarly situated taxpayers taxed similarly	There are two kinds of equity - horizontal equity and vertical equity. As per horizontal equity, similarly situated taxpayers should pay the same amount of tax. For vertical equity, taxpayers with greater ability to pay should pay more tax. Under the estate tax, two similarly situated taxpayers with the same amount of estate value would generally pay the same amount of the estate tax. Accordingly, the estate tax meets the principle of horizontal equity. With regards to vertical equity, the estate tax is one of the most progressive taxes in the federal tax system because of the high exemption limit and the graduated rate structure. It is based on the value of the taxable estate. The estate tax only affects the wealthy taxpayers and has no impact on middle income or low income taxpayers; if the estate of a taxpayer is of significant value, the taxpayer would have to pay higher amount of estate tax and vice-versa. Accordingly, the estate tax meets the principle of vertical equity. However, taxpayers may do a lot of planning, which can result in the reduction of the taxable estate of the decedent, thereby reducing the estate taxes. This violates the principle of vertical equity since large estate taxpayers, with the help of planning, will pay low or no estate taxes.	+ for horizontal equity +/- for vertical equity
Certainty – The tax rule should	The estate tax law clearly specifies the exemptions limits, slab rates, filing of return and payment of taxes within nine months after the date of death and all the relevant	+/-

[61] Shaping a Better Tax System, AICPA's Tax Reform Center; http://www.aicpa.org/Advocacy/Tax/Pages/TaxReform.aspx

clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined	instructions. It also lists the amounts to be included and deductions to be claimed to compute the taxable estate. Thus, the estate tax is certain to this extent. However, a taxpayer may not know for certain that his estate would owe any taxes after his death, because the tax base for estate tax is typically the market value of the property left by the deceased person on the day of death. Additionally, the valuation of certain assets such as business interests, artwork and antiques would be challenging and not as simple as valuing cash or publicly traded securities. This increases the uncertainty in determining the total value of the estates. Moreover, the timing of the estate tax depends on the death of a taxpayer. The estate tax base also cannot be determined until death. Therefore, the estate tax is uncertain to that extent.	
Convenience of Payment – A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer	The estate tax is due after the death of a person. However, wealthy taxpayers subject to estate tax would owe a huge amount of tax. It might be inconvenient to pay such large amounts of tax at once. In some cases, the estate may need to liquidate the assets to facilitate the estate tax payment. This would make the tax payment inconvenient. There is an exception whereby small businesses and farmers can pay the estate tax over a period of 10 years.[62] This would make the estate tax payment convenient for small businesses and farmers who may not have enough liquid assets to easily pay any applicable estate tax.	+/-
Economy in Collection – The costs to collect a tax should be kept to	Every tax involves some amount of compliance cost, and the estate tax is no different. The tax administration and the taxpayer have to invest huge amount of time, effort and cost.	-

[62] Internal Revenue Code, § 6166 - Extension of time for payment of estate tax where estate consists largely of interest in closely held business

a minimum for both the government and taxpayers	The executor of the estate has to have the property valued, which involves time and cost. Additionally, taxpayers spend substantial amount of money towards estate tax planning. Lawyers and accountants spend a lot of time in developing tax minimization strategies. Further, some of the taxpayers might think that they will owe an estate tax, and hence they spend money on estate planning. Later, if they do not owe any estate tax, all the money spent is a waste. Accordingly, the cost to collect estate tax is not a small amount for the taxpayer and the tax administration.	
Simplicity - Tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner	Computation of the estate tax is not a simple task for the executor of an estate. It is difficult for a taxpayer to understand and comply with it. Computing the estate tax involves complicated calculations, such as inclusion of gifts transferred during the lifetime of the deceased, determination of various deductions which could be claimed by the deceased, and valuation of the property left by the deceased person as on the date of death. The base estate tax return (Form 706) is 31 pages long (not including any potential attached schedules or forms). Due to its complexity, it is difficult for someone other than a tax accountant to prepare the estate tax return. Additionally, it involves a lot of record keeping by the decedent and the heir. In view of the above, the estate tax law is complicated for the taxpayers to understand and comply on their own; which might lead to calculation errors.	-
Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in	The estate tax influences a taxpayer's decision in a couple of ways. It affects the taxpayer's decision regarding how much they should save, invest and donate to charity and when to sell the appreciated assets. Because a taxpayer gets a complete deduction for charitable contributions, they would be influenced to donate more to charity to reduce their taxable estate and	-

a transaction should be kept to a minimum	thereby fall in a lower estate tax bracket. Various studies have found that there is a correlation between the estate tax and the amount of charitable giving. [63] The estate tax also encourages a person with large estates to make exempt gifts each year and reduce the amount of the estate tax liability on their death. For the year 2015, a gift of $14,000 or less received per recipient from a single person is exempt from tax.[64] Certain gifts are completely exempt from gift tax such as gifts given to spouses who are US citizens; gifts paid directly to a medical provider towards another's medical expenses or gifts paid directly to a college or university towards tuition expenses for someone else.[65] All of the above would reduce the amount of estate tax owed on the death of the estate holder. Based on the above arguments the estate tax influences the decision of a taxpayer to great extent. Hence, the estate tax does not meet the principle of neutrality.	
Economic Growth and Efficiency – The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined	The estate tax has different impact on different types of taxpayers. Due to the estate tax, some taxpayers might save less and would not be willing to invest and grow their money. This might be the case with small farmers and businesses. Therefore, there would be less capital available in the economy. To this extent, the estate tax does not meet the principle of economic growth and efficiency. However, some taxpayers might not react similarly. Even if the estate tax is likely, they would try to grow their business and invest more money. They would want to earn more money to offset the taxes paid to the government. Consequently, estate tax promotes economic	+/-

[63] Robert McClelland and Pamela Greene, "The Estate Tax and Charitable Giving," Congressional Budget Office, July 2004, https://www.cbo.gov/publication/15823?index=5650
[64] Internal Revenue Service, Frequently Asked Questions on Gift Tax, November 2, 2015; https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Frequently-Asked-Questions-on-Gift-Taxes
[65] Internal Revenue Code, § 2503(e) - Exclusion for certain transfers for educational expenses or medical expenses

	growth and efficiency. It is inconclusive whether the estate tax increases or reduces the productive capacity of the economy. A Congressional Service Report has also mentioned that it is unclear whether estate tax increases economic growth or impedes it.[66]	
Transparency and Visibility – Taxpayers should know that the tax exists and how and when it is imposed upon them and others	Taxpayers are aware that the estate tax exists. The taxpayers know that on death if the estate value exceeds the exemption limits then they have to pay the estate tax. The taxpayers would not know the exact amount of the estate tax they will owe. The estate tax is one of the very important political and economic topics. Any changes that affect the estate tax liability would be known to the public. As a result, the estate tax is transparent and visible to the taxpayers.	+
Minimum Tax Gap – A tax should be structured to minimize non-compliance	As mentioned above the estate tax is complex because of which the taxpayers might make accidental or unintentional errors. Additionally, taxpayers hire lawyers or accountants to develop tax minimization strategies to evade the estate tax. This has led to significant loss of revenue. There would not be a situation where the taxpayer would fail to file an estate tax return. It is clear that the tax has to be paid after a person dies. Accordingly, every estate will file the estate tax return.	+/-
Appropriate Government Revenues –	The government would be able to determine how much estate tax revenue would be collected in the future years. The Joint Committee of Taxation Report has predicted	+

[66] Jane G. Gravelle and Donald J. Marples, "Estate and Gift Taxes: Economic Issues," Congressional Research Service, November 27, 2009

The tax system should enable the government to determine how much tax revenue will likely be collected and when	the amount of estate tax revenue collected for next 10 years is $270 billion.[67] It also provides break-up of tax collection for each year. Accordingly, the government is able to determine the amount of tax they can collect over a specific period of time.	

[67] Joint Committee on Taxation, "Description of HR. 1105, The "Death Tax Repeal Act of 2015"," March 25, 2015, Pg 13; https://www.jct.gov/publications.html?func=startdown&id=4760

DOI: 10.31979/2381-3679.2016.050213

Conclusion

Based on the above analysis, the existing estate tax law does not completely meet all the principles of good tax policy. It satisfies one of the most important principles, that of equity. Additionally, the estate tax also meets the principles of transparency, visibility and appropriate government revenues. The estate tax partially meets the principle of certainty, convenience of payment, economic growth, and efficiency and minimum tax gap. The estate tax fails to meet the principle of economic collection, simplicity and neutrality.

Based on the above, there are certain shortcomings of the current estate tax law, and it should be reformed in the light of these principles. Two of the major principles which should be improved are the principle of simplicity and economy of collection. The revenue collected from estate tax is not justifiable to the amount of time, cost and effort spent by the tax administration and the taxpayer. The cost involved in estate planning is significant. As the collected amount is small, Congress should try to simplify the tax laws.

Congress should consider strengthening the estate tax because tax laws are being misused by the taxpayers to elude estate tax. The law related to the estate tax has been drafted very loosely, and leads to misuse and tax avoidance. Instead of proposing to repeal the estate tax under the H.R. 1105, Congress should consider making some major reforms to the existing estate tax law. In considering to completely repealing the estate tax law, Congress should make major changes in other related tax laws. It should also get rid of the stepped-value in the basis of a property when it is transferred by the deceased. The basis of the property to the heir should be the basis of the deceased. This could effectively serve the main purpose of the estate tax.

Taxes reduce a taxpayer's saving and consumption. At the same time, taxes are essential for a civilized society. With the increasing federal deficit, the government has to take measures to reduce the tax expenditures and increase the revenue raised. Estate tax is an important source of tax revenue for the government, and helps to maintain the equal distribution of wealth in the society.