EQUITY AND THE TAXATION OF WEALTH TRANSFERS

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Equity and the Taxation of Wealth Transfers *

ABSTRACT

Although the estate and gift tax is an important part of the Federal system of taxation in the United States, little attention has been paid to those principles of equity by which the fairness of the tax can be judged. This paper examines those principles of equity relevant to the development of a tax on the transfer of wealth. To apply one principle of equity -- taxation according to ability to pay -- it was first necessary to develop a definition of lifetime endowment similar to the Haig-Simons definition of income normally applied to shorter accounting periods. The paper then demonstrates how the choice and design of a tax on wealth transfers depends crucially upon both the principle of equity being followed and the choice of taxpaying unit to which that equity principle is applied. In one application of these principles, it is found that an accessions tax, i.e., a tax placed on aggregate wealth transfers received, is a more logical complement to an income tax than is the current estate and gift tax.

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I. BACKGROUND

Under current Federal law, there are no inheritance, succession, or gift taxes placed on wealth transfers received by individuals. Instead, the Federal Government imposes a tax on the non-charitable transfer of certain property by estates and donors. 1/ Technically, the current estate and gift tax is an excise tax upon transactions, though this type of tax is popularly regarded as a net worth tax. For the purposes of this analysis, this tax is treated as a progressive tax upon the cumulative transfers of certain property or net worth.

In 1978, the net worth of individuals in the United States totaled approximately $6.5 trillion. 2/ Of this amount, only about $19 billion was actually taxed as taxable transfers in taxable estates 3/, while total tax collections equaled about $5.4 billion. Thus, if viewed simply as a tax on net worth, the current estate and gift tax is levied

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1/ This paper does not deal with other types of transfers such as charitable or institutional transfers of wealth.

2/ Source: Board of Governors of the Federal Reserve System, 1979. The value of tangible assets was $4.5 trillion; financial assests, $3.5 trillion; and liabilities, $1.5 trillion.

3/ That is, this is the amount of taxable transfers which are reported on estate and gift tax returns and which are in excess of the implicit exemption level implied by the unified credit.

annually on a total base of less than one-half of 1 percent of the net worth of individuals, while total collections are less than one-tenth of 1 percent of net worth. 4/

Similarly, if viewed as a tax on transfers, the tax base is still quite small. The exact percent of all non-charitable transfers that are subject to tax is difficult to calculate. No one knows how many billions of dollars are transferred through gifts of money, durables, educational expenses, etc. that are not subject to tax because of the moderate size or nontaxability of each individual gift. Nonetheless, less than 3 percent of all households owning less than a third of all financial and tangible wealth 5/ are subject to estate or gift taxes, and more than half of the sum of their reportable gifts and estates are not subject to tax. Given these facts, certainly no more (and probably much

4/ See Lampman (1962), Smith (1974), and Statistics of Income--1972, Personal Wealth Estimated from Estate Tax Returns for estimates of the size distribution of wealth.

5/ It should be noted that a restricted definition of "net worth" is created by confining net worth to tangible and financial assets. Other valuable assets of persons are their knowledge, ability, skills, and capacity to generate wage income. These assets (or human capital) are never taxed directly except insofar as they yield a cash flow through income. Moreover, transfers of knowledge and skills from one generation to another are not subject to tax. Thus, a definition of transfers broadened to include all human as well as physical capital would imply an even lower rate of tax on the transfers of wealth of individuals.

less) than 10 percent of the monetary value of all transfers of financial or tangible assets is subject to taxation under current law.

Despite the small size of current estate and gift tax collections relative to total net worth or total transfers, there is widespread belief that a system of transfer taxes is a necessary and vital element in a total system of taxation. The next section of this paper clarifies those approaches to tax equity upon which most arguments for or against certain types of transfer taxes are based. Section III shows how the choice and design of any transfer tax system can be made to follow directly from the principle of equity being followed and the choice of the unit of taxation. Section IV examines the current combined income and transfer tax system and concludes that an accession tax would be a better complement to the income tax than would an estate and gift tax and that an accession tax would come closer to meeting certain equity criteria that are implicit in the current estate and gift tax system. Finally, a conclusion is presented in Section V.

II. PRINCIPLES OF EQUITY AND THEIR RELATIONSHIP TO THE TAXATION OF TRANSFERS OF WEALTH

A. Three Approaches to Equity

Most taxes are justified in terms of one or more principles of equity. 6/ Three principles of equity are discussed here, 7/ and the choice among these principles in turn affects the choice of an optimal system of transfer taxation. These principles are: (1) ability-to-pay; (2) standard-of-living; and (3) equalization-of-wealth or equalization-of-opportunity. 8/

The ability-to-pay approach to tax equity requires that tax burdens be distributed according to the taxpaying unit's ability to pay. Originally, both in England and America,

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6/ Only the equity arguments for transfer taxes are mentioned here, since equity is the prime justification for the taxation of transfers.

7/ Another common approach to tax equity (and efficiency) attempts to correlate taxes and expenditures in a "quid pro quo" process. This "benefit approach" to taxation is generally not applied to transfer taxation. Of course, in the rare case where benefits more or less coincide with ability to pay, one reaches the same conclusions about the development of a transfer tax from either a benefit or ability-to-pay principle.

8/ Various "aims" of death and gift taxes are noted in Shoup (1966) or Jantscher (1977). These aims include: raising revenue, taxing capital periodically (or once a generation), taxing windfalls, reducing the concentration of wealth, and taxing a special type of ability to pay -- that resulting from the receipt of a gift or inheritance.

ability to pay was measured by property ownership (Musgrave, 1959, p. 94), although the emphasis has since shifted rather sharply to income. This shift has been evidenced by the large role of the personal income tax relative to other taxes in the 20th century. One reason for this shift has been the increasing importance over time of wage income to most households' well-being. When wages were thought to equal only subsistence income, they were treated as nontaxable by the central government. With the rise of entrepreneurs, managers, skilled laborers, and the growth of the middle class, wage income began to vary substantially from one individual to the next and for many could no longer be considered merely as subsistance income. Increasingly, the taxable base under the ability-to-pay approach has come to be defined as property plus wage income in excess of the subsistence level of income. The difficulty with income as a measure of ability to pay, however, is that it is only a one period measure of potential consumption that does not fully capture certain lifetime economic circumstances of the taxpaying unit, particularly transfers received.

By contrast with ability-to-pay, the standard-of-living approach to tax equity, derived in part from the work of Irving Fisher, focuses less on what a taxpayer <u>can</u> consume during a given period of time than on what he actually <u>does</u> consume, i.e., what he actually draws from the "common pool" of resources of society. Under this approach, the consumption

of the taxpaying unit determines its tax base. Wealthholding itself is viewed as providing no direct benefit (or, at least, no taxable benefit) to the individual above and beyond the consumption that it allows. Thus, in a given period of time, an individual's well-being or utility is presumed implicitly to be the same for a given pattern of consumption regardless of his net worth. To the extent that wealthholding provides certain benefits--for instance, insurance or option value not reflected in direct consumption outlays--those benefits are ignored and not considered as part of the standard of living.

The third approach to tax equity argues for less inequality of wealth or opportunity in society. Less inequality itself implies a reduction in the variance in the amount of wealth owned by different individuals or families. Generally, an equalization-of-wealth or equalization-of-opportunity principle is invoked with regard to tangible and financial assets, rather than human capital, with the major exception of demand for equal educational opportunities. In the broadest sense, less inequality of wealth means bringing all parts of the wealth distribution closer to the median wealth. On the other hand, the policy objective may be a more limited one, such as constraining the amount of wealth held by top wealthholders or providing for ownership of some minimum amount of assets by the poorest part of the population. However, policies to achieve even these more

limited objectives generally have an impact upon individuals in each spectrum of the wealth distribution. This result arises because taxes affect savings and investment decisions and because redistribution affects not only those who pay the taxes but those who receive the transfers or government services as well.

As a policy objective, redistribution of wealth involves more than just a redistribution of consumption opportunities. Redistributive policy may also be directed toward preventing unusual concentrations of wealth or limiting the ability of top wealthholders to control economic resources. Redistribution of wealth to poorer families has also been justified on the ground that increments of wealth provide more benefit to poorer members of society than to richer ones and that some minimum amount of wealth is necessary to enable individuals to develop fully their human potential, for example, through investment in education.

B. Ability to Pay in the Presence of Wealth Transfers

In treating transfers of wealth which are made and received infrequently over a person's life, a lifetime measure of ability to pay is preferable to a more limited single period measure of taxpaying capacity. Therefore, before proceeding, we will develop a definition of ability to pay on the basis of lifetime endowment rather than on current

period income or consumption. Lifetime endowment, like annual income, can be defined in terms of either its sources or its uses. Consider the simplest case: there are no bequests and gifts, there are constant rates of return, and investment rates of return are equal to marginal rates of time preference. 9/ Then the following equation holds:

$$\text{Present Value of Wage Income} = \text{Endowment} = \text{Present Value of Consumption} \qquad (1)$$

However, individuals do make numerous and sometimes sizeable transfers and bequests, and an analysis of the total tax system irrespective of these transfers would be incomplete. Modifying equation (1) for the presence of transfers gives equation (2):

$$\text{Present Value of Transfers Received} + \text{Present Value of Wage Income} = \text{Endowment} = \text{Present Value of Consumption} + \text{Present Value of Transfers Given} \qquad (2)$$

Equation (2) presents an extremely useful reconciliation of a lifetime measure of sources of income with a lifetime measure of its uses. Income and consumption are often related over short accounting periods through the Haig-Simons concept that income equals consumption plus change in net worth (Goode, 1977). Equation (2) performs a similar reconciliation of income and consumption over the taxpaying

9/ That is, to calculate present value, it is necessary to discount wages and consumption by the same interest rate.

unit's lifetime by relating them to the net change in value of transfers received (or given). Because of the longer accounting period involved, however, equation (2) differs from a Haig-Simons equation by converting flows of income, consumption, and transfers into present value terms. Because a dollar of transfer, income, or foregone consumption can earn interest, the present value calculation treats a dollar as worth more to an individual the sooner it is received.

In the work of those concerned with the design of comprehensive consumption taxes, one can sometimes infer the "uses" side of equation (2). For instance, by "including gifts given and bequests in the (consumption) tax base of the donor," Bradford and Toder (1976) allow that "a consumption tax can easily be transferred into an ability-to-pay tax for each generation" (p. 31). Similarly, the "sources" side of the equation has been hinted by those concerned with the design of comprehensive income taxes. Pechman (1977) argues that "[b]equests and gifts, like income from work or investments, are a <u>source of ability to pay</u> (emphasis added). In theory, therefore, they should be taxable as income when received" (p. 221).

Under this lifetime accounting system, transfers given do not decrease the endowment, since the option to give them remains open to the giver. Transfers given are instead part of a tax unit's wealth to disperse, i.e., its ability to pay.

Transfers received are also counted in the endowment because they increase the ability to pay or the option to consume of the receiver.

Under an ability-to-pay approach to tax equity, if equals are defined in terms of the taxpaying unit's lifetime endowment, equation (2) indicates that an accessions tax (taxation of aggregate transfers received) would be an appropriate complement to an income tax on wages, while a unified estate and gift tax (taxation of aggregate transfers given) would be the proper complement to a consumption tax. Furthermore, equation (2) indicates that inclusion of wealth transfers in the tax base is <u>necessary</u> to make either a consumption tax or a wage income tax a tax on the ability to pay of each generation.

Of course, with a constant rate of taxation on all transfers, a tax on either the transferor or the transferee would be equivalent. However, the existence of exemptions, deductions, credits, and a progressive rate schedule causes the two taxes to differ. In general, an accessions tax would yield less revenue from a given estate or gift as the number of persons receiving transfers from that estate or gift increased, while a unified estate and gift tax would yield less revenue from a person's aggregate gifts and inheritances as the number of persons making transfers to that person increased.

When the case for a consumption tax is presented, it is often noted that an income tax on both wage and property income does not tax all persons equally because of its bias against those who save more of their income early in life, i.e, both wages and interest earned on savings from wages are taxed. However, the current income tax also has a bias against those who receive their endowment through wage income rather than gifts and bequests. In terms of equation (2), lifetime endowment recognized as wages is taxed directly, whereas endowment received through transfers is not. To observe this in the simplest case, suppose there were no rate of return on capital; income would equal wage income, and an income tax would only tax that portion of endowment recognized as wages, but not that portion received through transfers. Thus, the only way transferred endowment is taxed under an income tax is by including property income in the taxable base.

In the absence of property income, a tax on transfers received would be a perfect complement to an income tax. However, since income is generated from capital and is taxed

under an income tax, 10/ some portion of inherited capital is taxed indirectly, so that the complementarity of an income tax and an inheritance tax is imperfect. Nonetheless, some form of transfer tax is needed to make an income tax closer to a tax on the taxpaying unit's ability to pay and to eliminate the bias which exists against those whose endowments consist largely of wage income.

10/ Actually, the individual income tax in the United States is fairly close to a tax on wage income, plus a penalty tax on realizations of certain types of nominal (rather than real) income from capital. Over 80 percent of the assets of individuals (including owner-occupied real estate and pensions) is in a form for which there is tax preference arising through deferral, capital gains rates, exclusions or other means of non-taxation of the income from the assets. See Steuerle, 1980.

In the lifetime accounting identity of the previous section, either transfers given could be added to consumption or transfers received could be added to wage income in order to measure lifetime endowment. Since an income tax is neither a wage income tax nor a consumption tax, it is not possible to argue that either a tax on the transferor or a tax on the transferee is the perfect complement to the income tax. Nonetheless, the income tax is clearly a tax on receipts rather than disbursements of income and is closer to a tax on wage income than a tax on consumption. A consistent application of the ability-to-pay principle would require that the transfer tax also be imposed upon receipts rather than disbursements. 11/ Thus, on an ability-to-pay basis, an accessions tax rather than an estate and gift tax would make a better, although not perfect, complement to the existing income tax.

Yet, while the income tax is best considered as a tax based upon ability to pay, one critical feature of the existing estate and gift tax indicates that the equalization of wealth approach to equity was also an important

11/ One could also tax receipts of gifts and bequests under the income tax directly, although that would probably require a lifetime income averaging scheme.

consideration in the development of that tax. The telling feature is the application of the estate and gift tax only to top wealthholders. Thus, the tax ignores most but not all transfers -- something that would not be allowed under a pure ability-to-pay approach except on administrative grounds. While there certainly are many transfers that are impossible to trace, and hence untaxable under any system, the estate and gift tax additionally provides quite generous tax-free levels of transfers on recorded transfers. These credits, exemptions, and deductions -- under which such tax-free transfers are allowed -- indicate a major purpose of the tax is to limit the wealth of top wealthholders.

Even here, however, an accession tax would be preferred to the present structure of estate and gift taxes. As long as equalization of opportunity is desired across living members of society, the past wealth of the donor or decedent is of no consequence. It is the inheritance or gift received by the transferee that measures his additional opportunity or endowment vis-a-vis other members of society. Moreover, an accessions tax, rather than an estate and gift tax, will generally result in a greater dispersion of wealth for a given amount of tax collection. That is, the existence of exemptions and a progressive rate structure would permit an accessions tax to penalize the concentration of giving and, through the incentive of lower taxes, to reward the

dispersion of gifts across many individuals. Additionally, unlike the estate and gift tax, an accessions tax does not result in lower aggregate taxes for those heirs who receive their transfers from multiple sources.

Taxing inheritances and gifts received over a person's lifetime would also express a preference for imposing a tax on "good fortune" which is not related to the person's own effort, as opposed to the fortune or wealth of a donor or decedent which may be due to past effort. An inheritance tax explicitly works to equalize future opportunities for donees, while an estate tax more directly taxes the past successes of donors.

V. CONCLUSION

Current estate and gift taxes are levied on only a small portion of the net worth of individuals and an even smaller portion of their total transfers. Nonetheless, any tax system should be based upon an underlying set of equity principles. Three principles of equity can be applied to the development of a transfer tax -- ability to pay, standard of living, and equalization of wealth. In general, however, only the first and the last principle justify a transfer tax rate above zero.

When ability to pay is measured by lifetime endowment rather than single period income, a tax on transfers received is found to be a more logical, although not perfect, complement to an income tax than is a tax on transfers given. However, a tax on transfers received is definitely preferred under the equalization-of-wealth principle of tax equity because it penalizes the concentration of giving and rewards the dispersion of gifts across individuals through lower taxes. There is strong evidence that one or both of these equity principles forms the basis for the current taxation of transfers and that, therefore, the goals of the current estate and gift tax law can be better met by an accessions tax.

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