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The Estate Tax at 100

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The estate tax turns 100 on September 8, 2016.[1] It is the cornerstone of our current transfer tax system, which also consists of the gift tax and the generation-skipping transfer tax.[2] This discussion gives a brief overview of the estate tax and its "cousins," and offers selected thoughts on where we may go from here.

Inheritance taxes date back millennia—ancient Egypt had such a tax, as did ancient Rome.[3] In 1780, England imposed a legacy duty, and the new United States, in the Stamp Act of July 6, 1797[4] imposed a legacy tax that was collected by "stamp duties" on transfer receipts[5] (the tax was repealed in 1802). Inheritance taxes were imposed in 1862, during the Civil War, and repealed in 1870 when the additional revenue was no longer needed.[6] To help finance the Spanish-American War, the War Revenue Act of 1898[7] imposed a death tax, although property passing to a surviving spouse was exempt; in 1902, the tax was repealed.[8]

Prior to 1916, then, Congress helped finance war-related needs with national taxes on property passing at death; these taxes were short-lived, however, and apparently not designed to whittle down great fortunes. Yet President Theodore Roosevelt had that in mind when he gave a far-reaching speech on April 14, 1906, at the occasion of the cornerstone-laying for the House of Representatives building. His remarks included the following:

> As a matter of personal conviction…I feel that we shall ultimately have to consider the adoption of…a progressive tax on all fortunes, beyond a certain amount, either given in life or devised or bequeathed upon death to any individual—a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual; the tax of course, to be imposed by the national and not the state government. Such taxation should, of course, be aimed merely at the inheritance or transmission in their entirety of those fortunes swollen beyond all healthy limits.[9]

President Roosevelt reiterated that point in his State of the Union address on December 3, 1906, when he indicated that "an income tax stands on an entirely different footing from an inheritance tax; because it involves no question of the perpetuation of fortunes swollen to an unhealthy size."[10]

In his Inaugural Address on March 4, 1909, President William Howard Taft noted the need for additional revenues, and stated that if tariffs and import duties were insufficient, "new kinds of taxation must be adopted, and among these I recommend a graduated inheritance tax as correct in principle and as certain and easy of collection."[11]

President Woodrow Wilson was also confronted with declining tariff revenues due to the impact of World War I on international trade and the need to finance war preparedness. And progressives were keen to have the wealthy shoulder more of the revenue burden. The Revenue Act of 1916 thus included higher rates for the income tax that was passed in 1913[12] and an estate tax on the transfer of property at death.[13] This initial estate tax had progressive rates that ranged from one percent on net estates up to $50,000, to ten percent on net estates[14] over $5,000,000, with a $50,000 exemption.

So that was the beginning. Using very broad brush strokes, here are selected milestones on the way to where we are now:

- A gift tax came and went in the 1920s, but returned with the **Revenue Act of 1932**;[15] gift tax rates were three-quarters of the estate tax rates.

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- **Between 1934 and 1942**, various revenue acts increased estate and gift tax rates, and generally lowered the estate and gift tax exemptions.[16]
- **The Revenue Act of 1942**[17] introduced the $3,000 per donee annual gift tax exclusion; it also created a complicated system to address the unequal tax treatment of married couples in community property and non-community property jurisdictions (those in community property jurisdictions paid less tax, as each spouse was considered to own half of the community property and could therefore take advantage of the lower end of the steeply progressive income, gift and estate tax rates—see below).
- **The Revenue Act of 1948**[18] repealed the 1942 Act's "solution" to the community property inequity by introducing joint income tax returns and a marital deduction equal to one-half of the "adjusted gross estate" (for transfers at death to the surviving spouse) and one-half of the property transferred to the donee spouse. This 1948 Act also introduced "split gifts," which allowed a married couple to treat gifts to a third party as coming half from each spouse, as long as they agreed.[19]
- **The Tax Reform Act of 1976**[20] unified the gift and estate tax systems so that the same progressive rates applied to lifetime gifts and transfers at death. It also created the first generation-skipping transfer tax (GST), which was so complex and confusing that it never went into effect. Instead, the tax was retroactively repealed in the Tax Reform Act of 1986,[21] and replaced with a new GST. Finally, this 1976 Act imposed a "carry-over" basis on property received from a decedent, so that the basis of a decedent's property would no longer be "reset" to what was generally its date-of-death value (this basis adjustment rule wiped out built-in capital gains *and* losses).[22] Like the first GST, carryover basis never really went into effect, and was retroactively repealed in the Crude Oil Windfall Profits Tax Act of 1980.[23]
- **The Economic Recovery Act of 1981 (ERTA)**[24] phased in an increased exemption for gifts and estates—from $175,625 in 1981 to $600,000 by 1987 (a credit amount of $47,000 and $192,800, respectively). It was also the beginning of the unlimited gift and estate tax marital deduction and "qualified terminable interest property" (QTIP), which permitted a marital deduction for certain spousal lifetime income interests, in trust or otherwise. In addition, ERTA eliminated the estate tax inclusion rule for most gifts made within three years of death, upped the annual exclusion from $3,000 to $10,000 per donee, and permitted tax-free payments of a donee's tuition or medical expenses.
- As mentioned above, the **Tax Reform Act of 1986**[25] repealed the old GST, and replaced it with a new one. This GST had a special twist, and imposed GST on a transfer to a "skip person," such as a grandchild, even though the transfer was *already* subject to gift or estate tax (what is known as a "direct skip" under Code Sec. 2612(c)).
- **The Omnibus Budget Reconciliation Act of 1987**[26] (OBRA) eliminated the unified credit for taxable estates over $10,000,000, by way of a five percent surcharge (meaning that taxable estates between $10,000,000 and $17,184,000 were effectively taxed at 60 percent, after which the rate dropped back down to 55 percent). OBRA also introduced the ill-fated Code Sec. 2036(c), which was designed to limit estate "freezes," and was repealed retroactively by another OBRA in 1990 (see below).
- **The Technical and Miscellaneous Revenue Act of 1988 (TAMRA)**[27] eliminated the gift tax marital deduction for non-citizen spouses, but increased the gift tax annual exclusion for such spouses from $10,000 to $100,000;[28] it permitted the estate tax marital deduction for such spouses only if the property passed to a "qualified domestic trust" (QDOT).[29]
- **The Omnibus Budget Reconciliation Act of 1990**[30] replaced Code Sec. 2036(c) with Chapter 14 (Code Secs. 2701—2704), which was again designed to address estate freezes. (This was the birth of the GRAT, or grantor retained annuity trust, which planners have very successfully used to pass potential appreciation to heirs for little or no gift tax "cost.")
- **The Taxpayer Relief Act of 1997**[31] phased in an increase to what was now called "the applicable exclusion amount," so that the $600,000 applicable exclusion amount would reach $1,000,000 by 2006, and inflation-indexing would now apply to certain numbers, including the $10,000 gift tax annual exclusion and the $1,000,000 GST exemption.
- **By 2009**, the **Economic Growth and Tax Relief Reconciliation Act of 2001**[32] reduced the top

transfer tax rate to 45 percent (from 55 percent), retained the $1,000,000 gift tax exclusion while increasing the estate tax applicable exclusion and the GST exemption to $3,500,000. The 2001 Act repealed the estate tax and GST in 2010, but retained the gift tax with a $5,000,000 exclusion and 35 percent rate, and provided for a modified carryover basis regime. In 2011, because of the law's "sunset provision," transfer taxes would revert to where they would have been if the 2001 Act had never happened: a $1,000,000 gift and estate tax exclusion, an inflation-indexed $1,000,000 GST exemption and a top rate of 55 percent—unless, of course, Congress acted.

- **2010** dawned with the scenario planners were sure they would never see: estate tax and GST repeal. Congress postponed the 2011 reversion to pre-2001 Act transfer tax levels with the **Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010**,[33] which was enacted at the end of 2010. This 2010 Act retroactively reinstated the estate tax and GST to the beginning of 2010, subject to special rules: the estate tax exclusion and GST exemption were both increased to $5,000,000, the top estate tax rate was reduced to 35 percent (from 45 percent in 2009), and the GST rate—for 2010 only—was reduced to **zero percent**. In addition, executors for 2010 decedents could opt out of the estate tax in favor of the modified carryover basis regime mentioned above.
- **For 2011 and 2012** the gift tax exclusion (formerly $1,000,000) was reunified with the estate tax exclusion and GST exemption, which remained at $5,000,000 (indexed for inflation as of 2012), while the 35 percent gift tax rate was adopted for estate tax and GST purposes. "Portability" now allowed the surviving spouse to effectively "inherit" the unused exclusion of the deceased spouse. These provisions were set to expire at the end of 2012 (along with the rest of the 2001 and 2003 tax cuts that the 2010 Act had temporarily extended, such as lower income tax rates and taxing "qualified dividends" at capital gains tax rates[34]).
- **The American Taxpayer Relief Act of 2012 (ATRA)**,[35] enacted in the first days of 2013, made the 2001 and 2003 tax cuts permanent for most taxpayers, while raising taxes on the top one to two percent of taxpayers. As to transfer taxes, ATRA stabilized them, by making the $5,000,000 exclusion and portability "permanent." ATRA also increased the top transfer tax rate from 35 to 40 percent.

... which brings us to where we are now. As any student of taxes knows, "permanent" tax law changes simply mean that a given law has no built-in expiration date. And, as the selected history above illustrates, future Congresses can, and frequently do, change previously enacted legislation.

The estate tax was born not only of a desire to raise increased revenue for government needs, but to address dynastic wealth. The gift tax[36] was designed as a backstop to both income and estate taxes,[37] and the GST was designed to further reduce dynastic wealth, even if it was already subject to gift or estate tax.

Considering that we are facing a major national election in November, and that there are deep philosophical divides between Republicans and Democrats, where might things stand with transfer taxes?

As always, the answer depends. If there is a "trifecta," with one party winning the White House along with both the House and the Senate, far-ranging tax changes seem possible; if there is a split, with one party in the White House, but without control of one or both houses of Congress—an outcome voters have endorsed more than once—the status quo seems a more likely outcome.

Yet if Democratic changes came about, they would probably mirror proposals in President Obama's more recent budgets, including a return to the 2009 transfer tax regime (see above) and even—although it would doubtless face stiff resistance—eliminating the basis "step-up" rule, which eliminates a decedent's built-in capital gains.[38]

If Republican changes came about, they could include eliminating the estate tax (and also the GST), while perhaps retaining the gift tax.

Much is unknown. What's known, though, is that wealth and transfer taxes are true "hot button" issues that engender passionate debate. Theodore Roosevelt's statement regarding wanting to curb the transmission of fortunes "swollen beyond all healthy limits" seems just as topical today as when he uttered it over 100 years ago.

So yes, the estate tax is turning 100 in September. It has shown that it has "legs." Whether those legs keep standing, however, remains to be seen.

ENDNOTES

1 The estate tax was enacted as part of the Revenue Act of 1916, 39 Stat. 756.

2 Under current law, the estate tax statutes are in Chapter 11 of the Internal Revenue Code (Code Secs. 2001-2209). the gift tax statutes are in Chapter 12 (Code Secs. 2501-2524), the generation-skipping transfer tax statutes are in Chapter 13 (Code Secs. 2601-2664), special valuation rules are in Chapter 14 (Code Secs. 2701-2704) and the rules regarding gifts and bequests from expatriates are in Chapter 15 (Code Sec. 2801).

3 See Act of September 8, 1916, Title II – Estate Tax, pp. 97 - 102, from *Bender's Federal Revenue Law 1916*, Albany, NY, Matthew Bender & Co., 1917; retrieved at *https://archive.org/details/cu31924020019349*. This volume has an excellent discussion of the estate tax's historical antecedents.

4 Ch. 11, 1 Stat. 527.

5 Documents subject to a "stamp duty" (or "stamp tax") were not valid until the document had been stamped to show that the appropriate amount of tax was paid.

6 Act of July 1, 1862, 12 Stat. 432 and Act of July 15, 1870, 16 Stat. 256. The Income Tax Act of 1894 (Act of August 27, 1894, 28 Stat. 509) taxed gifts and inheritances as income, but the Supreme Court found the income tax unconstitutional in 1895 in *Pollock v. Farmers' Loan and Trust Company*, 157 U.S. 429, 15 SCt 673. See *infra* Endnote 12.

7 Act of June 4, 1898, 30 Stat. 448.

8 Act of April 12, 1902, 32 Stat. 96.

9 This speech became known as "The Man with the Muck-Rake," and can be read at the following site: *http://www.americanrhetoric.com/speeches/teddyrooseveltmuckrake.htm*.

10 See *http://www.infoplease.com/t/hist/state-of-the-union/118.html*.

11 William Howard Taft – Inaugural Address, March 4, 1909, available at: *http://www.bartleby.com/124/pres43.html*.

12 Revenue Act of 1913, Act of Oct. 3, 1913, c. 16, 38 Stat. 114. This 1913 income tax was made possible by the ratification of the 16th Amendment to the Constitution, as the Supreme Court had held, in *Pollock v. Farmers' Loan and Trust Company*, 157 U.S. 429, 15 SCt 673 (1895), *on reh'g*, 158 U.S. 601 (1895), that the income tax enacted in 1894 was unconstitutional because it was an unapportioned direct tax.

13 For a detailed discussion of what went into the passage of the Revenue Act of 1916, see "Wilson and Financing the Modern State: the Revenue Act of 1916," by W. Elliott Brownlee, *Proceedings of the American Philosophical Society*, Vol. 129, No. 2 (Jun., 1985), pp. 173-210, Published by: American Philosophical Society, Stable URL: *http://www.jstor.org/stable/986988*.

14 Sec. 203 of the Revenue Act of 1916 allowed various deductions against the gross estate, such as funeral and administration expenses, to arrive at the "net estate."

15 Act of June 6, 1932, 47 Stat. 169. The Revenue Act of 1924 added a gift tax (43 Stat. 253) that was repealed by the Revenue Act of 1926 (44 Stat. 9). See "A History of Federal Estate, Gift, and Generation-Skipping Taxes," Updated January 6, 2006, by John R. Luckey, CRS Report for Congress, Order Code 95-444A, for a thorough discussion of these taxes and their fluctuating rates and structure [hereafter referred to as "Luckey"].

16 See Luckey, *supra* endnote 15, pp. 9 - 10.

17 Act of October 21, 1942, 56 Stat. 798.

18 Act of April 2, 1948, 62 Stat. 110.

19 As noted above, income tax and estate tax rates were steeply progressive. In a community property jurisdiction, each spouse was deemed to own—and be taxed on—half of the "community" income, even if only one spouse earned it; similarly, each spouse was deemed to own half of the community property during life or at death, and would therefore only be subject to gift or estate tax on half of it. By contrast, married couples in non-community property jurisdictions were not entitled to this treatment, and therefore paid higher income, gift and estate taxes. The Revenue Act of 1948 was, thus, largely devoted to the "geographic equalization" of these taxes. See S. Rept. 1013, 80th Cong., 2d Sess., 1948-1 C.B. 301-306, 301.

20 P.L. 94-455.

21 P.L. 99-514.

22 See Code Sec. 1014 for the current basis adjustment rules that apply to property acquired from a decedent.

23 P.L. 96-223.

24 P.L. 97-34.

25 See Endnote 21.

26 P.L. 100-203.

27 P.L. 100-647.

28 See Code Sec. 2523(i).

29 See Code Secs. 2056(d) and 2056A.

30 P.L. 101-508.

31 P.L. 105-34.

32 P.L. 107-16.

33 P. L. 111-312.

34 This change in the taxation of "qualified dividends" was part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27).

35 P. L. 112-240.

36 The gift tax followed soon on the heels of *Heiner v. Donnan*, a 1932 Supreme Court decision that held unconstitutional the conclusive presumption that gifts made within two years of death were made "in contemplation of death." 3 USTC ¶913, 285 U.S. 312, 52 SCt 358 (1932). (Yes, the original "pull back" was two, instead of three, years.)

37 The House Report accompanying the 1932 Act stated the following: "The gift tax will supplement both the estate and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the highest brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax." H.R. Rep. No. 708 72d Cong., 1st Sess. 27 (1932), *reprinted* in 1939-1 C.B. (Part 2) 476, 477.

38 This proposal to eliminate the basis step-up for a decedent's appreciated property first appeared in Mr. Obama's Fiscal Year 2016 Budget. Although there would be modest exemptions at death, and special rules for spousal and charitable transfers, the proposal would effectively impose a capital gains tax at death, in addition to imposing a "deemed sale" on the gratuitous lifetime transfer of appreciated property. See the Treasury Department's *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, issued on February 2, 2015, for more details.