

MEMORANDUM

To: Pat Soldano
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From: John F. O'Hare

Date: March 28th, 2018

Subject: Update and Extend Earlier Estimates of Proposals to Modify
The Estate, Gift and Generation Skipping Transfer Taxes

In this memorandum we update and extend our earlier estimates of three (3) proposals to modify the existing estate, gift and generation skipping transfer tax (GST). These updated estimates will take into account the recent changes to the estate tax enacted as part of the "Tax Cuts and Jobs Act" enacted in December of last year. The proposals relate to repeal of the estate, gift and GST tax as well as lowering the maximum tax rate on wealth transfers.

Because the recently enacted changes substantially increased the thresholds at which estates become subject to the tax, the estimated revenue effects will be less under the new, present law baseline because fewer estates will now be subject to the tax.

In simulating these revenue effects we will rely on the most recently available data from the Internal Revenue Service on estate and gift tax returns filed in 2016. We will also incorporate the most recent forecast of the U.S. Economy by the Congressional Budget Office (CBO). As before, we will adopt the Joint Committee on Taxation (JCT) assumptions as to the likely behavioral changes that these changes will induce.

Background

In December of last year, Congress passed the "Tax Cuts and Jobs Act". The legislation made broad and sweeping changes to all facets of our tax system and some effects will not be fully understood for several years. For the present analysis, the most relevant reforms relate to the doubling of the exemption for the estate, gift and GST tax. For decedents dying on or after January 1, 2018, a married couple can pass along \$22.4 million to heirs

before being subject to the tax. (For single decedents, this figure is \$11.2 million.) These amounts are indexed for inflation in subsequent years. In addition, the annual gift tax exclusion was increased from \$14,000 to \$15,000.

During consideration of the tax reform legislation, we provided FEUSA with estimates of three proposals to reform the estate, gift and GST tax. Table 1 summarizes our findings and compares them to similar estimates released by JCT in September of last year, shortly after we completed our analysis.

Table 1 – Comparison of Quantria and JCT Estimates, Fiscal Years 2018-2027

(Billions of Dollars)

PROVISION	QUANTRIA	JCT */
<u>Option A</u> : Full Repeal of Estate, Gift and GST taxes; Retain Current Law Step-up.	-280.2	-275.0
<u>Option B</u> : Full Repeal of Estate, Gift and GST taxes with a Modified Step-up In Basis limited to the amount of the personal estate tax exemption and indexed to inflation.	-184.7	-391.3
<u>Option C</u> : Maintain the Current Estate, Gift and GST System with Full Step-up in Basis and Reduce the Current Maximum Tax Rate to 20%	-147.2	-130.4
*/ Letter to Rep. Sherman, September 27 th , 2017.		

You see that our estimates of Options A and C were reasonably close to JCT's. However, we differed substantially with JCT on the revenue effect of Option B, which included repeal of the gift tax in addition to a modified step-up in basis. Because, relative to Option A, the modified step-up should result in less of a revenue loss, we surmise that the JCT attributed large revenue losses to repeal of the gift tax. We find this conclusion puzzling because, among other reasons, repeal of the estate tax should greatly diminish the

number and amount of taxable gifts as no gift tax need be incurred if assets are held until death. Put somewhat differently, Option A effectively repeals the gift tax (in our view) so attributing any revenue loss to gift tax repeal in Option B is double counting. We elaborate on this theme below.

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Description of Current Law

Our present transfer tax system has three components: the estate tax, the gift tax and the generation-skipping transfer tax. The three taxes work together to ensure that at least some tax is paid when wealth is transferred to heirs either at death (the estate tax), by transferring assets during lifetime (the gift tax) or passing wealth to a beneficiary that is more than one generation below (the GST tax). The maximum tax rate imposed by the estate, gift and GST tax is 40%.

An estate tax is imposed on the fair market value of assets in the estate at the time of death (or, optionally, 6 months after the date of death). Numerous deductions are allowed when arriving at the taxable estate, including any bequests to a spouse or transfers to charity. Assets transferred at death receive a step-up in basis to the fair market value and the amount of the step-up is exempt from subsequent capital gains taxes.

A gift tax is imposed on cumulative lifetime gifts and is calculated by (1) figuring the tax on cumulative gifts made in prior years; (2) including taxable gifts made in the current year; and (3) subtracting the two. Individuals are allowed an annual gift tax exclusion before any gift tax is owed. For 2018, this annual exclusion is \$15,000 and indexed for inflation. Unlike assets transferred at death, assets transferred as a gift retain the basis of the transferor (i.e., carry-over of basis) and capital gains taxes would be imposed if the beneficiary subsequently sells the assets.

A separate transfer tax is imposed on generation skipping transfers made while living or in death. The GST tax rate is the maximum estate tax rate imposed in excess of the estate tax exemption amount.

The “Tax Cut and Jobs Act” doubled the estate tax exemption to \$22.4 million for married decedents and \$11.2 million for single decedents.

Modeling Behavioral Effects

The JCT recognizes that changes in the estate and gift tax are likely to induce a significant behavioral response to affected taxpayers and that these effects will effect estate, gift and income tax receipts. The JCT identifies and attempts to measure three principle behavioral adjustments¹:

¹ See JCX-76-12, *Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation*, November 9, 2012. JCT identifies two other potential behavioral effects that we ignore in our analysis. One relates to “form shopping” or shifting deductions between estate and income tax returns. Our anecdotal evidence suggests this behavior is rare. Another relates to tax planning opportunities that may arise when the tax rates of beneficiaries differ from the transferor. Such behavior is difficult to quantify.

- Changing the timing and amount of *inter vivos* giving. Here, it is assumed that individuals exploit differences in the tax rates between the estate and income tax. For example, differences in rates may alter the relative advantages of lifetime giving or bequests at death.
- Changing the timing and amount of charitable contributions claimed on income and estate tax returns. If estate taxes are reduced, individuals will experience an increase in wealth that would, generally, cause them to give more (wealth effect). Alternatively, reducing the tax rate will reduce the benefit of making a charitable contribution (price effect). The JCT's reading of the extant literature suggests that the price effect dominates and a reduction in the estate tax rate would lead to an overall reduction in charitable giving and a subsequent increase in income tax revenues.²
- Changing the amount of capital gains realized on income tax returns. Capital gains realizations are sensitive to both income tax rates and estate tax rates. A third factor affecting capital gains realizations is the step-up in basis that will prevent any capital gains tax to be paid on assets in the estate. As the estate tax is reduced, the JCT assumes that certain individuals will find it more advantageous to reduce current realization and keep appreciated assets in the estate. This will have the effect of reducing federal income tax revenues.

Our estimates attempt to capture each of these effects.

Role of the Gift Tax as a Backstop to the Income Tax

The JCT ascribes an important role to the gift tax in shoring up income tax revenues. This occurs when lifetime gifts result in additional capital gains revenue when the transferred assets are subsequently sold. These additional revenues are partially the result of the fact that assets transferred by gift receive no step-up in basis so any accrued gain attributable to the transferor doesn't escape tax.

While we agree with this analysis, we point out that it assumes the estate tax is already in place and transferors make decisions about giving based on the relative benefits of holding on to assets until death versus making lifetime transfers. Changes in the estate and gift tax rate structure are likely to alter these decisions. As JCT points out:

“While many factors affect a taxpayer’s decision between lifetime gifts and bequests at death, *generally a reduction in the estate tax rate*

² Revenues would increase through two primary channels. First, there would be fewer charitable donations claimed on individual tax returns so individual tax revenues would increase. Second, fewer assets in the non-taxable, charitable section would result in these assets being deployed in the taxable economy where they would result in additional, taxable interest and dividend income.

reduces the tax incentive to make lifetime taxable gifts. (Emphasis added)”

JCX-76-12, p. 18

This suggests that lifetime taxable gifts should be substantially reduced when the estate tax is repealed. This has important consequences for the revenue effect of Option B where the gift tax is repealed in a system where the estate and GST tax are already repealed (Option A). Essentially, the reduction in lifetime gifts – and the resulting reduction in capital gains revenue – are already “baked into” the estimates of Option A. Repealing the gift tax in a system without an estate tax should cost very little revenue. This is why we think JCT has overestimated the effect of repealing the gift tax.

There are several other reasons to believe the JCT estimate is overstated. First, basis rules (step-up for transfers at death; carry-over for gifts) make transfers at death more favorable than lifetime giving even when the estate tax is in place. Without an estate tax, this effect is more pronounced.

A second effect relates to charitable giving. Research has shown that as the estate tax is reduced charitable giving drops as the “price” of giving goes up. Reduced charitable giving would increase revenues through two primary channels. First, there would be fewer charitable donations claimed on individual tax returns so individual tax revenues would increase. Second, fewer assets in the non-taxable, charitable section would result in these assets being deployed in the taxable economy where they would result in additional, taxable interest and dividend income.

A third affect relates to revenues from capital gains. As the estate rate falls, there is more incentive to keep assets in the estate and capital gains revenue will fall. Again, this effect is captured in Option A and should not be affected by repeal of the gift tax.

To summarize, we believe any revenue lost from repeal of the gift tax is already captured in the estimate of repeal of the estate tax – in revenue estimating jargon, repeal of the gift tax is “stacked last” – and any additional revenue losses would be minimal.

Revenue Estimates

In this section, we present updated estimates of three proposals to modify the taxation of the estate, gift and GST tax. These updates relate to (i) the new estate tax exclusion enacted late last year; (ii) more recent IRS data on estate and gift tax returns; and (iii) the most recent CBO forecast of the U.S. economy.

The proposals we estimate are:

Option A: Full repeal of Estate and GST w/ current law step-up in basis.

Option B: Full repeal of Estate, Gift and GST w/ modified step-up in basis.³

Option C-1: Tax estate, gift and GST as capital gains: (i) immediately and (ii) phased-in over 5-years.

Option C-2: Reduction in the maximum estate tax rate to 25%; (i) immediately and (ii) phased-in over 5-years.

We assume the proposals would be effective for decedents dying on or after January 1, 2019. In preparing our estimates we rely on the most recent IRS data on estate tax returns filed in 2016 (representing most decedents who died in 2015). Next, we extrapolate, or “age” this data to 2019, the first year we assume the proposal will take effect. Then we adjust the figures to reflect the fact that the estate tax exclusion is higher because of the “Tax Cuts and Jobs Act”. The estimates reflect anticipated changes in revenue attributable to the estate, gift, GST and individual income taxes.

Option A: Complete Repeal of Federal Estate and GST Taxes

The first option we examine is complete repeal of the estate and the GST taxes. In this option, we also retain the current step-up in basis rules.

As explained above, in our model we estimate three separate behavioral effects: (i) a reduction in lifetime giving and the reduction in gift tax revenues; (ii) the increase in income taxes due to a reduction in lifetime charitable giving; and (iii) a reduction in income tax revenues due to a reduction in capital gains realizations. We estimate that if this option were enacted, federal estate, gift and GST revenues would be reduced by \$227.8 billion.⁴

Option B: Complete Repeal of Federal Estate, Gift and GST Taxes With a Modified Step-up In Basis

This option is similar to Option A, but imposes a modified step-up in basis regime. Specifically, the current law step-up in basis for appreciated assets would exempt from capital gains tax the value of inherited assets up to the existing personal estate tax exemption amount (currently \$11.2 million for 2018) and index this amount for inflation occurring after 2018. Our estimate

³ Modified step-up is limited to the personal exemption (e.g., \$11.2 million and \$22.4 million in 2018, indexed for inflation).

⁴ In their estimate of H.R. 1105, “The Death Tax Repeal Act of 2015”, the JCT calculated a revenue loss of about \$269 billion but they assumed a slightly different effective date. In addition, H.R. 1105 kept the gift tax in place.

assumes a substantial behavioral response for taxpayers affected by the limitation who would respond to the change by increasing their capital gains realizations as explained above. This effect would be offset somewhat by the reduced realizations of heirs who would now have to pay higher capital gains taxes on the sale of inherited assets. However, the net effect is to reduce the estimate of complete repeal by about \$60 billion. We estimate this proposal would reduce federal budget receipts by \$168.9 billion.

Option C-1: Tax Estate, Gift and GST as Capital Gains

Option C-1 retains the current law treatment of estate, gift, GST taxes and current step-up in basis rules and taxes estate, gift and GST as capital gains (maximum rate of 20%). We present two versions of this option. In the first option, we assume the provision is effective in 2019. In the second option, we assume the reduction is phased-in ratably over 5 years beginning in 2019.

In preparing our estimate, we assume a similar behavioral response with respect to charitable giving and capital gains realizations. We also assume the current law unified credit is unchanged. If this provision were to become law, we estimate that federal budget receipts would be reduced by \$111.3 billion if the provision were effective immediately and by \$91.3 billion if phased-in over 5 years.

Option C-2: Reduce The Maximum Tax Rate to 25%

Option C-2 is similar to Option C-1 except that the maximum tax rate is reduced to 25% rather than treated as capital gains. If this provision were to become law, we estimate that federal budget receipts would be reduced by \$93.5 billion if the provision were effective immediately and by \$74.8 billion if phased-in ratably over 5 years.

Table 3 summarizes these revenue effects for fiscal years 2019-2028 for decedents dying on or after January 1, 2019:

Table 3 – Summary of Revenue Effects, Fiscal Years 2018 – 2027

Description	Revenue Effect (Billions of Dollars)
<u>Option A</u> : Full Repeal of Estate and GST taxes; Retain Current Law Step-up.	-227.8
<u>Option B</u> : Full Repeal of Estate, Gift and GST taxes with a Modified Step-up In Basis limited	-168.9

to the amount of the personal estate tax exemption and indexed to inflation.	
<u>Option C-1</u> : Maintain the Current Estate, Gift and GST System with Full Step-up in Basis and Treat Estate, Gift and GST as Capital Gains:	
-Effective Immediately	-111.3
-Phased-in Over 5-years	-91.3
<u>Option C-2</u> : Maintain the Current Estate, Gift and GST System with Full Step-up in Basis and Reduce the Current Maximum Tax Rate to 25%:	
-Effective Immediately	-97.2
-Phased-in Over 5-years	-76.3

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Appendix – Background Data

Estate Tax Summary – 2016

(Billions of Dollars)

Size of gross estate	Gross Estate			Total allowable deductions			Net estate tax		
	Number	Amount	Average	Number	Amount	Average	Number	Amount	Average
Under \$5 million	1,218	4.1	\$3,343,617	1,212	1.1	\$913,203	611	0.3	\$568,079
\$5 million < \$10 million	7,052	49.3	\$6,989,895	6,994	17.5	\$2,500,005	2,402	2.0	\$822,381
\$10 million < \$20 million	2,635	35.8	\$13,595,485	2,633	16.1	\$6,100,749	1,293	3.8	\$2,968,242
\$20 million < \$50 million	1,073	31.6	\$29,438,014	1,073	16.5	\$15,389,868	611	4.6	\$7,490,951
\$50 million or more	434	71.4	\$164,614,323	434	50.7	\$116,821,979	300	7.6	\$25,196,170
All returns	12,411	192.2	\$15,487,791	12,345	101.9	\$8,251,857	5,219	18.3	\$3,505,694

Source: IRS Statistics of Income

Table 2 - Composition of Gross Estate, By Type of Property, 2016

Type of Property	Amount (Billions of Dollars)	Percent
Personal residence	9.4	4.9%
Other real estate	15.3	8.0%
Real estate partnerships	10.4	5.4%
Closely held stock	24.8	12.9%
Publicly traded stock	46.7	24.3%
State and local bonds	14.3	7.5%
Federal bonds	1.9	1.0%
Corporate and foreign bonds	2.7	1.4%
Bond funds	0.8	0.4%
Unclassifiable mutual funds	1.1	0.6%
Unallocated investments	0.8	0.4%
Cash assets	14.8	7.7%
Net life insurance	2.4	1.3%
Farm assets	6.1	3.2%
Private equity and hedge funds	4.2	2.2%
Other limited partnerships	6.9	3.6%
Other noncorporate business assets	5.7	3.0%
Mortgages and notes	6.8	3.5%
Retirement assets	11.0	5.7%
Depletables / intangibles	0.5	0.3%
Art	2.2	1.2%
Other assets	3.0	1.6%
Total, All Property	192.2	100.0%

Source: IRS Statistics of Income