INHERITANCE AND GIFT TAXATION

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Abstract

This chapter reviews the economic literature on inheritance and gift taxation. It discusses, among other things, the arguments for subsidizing transfers, the advantages of and problems with accessions taxation, the relationship of transfer taxes to income tax, proposals for unification of tax rates, proposals for base integration, special rules for transfers within family units, problems with interspousal transfers, and the implementation of generation-skipping-transfer taxes.

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1. Introduction

Although death duties and comparable excises have existed since ancient times, long outstripping income taxation in length of history, no modern industrial or postindustrial state relies on estate, inheritance, or gifts taxes (‘transfer taxes’) for a significant portion of its revenues. As a result, transfer taxation plays almost no role in fiscal policy. Moreover, in most countries transfer taxes affect a small proportion of the population. In the United States, for example, less than 1 percent of all decedents who have died since the 1981 rate cuts went into effect have had to file estate tax returns, much less pay any tax. But for the few persons affected by transfer taxation, either as a potential transferor or transferee, the levy can be huge. For the wealthiest persons in the United States, a bequest to grandchild might be taxed at a 78.25 percent marginal rate.

2. Historical Pattern

Perhaps for these reasons, the law and economics literature has not focused on transfer taxation to the extent it has on other tax issues. Rather, one may detect a pattern where, every generation or so, there takes place broad normative
discussions of transfer tax design. The discussion plays itself out, usually without much consequence for the actual tax rules. The topic disappears from view, to return some years later. When less radical changes do transpire, the ensuing commentary reflects the broad-based literature but does not necessarily build upon it. Thus in the 1960s Meade (1964), Shoup (1966), Tait (1967), Jantscher (1969), and Andrews (1973), among others, either initiated or responded to proposals for systemic and expansionary transformation of transfer taxation. These proposals in turn drew on ideas propounded in Simons (1938) and Vickrey (1947). Two decades after this flurry of interest in increasing the effectiveness of transfer taxation, Bracewell-Milnes (1989) presented diametrically opposed, but at least as radical, proposals to abolish taxes on gifts and bequests. These works and the scholarly traditions to which they have contributed have framed a number of policy issues, some fundamental and others more technical, but have not provided definitive answers to any of the questions raised.

3. Role in Redistribution of Wealth

Most transfer tax systems, and particular that of the United States, target the rich, either largely or exclusively. Much of the debate about these taxes therefore turn on assumptions about the existing distribution of wealth and the feasibility of effecting a redistribution. Both sides of this debate accept for purposes of argument the legitimacy of wealth redistribution as a social goal. Proponents of transfer taxation argue that ownership of assets is concentrated among a small portion of the population, that this concentration of wealth does not represent only differences in lifetime consumption, and that transfer taxation represents an effective way of redressing the misdistribution of economic power. These points are forcefully put in Vickrey (1947), Meade (1964), Shoup (1966), Tait (1967), Jantscher (1969), Kurtz and Surrey (1970), Brannon (1973), Graetz (1983) and Pechman (1987). Critics argue that measures of the concentration of wealth are underinclusive and therefore exaggerate the extent of concentration, that a large portion of wealth represents provisions against future consumption, and that the causes of inequality in society either are not related to family property holdings or cannot be remedied by a tax on gratuitous transfers of property. Variations of these points can be found in Collie (1973), Covey (1973), McCaffery (1994), Wagner (1977) and Bracewell-Milnes (1989).
4. Life-Cycle Assets versus Capital Assets

One important empirical question that underlies the debate over the efficacy of transfer taxation as a means of redistributing wealth is the proportion of wealth that is transferred gratuitously. The literature has developed a distinction between life-cycle assets, which represent household savings intended to finance future consumption, and capital assets, which households accumulate with the purpose of transferring to future generations. If most wealth is acquired for future consumption, a tax that applies only to transfers will not reach it. People would die holding assets only because of unanticipated mortality, and transfer taxes would serve only to punish the unlucky. If, on the other hand, a large portion of wealth constitutes capital assets, a tax on gratuitous transfers would have a significant impact on its ownership and could contribute to its redistribution.

5. Relative Mix of Life-Cycle and Capital Assets

A sharp disagreement exists among researchers who have tried to estimate the relative mix of life-cycle and capital assets. Modigliani (1988) estimates that 80 percent of US wealth constitutes life-cycle assets, while Summers (1981) and Kotlikoff (1988) argue that more than half of all wealth represents capital assets. The gap reflects a dispute over how to characterize particular types of transfers, in particular income from inherited property and support of children over the age of majority but still in school. Underlying these disagreements are deep problems. In a post-industrial society, one might argue, the education purchased by affluent parents may prove to have greater income-generating capacity than financial property such as stock and bonds. This claim would support the characterization of tuition payments and similar support to students as the creation of a capital asset. But, at least in the United States, a substantial portion of the cost of education is financed by alumni, who make deferred payments in the form of nominally charitable contributions once their investment reaches its peak income-producing potential. If parental funding is incidental to education’s wealth-creating potential, then one instead might characterize education-related payments as a form of intrahousehold consumption.
6. Research on Distribution of Wealth

Aaron and Munnell (1992) provide a relatively recent review of the research on the distribution of wealth and the relative distribution of assets used for consumption and other purposes. \( W_1 \) consists of tangible assets, equities and bonds, and the cash surrender value of trust funds and pension plans. \( W_2 \) adjusts \( W_1 \) to take into account the full value of trust funds and pension plans. \( W_3 \) adds the discounted present value of future social insurance receipts. The authors further attempt to estimate the distribution of life-cycle wealth and capital wealth by splitting the difference between the Modigliani and Summers-Kotlikoff approaches. If one looks only at \( W_1 \), the data suggest that in the United States the proportion of capital wealth to life-cycle wealth has grown significantly between 1930 and 1990, which in turn implies an increase in the power of assets holders to wield dynastic power. If one instead includes \( W_3 \), the data indicate that the proportion of capital wealth to total wealth has remained fairly steady. In other words, the rich are getting richer, but only at the same rate as everyone else. Other survey data suggest that the amount of \( W_1 \) held by the wealthiest 1 percent of the population increased substantially during the 1980s, after the 1981 transfer tax rate cut went into effect, but these surveys do not measure \( W_3 \) after 1983. Studies of Great Britain and Sweden show a marked decline in the concentration of ownership of \( W_1 \) between 1940 and 1980.

7. Unconventional Forms of Property

Part of the debate over the efficacy of transfer taxation as a means of redressing wealth inequality turns on the capacity of such taxes to reach not just traditional forms of property, but other kinds of rights, powers, and expectations that might seem analogous to property *simpliciter*. One much-discussed problem is the so-called ‘estate freeze’, which allows an owner to retain some degree of control over an asset while transferring the formal right to enjoy all further appreciation in the asset’s value. A simple example would be a restructuring of a family business in which the sole owner of a company transfers a new class of common stock to children while retaining preferred stock equal in value to the firm’s current worth. US lawmakers have taken several stabs at limiting the freedom of owners to achieve these results, notably in the Revenue Act of 1987 and the Budget Act of 1990 (which substituted a new scheme for the one created only three years previously). Most observers, however, believe that the capacity of families to accommodate their business transactions to the forms required by the tax law outstrips the ability of the legislature to attack the problem. As a result, the transfer tax seems largely an excise extracted from the inattentive or improvident wealthy. Shoup (1966) asks the question of why
wealthy persons ever find themselves in the position of paying the federal estate
tax, given the many means available for avoiding it. At the same time he
recounts substantial anecdotal evidence indicating that some extremely rich
people do fall prey to this levy.

8. Contribution of US Tax to Progressivity

Reforms proposed in 1969 and to some extent adopted in 1976 broadened the
scope of US transfer taxation but did not significantly change the rate schedule
as such. In 1981 the United States both lowered the maximum tax rates
applicable to gifts and estates and increased the amounts that could be
transferred exempt from tax. In real dollar terms, the enlarged exemptions were
still smaller than those in effect in 1932, when the federal taxes were made
permanent. Nonetheless, a number of commentators contend that the 1981
changes represented a significant departure from the previous policy of
promoting the redistribution of wealth. Graetz (1983) argues that the pre-1981
federal transfer taxes, although insignificant in terms of absolute amount of
government revenues, were responsible for about a third of the total amount of
progressivity in federal taxation. He defines progressivity as the increment in
taxes collected from persons with greater than average wealth over the amount
they would pay if average tax rates applied at all levels of income. He deplores
the move away from redistribution implied by the 1981 changes. However, he
does not consider the claim that such progressivity as the pre-1981 taxes
achieved represented levies against unusually improvident or poorly advised
persons, rather than a systematic effort to redistribute wealth.

9. Welfare Analysis of Voluntary Wealth Transmission

The intuition that a gratuitous transfer represents a form of valuable
consumption for the transferor while benefiting the transferee by increasing
either capital or the capacity to consume appears in Simons (1938). The
transferor has revealed a preference for the transferee’s welfare, which the
transferor values at least as much as possession of the property transferred. The
transferee is enriched by the value of the property, defined as the amount for
which the property could be exchanged. A formal statement of the claim can
be found in Becker (1974). The implications of this insight for tax policy took
longer to work out. For Simons, it was enough to show that gratuitous transfers
were economically indistinguishable from other transactions normally subjected
to income taxation. Following a principle of strict nondiscrimination among
categories of income, he therefore would have included the transfers in the
transferee’s income tax base while continuing the existing rule of not allowing transferors a deduction. A Canadian government study proposed exactly this step in 1966 (Jantscher, 1969), and a study commissioned by the US Treasury explored the implications of such a system in 1976. Other scholars, notably Dodge (1978), also have advocated including gratuitous transfers in the income tax base.

10. Arguments for Subsidizing Transfers

More recently, scholars have seized on the welfare implications of Simons’ insight to argue against transfer taxation. Bracewell-Milnes (1989) puts the argument in nontechnical terms by coining the term ‘owner’s surplus’ to connote the value owners attach to their assets in excess of the discounted present value of the asset’s anticipated income stream. He claims that gratuitous transfers, whether charitable or intrafamilial, increase welfare by bestowing owner’s surplus on transferees while providing transferors with value equal to the discounted present value of the anticipated income from the asset. Kaplow (1995) states the argument in formal terms and with great rigor. They both conclude that, to the extent welfare maximization is a legitimate social end, society ought to subsidize gratuitous transfers rather than tax them. Kaplow notes that a number of rules found in US law - income tax deductibility of charitable transfers, the treatment of gratuitous transfers as a nonrealization event to the transferor and as excluded from the transferee’s income tax base, and the basis increase for assets received from a decedent - might be characterized as a kind of subsidy for giving.

11. Arguments for Subsidizing Earlier Transfers

A variation on this argument looks at evidence suggesting that younger owners may tend to prefer riskier investments than do older persons. To the extent this claim is true, it would imply that, ceteris paribus, younger owners might underwrite a greater amount of technological innovation and therefore increase social welfare. The data presented by Menchick and David (1983) is suggestive but not conclusive. Stephan (1986) uses this hypothesis to support an argument for tax rules that subsidize lifetime gifts relative to deathtime bequests. He notes that US law generally encourages gifts: the effective gift tax rates are substantially less because the tax is not included in the base, as it is with respect to estates. US income tax rules do disfavor gifts to the extent that gifts are not eligible for the basis step up to fair market value that applies to bequests, but in many cases this distinction is inconsequential because of the upward basis
adjustment available to gifts subject to the gift tax.

12. Rate Differential Depending on Whether First- or Later-Generation Wealth

Economists have made a somewhat different distinction between wealth in the possession of the person who accumulated it and inherited wealth. Rignano (1924) was the first to argue that either an estate or inheritance tax should base the rate of taxation on the age of the wealth. He would have imposed low rates on wealth being transferred by the person who created it and progressively higher rates on those who acquire wealth by inheritance and then seek to pass it on to later generations. He argued that such a system could achieve significant socialization of wealth without destroying the incentive to save and take risks. Kiesling (1992) returned to this proposal and defended it against criticisms based on its difficulty of administration. He proposed operating with a presumption that all wealth passing at death had been ‘aged’ and then placing the burden on the decedent or his beneficiaries to present evidence justifying lower rates. The US generation-skipping-transfer tax, discussed below in Sections 34-35, offers an alternative approach to an analogous problem.

13. Transferor Tax versus Accessions Tax

Were all transfers taxed at a uniform rate, it would make no difference whether the levy fell on transferors or transferees. For most purposes the administration of these taxes is indistinguishable, especially if one party has secondary liability for the other’s tax obligation. But as soon as one introduces exempt amounts and a progressive rate structure, the identification of the taxpayer becomes significant. Estate and gift taxes calculate the amount owed by reference to the size of the decedent’s holdings. Inheritance and other accessions taxes look instead at what the transferee receives. The United States and the United Kingdom tax transferors, although their systems differ substantially. Most Continental European countries have accessions taxes instead.
14. Advantages of Accessions Taxation

Advocates of accessions taxes contend that this system has two main advantages over the estate tax (see Andrews, 1973, and Aaron and Munnell, 1992). First, to the extent gratuitous transfers involve life-cycle assets and therefore increase the transferee’s consumption, the tax should fall on the person engaged in the higher level of consumption. Second, to the extent that the tax is intended to encourage the redistribution of capital assets through dispersion of ownership, it should impose a lower burden on bequests to multiple beneficiaries. An estate tax, which does not take into account how a decedent spreads the estate among noncharitable beneficiaries, cannot do this.

15. Income Taxation of Transfers as an Alternative Accessions Tax

A variation on the imposition of accessions taxes would be the inclusion of bequests and gifts in the income tax base, as advocated by Simons (1938) and Dodge (1978). The 1966 Canadian proposal contains the most detailed analysis of what this approach would entail. One important collateral consequence of including accessions in income would be the greater likelihood of high taxes during years in which a taxpayer received an extraordinary accession, such as a once-in-a-lifetime bequest. The Canadian proposal would have introduced a form of income-averaging to alleviate this problem.

16. Problems with Accessions Taxes

A complication associated with accessions taxes is the opportunity trusts present for separating the transferor’s relinquishment of ownership from the transferee’s accession to wealth. The creation of the trust may give beneficiaries an expectation sufficient to alter their behavior but not create property interests substantial enough to sustain immediate taxation (compare Dickens, 1861). The problem does not exist in the case of trusts where all interests are fixed (for example, to A for life, remainder to B), because an inheritance tax can be levied on the discounted present value of a vested future interest. But it is easy enough to design trusts where vesting is delayed (for example, to W for life, then income divided equally among those of my children alive at the time of W’s death, then the corpus distributed equally to my issue per stirpes; only W’s interest would be vested). Nor is there a problem even in such cases, if the trust corpus grows at the rate that the designated discount rate assumes. The increased tax paid on distribution attributable to appreciation of the trust property would offset the benefit of deferral. But discount rates are only guesses...
as to future value, and become less useful to the extent that trust corpus does not comprise assets for which reliable and thick markets exist. Income taxation of the trust may substitute in part, but is not equivalent to an immediate levy at the inheritance tax rate on the discounted present value of the future distribution.

17. Withholding on Trusts under Accessions Taxation

An alternative approach would be to impose a withholding tax on complex trusts that could be credited against accessions taxes due on distribution of trust property (see Andrews, 1973). To be a complete substitute for the ultimate inheritance tax payable, however, the credits attributable to withholding would have to be refundable and interest would have to be paid, by the taxpayer or the government as the case may be, on any difference between the amount withheld and the amount of tax payable at the time of distribution. Such refinements would add to the administrative burden of the tax and to that extent make it somewhat less attractive.

18. Relationship of Transfer Taxes to Income Tax

Transfer taxes, and in particular taxes levied on transferors, are sometimes defended on the grounds that the property subject to these levies benefits from unavoidable but undesirable gaps in the income tax. Gutman (1981) argues that the US estate and gift taxes compensate for the income tax deferral implicit in the rule treating gifts as nonrealization events, and for the foregone income tax produced by the basis increase enjoyed by holders of property received from a decedent. More generally, capital assets tend to benefit from the realization principle, which defers taxation of capital gain until the holder sells or exchanges the asset. Imposition of a substitute tax on persons who benefit from these gaps brings the income tax closer to the ideal of nondiscrimination among types of income.

19. Difficulties with Nondiscrimination Principle

Appeals to the nondiscrimination principle have a certain intuitive attraction but often obscure difficult issues. Recalling the concept of $W_g$, for example, one might note that most income taxes do not include social insurance in their base. Yet transfer taxes for the most part reach very few people who benefit from this exclusion. The point is illustrative: all income taxes in practice contain many
violations of a strict nondiscrimination principle, and the nondiscrimination norm standing alone does not suggest a weighting strategy that can indicate which violations should be seen as more serious than others.

20. Choice of Nondiscrimination Principles

Moreover, as Andrews (1974) was among the first to note, to the extent existing law indicates adherence to any nondiscrimination principle, it suggests a commitment to neutrality among types of consumption, with a surtax on the kinds of capital held by the most wealthy. The US (so-called) income tax, like those of many countries, excludes from the base imputed rents from owner-occupied housing and most employer contributions to retirement savings. The exclusion of imputed rents in turn can be seen as equivalent to allowing an immediate deduction for the cost of acquiring an asset, as a consumption tax would require. And for the nonwealthy, housing and pension plans are the most significant forms of savings. In other words, when considered from the perspective of neutrality among types of consumption, these systems discriminate against financial assets such as stock and bonds, the ownership of which (disregarding tax-favored retirement savings) is heavily concentrated among the wealthiest persons. Taking this point to its logical conclusion, one might argue that the structure of the income tax implies an argument against any further taxation of wealth transfers.

21. Unification of Transfer Taxes

Some countries tax gifts separately from deathtime transfers, others treat gifts as deathtime transfers if the donation precedes death by less than a specified period, and a few attempt to treat gifts and deathtime transfers as functionally equivalent. Aaron and Munnell (1992) and Andrews (1973) advocate development of an accessions tax that would include gifts and bequests in an integrated base, with the tax rate increasing with the amount of the transferee’s lifetime receipts. Shoup (1966), Kurtz and Surrey (1970), Brannon (1973) and Sims (1984) instead call for an integrated progressive transfer tax that would determine its rate by reference to the sum of the transferor’s lifetime and deathtime transfers.
22. Unification and US Practice

Before 1976 US law subjected lifetime and deathtime transfers to completely different levies. Gifts made in ‘contemplation of death’, a gloriously open-ended standard, were subjected to both taxes, but the gift tax paid on these transfers was both credited against the estate tax and excluded from the estate tax base. Since 1976, the US has had a partially integrated system. The rate of tax on estates depends on the decedent’s lifetime taxable transfers, and all transfers have a single ‘unified credit’ to offset gift and estate taxes. But gifts occurring more than three years before death (whether made in contemplation of death or not) enjoy a distinct benefit. First, a per-person exemption of $10,000 a year exists for gifts. The gift tax base does not include the amount of tax. By contrast, the estate tax base is tax inclusive. To illustrate, a US transferor in the highest rate bracket would part with $1,550,000 to effect a gift of $1,000,000 (disregarding the $10,000 exemption). A decedent in the highest bracket (because of lifetime gifts) would have to have a taxable estate of $2,222,222 to make an after-tax bequest of $1,000,000. Stated differently, the top gift tax rate, translated into tax-inclusive terms, is slightly in excess of 36 percent, while the equivalent estate tax rate is 55 percent.

23. Proposals for Unification of Tax Rates

In 1984 the US Treasury proposed a more complete integration of the gift and estate taxes (Department of the Treasury, 1984). This would have been accomplished by increasing the tax rate on gifts. This proposal was not incorporated into the major tax changes enacted in 1986. Stephan (1986) subsequently criticized it for its failure to take account of differences in both the income tax treatment and welfare implications of gifts and bequests.

24. Issue of Base Integration

A different kind of integration occurs when the same transaction comes under both taxes. A simple example would involve a trust in which the transferor retains income for life, remainder to the beneficiary. The creation of the vested remainder constitutes a completed gift and is subject to tax. This transaction, however, seems functionally indistinguishable from retention of full ownership until death, at least for those persons with no need to invade capital. As a result, US law for many years also has included the full value of the trust corpus in the decedent’s taxable estate. The decedent is given a credit against the estate tax for the gift tax payable on the remainder.
25. Historical Dimensions of Problem

The actual rules for determining which lifetime transfers are includible in the estate tax base are complex and inconsistent. During the early years of the US estate tax, the Supreme Court expressed its hostility to this levy by imposing narrow constructions on the statutory language. These decisions in turn provoked the Congress to overrule the Court through new legislation. In the period after World War II, a more liberal Court both repudiated some of its earlier decisions and imposed expansive constructions on the new legislation, provoking a by-then more conservative Congress to enact further legislation. The resulting hodgepodge produces rents for professors and specialists but otherwise serves no apparent good.

26. Proposals for Base Integration

Various suggestions have been made for cutting this Gordian knot. The Department of the Treasury (1984) would subject all transfers to either a gift or an estate tax but not both. It would have included transactions where the transferor retained some form of present enjoyment in the estate tax base. In all other cases, it would have imposed a gift tax on the value of the transferred property. Isenbergh (1984) and Sims (1984) offer schemes that differed in detail but in general followed the Treasury’s ‘easy to complete’ preference for earlier gift taxation. Stephan (1986) instead favors ‘hard to complete’ rules that would classify more transactions as death time. His rule would regard any transfer where the determination of the interest depends on the transfer’s life as testamentary. Thus in the case of a trust with income to accumulate, then the corpus to B at the transferor’s death, only the estate tax would apply.

27. Special Rules for Transfers within Family Units

Most transfer tax systems, whether levied on transferors or transferees, contain special exemptions or reduced rates where the transfers involve specific family relationships. Transfers between spouses present particular problems, because the underlying law of ownership may depend on marital status. In the United States, for example, an asset acquired by a married couple living in a community property state often will become the common property of the couple, regardless of who furnished the consideration for the acquisition. In 1948 the United States sought to create a uniform national tax rule by allowing a 50 percent deduction for gifts to a spouse and a deduction up to half the size of the taxable estate for death time transfers. The 1981 amendments exclude most
interspousal transfers from both taxes.

28. Implications of Complete Exclusion for Interspousal Transfers

A rule of complete exclusion creates a hypothetical possibility for indefinite avoidance of the transfer taxes in cases where remarriage occurs successively. As a practical matter, however, the progressive nature of the transfer taxes still creates an incentive for most spouses to split their estates between the survivor and other noncharitable beneficiaries. All other things being equal, under a progressive rate structure a tax equal to twice the tax on half of a large sum is less than the tax on that sum. In other words, spouses still will benefit if their property is distributed in such a way that at least one is treated for estate tax purposes as having an estate that does not fall into the top taxable bracket.

29. Problems with Interspousal Transfers

Transfers to spouses in trust continue to present problems. In the simplest case, namely a transfer to a spouse for life, remainder to the children, permitting a deduction for the spouse’s interest may present tax avoidance opportunities. If standard actuarial tables overestimated the spouse’s actual life expectancy or if the applicable discount rate underestimates the appreciation of the corpus, a present tax on the remainder interest will not be economically equivalent to a deferred tax on the full value of the property. US law instead denies a deduction for the spouse’s interest in most cases where that interest terminates and, upon that event, others acquire an interest in the property. The rules implementing this policy, which contain many exceptions, are exceedingly complex and have occasioned much litigation.

30. Nonspousal Intrafamilial Transfers

Interspousal transfers aside, US gift and estate taxation generally attaches little significance to consanguinity. Most inheritance taxes, however, do increase the rate of tax with the degree of separation between transferor and transferee. As Tait (1967) observes, to the extent these taxes are designed to break up economic dynasties, this characteristic seems perverse. Bequests to children suffer lower taxes than bequests to strangers. Nor, in Tait’s view, do there exist other reasons for treating transfers among close family members more favorably than others. He dismisses one common claim - that inheritances from distant relatives come as windfalls and therefore are more easily surrendered to the tax
authorities - as dependent on what he considers the dubious assumption that expectancy is correlated with closeness of relationship.

31. Defenses of Consanguinity Preferences

In response to Tait, Richter (1987) argues that consanguinity rate reductions make sense if one regards inheritance taxation not as a mechanism to redistribute wealth, but rather as a form of social insurance. Drawing on Friedman (1957), Richter distinguishes between ‘permanent’ and ‘transitory’ inheritances. The former are reliable, in the sense that the potential beneficiary reasonably may make plans based on the expectation of receiving them. The latter become reliable only if the beneficiary can insure against nonreceipt. The market does not supply inheritance insurance as such, but a tax on transitory inheritances, to the extent that the tax receipts are converted by the state into commonly shared benefits, serves the same function. To conclude the argument, Richter maintains that consanguinity is a good proxy for the relative mix of permanent and transitory components in any given inheritance.

32. Consanguinity Preferences and Redistribution

Cremer and Pestieau (1988) extend Richter’s argument to defend the consanguinity preference on grounds of promoting redistribution. Their model assumes variability in the number of children, including the existence of childless transferors. They show that under certain plausible assumptions about inheritance patterns, wealth transferred to lineal descendents result in dispersion of property among children and grandchildren. Transfers to collateral relatives, however, may result in concentration of multiple couples’ assets in the hands of a single niece or nephew. A rate preference for lineal over collateral transfers thus may reflect a desire to disperse the ownership of property.

33. Generational Issues

Although US estate taxation does not take consanguinity into account, the system does adjust the tax rates to take into account wealth transfers that skip over one or more generations. The argument for this surtax on generation-skipping transfers is that the transfer taxes should function as a once-a-generation levy on financial capital. Moderately wealthy people transfer capital to children, with the assumption that the children will consume the income thrown off by the assets and then transfer them to grandchildren. Persons so
wealthy that they can provide for their children and still have capital left over to transfer to grandchildren should be taxed as if their capital first passed through their children’s hands, whether or not the children directly benefited from the property. An exception to this policy exists for orphaned grandchildren, who are treated as if they were the transferor’s children.

34. Implementation of the Generation-Skipping Transfer Tax

The United States first enacted a generation-skipping transfer (GST) tax in 1976 but deferred its implementation for several years. In 1986 Congress created a significantly different tax in place of the earlier one. The current levy imposes a flat rate of 55 percent on generation-skipping transfers in excess of $1,000,000 per transferor. The statute assigns persons to generations based on lineal relationship to the transferor; nonrelative transferees are assigned to a generation on the basis of difference in age with the transferor. The tax is calculated by reference to the amount received by the transferee, which means that any estate or gift tax generated by the transfer will not be included in the tax base. The amount of GST tax is, however, treated as a taxable gift. The GST tax on direct transfers is not included in the GST tax base, but the tax on generation-skipping transfers from trusts, either of income or corpus, is.

35. Technical Issues in Generation-Skipping Transfer Taxation

The GST tax treats direct transfers to grandchildren more favorably than it does trust transactions that encumber financial capital and delay ultimate power to dispose of the property. Stephan (1986) observes that this difference parallels the lower rates imposed on gifts as opposed to deathtime transfers, and may reflect a similar policy of encouraging wealthy people to transfer control over financial capital to younger persons sooner rather than later.
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