Theoretical and Practical Concerns in Moving to a Federal Inheritance Tax

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Wendy C. Gerzog, *What's Wrong with a Federal Inheritance Tax*, 49 **Real Prop., Tr. & Est. L.J.** 163 (2014), available at SSRN.

Professor Wendy Gerzog has written a thought-provoking article reviewing inheritance tax systems both in the United States and abroad, and then Professor Lily Batchelder's proposed comprehensive inheritance tax (CIT).[1] Professor Gerzog has three principal criticisms of inheritance tax systems: (1) they inequitably tax the recipient based on the closeness of relationship to the donor or decedent (which rationale is "neither a good measure of ability to pay nor an effective means of wealth redistribution,"); (2) they lack a gift tax back-up; and, (3) they apply to more individuals, increasing administrative costs and decreasing compliance rates. (P. 200) As to Professor Batchelder's CIT, Professor Gerzog supports its elimination of the "disparity of burdens for some beneficiaries under the current transfer system" and its solving "the problems of timing and valuation abuses that involve actuarial problems," but Professor Gerzog contends that the CIT "engenders its own problems": (1) increased family wealth; (2) increased valuation abuse; (3) increased recordkeeping costs; (4) increased compliance problems; and, (5) increased complexity. (P. 201.) Professor Gerzog concludes that "the transfer tax system works relatively well and has significant practical and theoretical advantages over a federal inheritance tax or a CIT." (P. 201.)

Professor Gerzog believes that basing tax rates on a decedent's relation to a beneficiary is "objectionable on fairness considerations." (Pp. 164-165.) Given that most wealthy decedents leave their property to other wealthy individuals and the majority of beneficiaries are the decedent's close relatives, there are comparatively few estates with non-relative heirs, and "no policy rationale supports subjecting those few unrelated individuals to either a higher or a lower tax rate." (P. 165.) Professor Gerzog contends that an inheritance tax with greater tax rates when there are "a fairly small number of the beneficiaries" or "a distant familial relationship … of the decedent's beneficiaries" "cannot realistically achieve the reduction of concentrated family wealth and its associated power." (P. 166.)

Professor Gerzog's second principal criticism of inheritance tax systems in general is that they lack a gift tax back-up on *inter vivos* transfers. (P. 166.) Professor Gerzog notes that, because inheritance taxes generally do not apply to gifts over which the decedent retained control until (or shortly before) the decedent's death, wealthy individuals might avoid an inheritance tax by making lifetime gifts while retaining control over the property, which "contrasts sharply to the inclusion of such transfers under the current estate tax provisions." (P. 167.) Professor Gerzog's criticism is apt. An inheritance tax, however, need not stand alone—in Professor Batchelder's proposal, for example, her Comprehensive Inheritance Tax aggregates a recipient's gifts and bequests.

Professor Gerzog's third principal criticism of inheritance tax systems in general is that, because an inheritance tax focuses on the decedent's beneficiaries rather than just the decedent alone, more individuals being subject to the tax increases administrative costs, decreases compliance rates, and "results in a lifetime of unreported cash and untracked property transfers among family members." (P. 200.) Professor Gerzog's other criticisms include: (1) increased complexity because any new inheritance tax system "would likely need to borrow or replicate much of the law and language of the current

transfer tax system," (2) the valuation distortion questions and abuses in the transfer tax area would resurface in an inheritance tax, and (3) "fractional interests discounts would proliferate." (P. 168)

Professor Gerzog then discusses Professor Batchelder's proposed CIT. Professor Batchelder "suggests merging transfer taxes into the income tax system when gifts or bequests received by an individual aggregate to more than $1.9 million" and, beyond that amount, "the donee's excess would be subject to income tax inclusion at a 15% surtax above the donee's income tax rate," imposed "to replicate the effect of the payroll tax." (P. 187)

Professor Batchelder, in her proposal, cites several times to her (and Surachai Khitatrakun's) estimate that "about 22% of heirs burdened by the U.S. estate tax have inherited less than $500,000, while 21% of heirs who inherit more than $2,500,000 bear no estate tax burden" (P. 170.) Professor Gerzog argues that Professor Batchelder's numbers "do not explain to what extent this onus is the result of the decedent's design, or is the result of the applicable apportionment statute, or is the consequence of a lack of progressivity in our current flat transfer tax rate or an estate planning technique." (P. 170.)

Professor Gerzog, in responding to Professor Batchelder's criticism that the present transfer tax system taxes inherited wealth less than earned income, concedes that "the current transfer tax may well under-tax wealth" but argues that "any inheritance tax advocating a high exemption level per recipient is open to that same criticism." (Pp. 187-188.) Professor Gerzog proposes that "Congress more easily could accomplish the same result [that the 15% surtax does] by raising estate and gift tax rates or by lowering the exemption level." (P. 188.) Professor Gerzog contends, "For the majority of recipients, the CIT has no significant policy objective and may well decrease the taxation of wealth" and that, because of the $1.9 million per donee exemption, "family wealth concentration would persist." (P. 188.)

Professor Gerzog suggests that "Professor Batchelder's information may simply argue for reinstituting a more progressive rate structure into the current flat transfer tax rates." (P. 172.) Professor Gerzog, noting that the then-current, 2014 current estate and gift tax exemptions ($5.34 million combined) are larger than "the $1 million gift tax and the $3.5 million aggregate transfer tax exemption in 2009 when Professor Batchelder published her CIT proposal," writes that "the skewed burden Professor Batchelder addresses more likely affects a small minority of heirs today." (Pp. 172-173.) Following Professor Gerzog's argument, I wonder whether the portability of any unused exemption (available now but not in 2009) also reduces the existence of that skewed burden.

Another problem Professor Gerzog identified in the inheritance tax is that "focusing on beneficiaries rather than on the decedent multiplies the number of taxpayers involved in reporting transactions that are inherently difficult to police." (P. 174.) She writes, "Compliance rates would decrease significantly under an income-inclusion or CIT system, and administrative costs would increase." (P. 174.) Professor Gerzog contends that, to the extent that increased complexity "falls on lower income taxpayers, whom Professor Batchelder aims to assist, the CIT would increase those taxpayers' tax return preparation costs." (P. 191.) I would submit that, given Professor Batchelder's CIT allowance to spread bequests "over the current year and the previous four years,"[2], the CIT would likely increase those taxpayers' costs to prepare multiple tax returns, or, at least, to obtain tax advice on whether to file multiple tax returns.

The carryover basis feature of the CIT, to me, also increases complexity and cost for the decedent's personal representative and for the decedent's beneficiaries. Professor Lawrence Zelenak (addressing carryover basis systems in general[3] and Professor Laura E. Cunningham and Professor Noël B. Cunningham[4] have expressed concerns about carryover basis, among them: (1) fiduciaries must equitably apportion among the beneficiaries both value and basis[5], (2) fiduciaries must "increase the basis of appreciated carryover property by the death taxes (federal and state estate taxes, and state

succession tax)"[6] and, under the CIT, both the decedent's "adjustment for CIT taxes" on the decedent's death and the beneficiaries' "own adjustment for CIT taxes on unrealized appreciation" at decedent's death[7], and (3) basis must be accounted for over one or more generations.[8]. (On a side note, Professor Batchelder's article proposing the CIT appears not to address decedents' differing levels of income tax basis to be carried over to beneficiaries—I assume in large part because of the difficulty to obtain such information.) Cleverer people than I could think of more elegant solutions, but I wonder whether a decedent, in an attempt under decedent's will or trust to reduce potential complexity and cost from carryover basis under the CIT, might have the decedent's estate (and not decedent's beneficiaries) realize gain by providing: (1) mandatory or discretionary authority to decedent's personal representatives to sell decedent's property, or (2) pecuniary bequests under decedent's will or trust.

In her piece, Professor Gerzog comprehensively discusses inheritance tax systems in general and Professor Batchelder's CIT in particular. The goals of any inheritance tax system usually include allocating tax burdens according to ability to pay, redistributing wealth, and providing an ostensibly more equitable and efficient tax system. For any inheritance tax system to achieve those goals and to improve upon the existing transfer tax system, Professor Gerzog writes persuasively about several theoretical and practical issues that must first be addressed.

1. Lily Batchelder, What should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax, 63 **Tax L. Rev.** 1 (2009).
2. Batchelder, *supra* note 1, at 64.
3. Lawrence Zelenak, Taxing Gains at Death, 46 **Vand. L. Rev.** 361, 368 (1993).
4. Addressing Professor Batchelder's CIT in Laura E. Cunningham and Professor Noël B. Cunningham, *Realization of Gains under the Comprehensive Inheritance Tax*, 63 **Tax L. Rev.** 271 (2009).
5. Id. at 276, citing to Zelenak, *supra* note 3, at 368.
6. Zelenak, *supra* note 3, at 368.
7. Cunningham and Cunningham, *supra* note 4, at 277.
8. Zelenak, *supra* note 3, at 368; Cunningham and Cunningham, *supra* note 4, at 277.

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