INTRODUCTORY REMARKS AND BACKGROUND

With the election of George W. Bush, the trusts and estates community must realistically face the prospect of an outright repeal of the wealth transfer (i.e., estate and gift) tax system. In the comments we make below, we first briefly review the arguments, both pro and con, that will inform the debate over repeal. We confess, at the outset, our own prejudice in favor of retaining the system, though we do believe that much work needs to be done in the area of reform. We then turn our attention to the income tax savings that, with careful planning, repeal would make indirectly possible. Our objective in previewing this planning is not simply to provide an alert as to the issues we will face as practitioners under repeal but also to make certain that all of the consequences of repeal will be fully considered before Congress and the new administration reach a final decision on the question of transfer taxation.

Our tax system is predicated on the principle of progression: People who enjoy an enhanced capacity to contribute to the cost of government ought to be required to bear a disproportionately larger share of the tax burden. The transfer tax system is often justified on the ground that it improves the distribution of the tax burden by making it more progressive. Under current law, the estate tax is imposed on only 2 percent of decedents’ estates; only 1 percent of estates pays more than 5 percent of the estates in taxes.

The principal argument against progression is that it is inefficient because of the disincentives it creates. If we punish our most successful economic producers by subjecting them to high marginal tax rates, the argument goes, they will be less inclined to be productive and, as a result, the entire economy will suffer. Our future productivity will also be adversely affected, the argument continues, if high tax rates diminish the incentive to save (given that savings provide the funds necessary to modernize plant and equipment and thereby assure our economic success over the longer term). With a maximum income tax rate of 39.6 percent and a maximum transfer tax rate of 55 percent, the combined marginal rate can be viewed as 73 percent (assuming the taxpayer pays income tax at the highest rate and then makes a bequest of...
the remaining money subject to the highest estate tax rate). The opponents of progression argue that this rate structure produces disincentives in terms of work effort and savings and that, therefore, a shift must occur in the way we share our tax burden so that the more successful members of our society no longer face marginal tax rates of this magnitude.

The proponents of progression argue, in response, that there is no clear empirical evidence to suggest that the current rate structure significantly undermines the incentive to save and work. Even conceding, however, as many proponents of progression do, that a progressive rate structure produces some disincentives, they argue that fairness requires a progressive approach and that any resulting inefficiency is a cost worth incurring.

Ultimately, given the lack of definitive empirical evidence as well as the progressive argument that fairness trumps efficiency, any judgment as to the balance between efficiency and fairness is a matter of aesthetics, requiring political resolution. Indeed, in the election just held, the question of progression was hotly contested. Vice President Gore strongly argued for the retention of the current income tax rate structure and the wealth transfer tax system (with modifications), and President–Elect Bush argued just as strongly for a significant reduction in income tax brackets and a repeal of the transfer tax system.

Apparently, perceiving the election’s outcome as a mandate of sorts, President–Elect Bush anticipates proposing legislation that would reduce the maximum income tax bracket to 33 percent and that would repeal the transfer tax system. That represents a very serious threat to the progressive character of our present structure. While the reduction in the maximum income tax rate will certainly have a significant impact on the distribution of the tax burden, it may not, by itself, alter the percentage of tax revenue paid by the wealthy: The Bush tax–cut proposals aimed at the less wealthy may sufficiently compensate for the reduction in the maximum bracket so as to preserve the current distribution of the burden in terms of income tax revenue.

The elimination of the wealth transfer tax system, however, is a different matter. The system is designed to make the distribution of the tax burden effected under the income tax more progressive while minimizing the disincentive effects inherent in high marginal rates. This is achieved by imposing, under current law, a maximum bracket of 39.6 percent on income as earned, with a deferred tax (the estate tax) at a maximum rate of 55 percent payable on unconsumed resources at death. The disincentive effect, under this kind of approach, is less acute than it would be under an equivalent tax rate imposed on income as earned (i.e., 73 percent). To put it concretely, while a taxpayer who faced a 73 percent marginal income tax rate might decide to work less and therefore save less as well, the same taxpayer might very well reach a different conclusion if the rate immediately payable were only 39.6 percent and the balance of the tax (i.e., 55 percent of unconsumed resources) were payable at death. The difference in the taxpayer’s reaction is easily understood in that people typically find events that will necessarily occur after their death difficult to incorporate into their decision making. In short, by deferring a portion of the tax until death, the estate tax permits a higher rate of tax to be imposed on the wealthy without creating the same disincentive effects that are inherent in an immediate, equivalent income tax. So viewed, the estate tax is not, contrary to the characterization of its opponents, a form of double taxation.

Repeal would unquestionably work a radical transformation in the taxation of wealth transfers. Under repeal, once a taxpayer earned income and paid income tax, no further tax would be imposed on the
taxpayer in connection with any transfer of that income by gift or bequest. Nor would the recipient be required to pay income tax on the receipt of the gift or bequest inasmuch as the proposal does not alter the exclusion from gross income under section 102 of gifts, bequests, and inheritance—even though many have thought that section 102’s protection for taxpayers was driven by the fact that transfers were separately taxed under the estate and gift tax system. Repeal, therefore, would significantly reduce the level of taxation imposed on wealth transfers and, concomitantly, the share of the tax burden the wealthy are required to bear.

Thus, for those who believe that, as a matter of fairness, the distribution of our tax burden should not be made less progressive, the proposal to repeal the estate and gift tax and simultaneously reduce the maximum income tax rates is an unwelcome development. That is not to say, however, that the estate tax must retain its present form. Those who argue against it often cite to the loopholes that exist under current law. It would be difficult to quarrel with the validity of these criticisms. Accepting them as true, however, does not lead to the conclusion of repeal. The criticisms simply suggest the need for reform. The concern that the burden of the estate tax may fall too harshly on farmers or on taxpayers who cannot, under contemporary standards, be considered wealthy must also be addressed. But, again, the solution is reform, not repeal.

During the campaign, Vice–President–Elect Cheney argued against the estate tax by suggesting that it is wrong to view it as a burden imposed on the wealthy and, by implication, it is consequently wrong to view it as an instrument that helps achieve a more progressive distribution of the tax burden. He maintained that the tax is not borne by the transferor but rather by the transferee, who, he claimed, might not be wealthy at all. Since, as suggested, however, the present system imposes the tax on the unconsumed earnings of the transferor on a deferred basis in order to create more progression while minimizing disincentive effects, it seems inappropriate to abandon the tax on the ground that it is paid at death and may therefore fall on less wealthy transferees. But even assuming with the Vice–President–Elect that it is correct to view the transferee as bearing the burden of the tax, it is unlikely that a transferor who dies with an estate of, say, one billion dollars will bequeath it to people of such limited economic means so as to call into question the progressive character of the tax.

Moreover, the argument runs contrary to the double taxation argument repeatedly invoked during the campaign. If, as the Vice–President–Elect suggests, the burden of the tax really does fall on the transferee, then no taxpayer is subject to two levels of tax. Rather, the transferor pays tax on income as earned, and the transferee pays tax on the gift or bequest as received.

In any event, the answer to the Vice–President–Elect’s argument is once again reform, not repeal: If we seriously believe that wealthy transferors die bequeathing their estates to poor transferees, we can remedy any perceived inequity by creating rules that ameliorate the tax liability, or perhaps even eliminate it, where such inequity occurs (by, for example, repealing the estate tax and subjecting the transferee to income tax on the bequest instead, with an income–averaging device and a special exclusion for transferees having insubstantial resources of their own and receiving small inheritances).

It is worth noting that, while President–Elect Bush has in the aftermath of the election sought to justify the income tax cut on the ground that a fiscal stimulus is necessary to avert a slowing economy, no such justification has been suggested with respect to the repeal of the estate tax. That is not surprising inasmuch as any tax cut designed as such a stimulus would nec-
nessarily have to be aimed at taxpayers having a propensity to consume most, if not all, of their tax savings. Clearly, a repeal of the estate tax would not produce a tax savings for taxpayers with such a propensity. Indeed, for the same reason, the proposal to reduce the maximum income tax brackets cannot be justified on the basis of a slowing economy. Even more important, perhaps, many economists believe that, as a general rule, fiscal stimulus is not an appropriate corrective for a faltering economy. They suggest that an expansionary monetary policy provides a more effective remedy. In any event, whatever the merits of fiscal stimulus as a justification for the proposed income tax cut, it certainly cannot be invoked as an argument in support of repealing the estate tax. Moreover, the cost of estate tax repeal may prove to be prohibitive, given the loss in revenue the government will sustain (compounded by the loss of revenue attributable to any income tax cut) should the economy actually slow down.

The impact of estate and gift tax repeal on philanthropy must also be considered. As presently structured, our tax system offers a subsidy to charity of approximately 73 cents on every dollar contributed during life by high–earning, wealthy taxpayers (the subsidy is 55 cents on the dollar if made at death, though it approaches 80 cents on the dollar if the generation–skipping–tax is taken into account). If the estate tax is repealed and the President–Elect’s income tax proposal is also adopted, the subsidy for such contributions will fall to no greater than 33 cents on the dollar. It cannot be denied that such a substantial reduction in the subsidy will have a very significant effect on the propensity to make charitable contributions. If we are not to suffer the consequences that flow from diminished philanthropy, Congress will have to replace the tax subsidy with appropriated direct expenditures.

While this is certainly feasible, two points about this approach should be made. First, the cost of direct expenditures should not be ignored in the forthcoming debate about repeal. In other words, it must be viewed as part of the cost of repeal. Second, a direct–expenditure approach flies in the teeth of the notion (often cited by the President–Elect) that government intervention should, as a general matter, be limited and that therefore government’s role in “picking winners” should not be extended in the absence of an important justification. It would be unfortunate if philanthropy were to become so extensively controlled by government and therefore so rampantly politicized. Indeed, in the case of religious charities, such direct expenditures could even raise constitutional questions (potentially violating the separation between church and state). In short, if the subsidy is to be reduced without precipitating a deleterious reduction in charitable activity, it must be replaced by direct expenditures, entailing its own cost and substantially expanding (to the extent constitutionally permissible) the scope of the government’s decision making authority in the context of philanthropy.

Finally, quite aside from the repeal of the estate tax, the repeal of the gift tax will have its own pernicious effects. The gift tax is ordinarily justified as an adjunct to the estate tax: In the absence of the gift tax, the integrity of the estate tax could not be maintained in that taxpayers would simply make lifetime gifts and thereby defeat the estate tax. The gift tax, however, does have an additional justification. As the Supreme Court has suggested, the gift tax is necessary in order to secure not solely the integrity of the estate tax, but also the integrity of the progressive character of the income tax (see Dickman v. United States, 465 U.S. 330 (1984)). While those who seek repeal have focused their rhetoric on existing loopholes, farmers
Wealth Transfer Tax Repeal

and other taxpayers who probably should not subject to the tax, they have not considered the ways in which taxpayers will be able to “game” the income tax system, and thereby undermine its progressive character, if repeal of the gift tax is achieved.

After briefly outlining the repeal proposals, we will then turn our attention to the planning opportunities that we anticipate would become available under repeal and the revenue loss that the states will suffer as a result.

REPUBLICAN ESTATE TAX REPEAL PROPOSALS

Under prior Republican proposals, the estate tax would be phased–out over ten years (see, e.g., HR 8). A proposal has now been drafted, however, under which the estate, gift, and generation skipping transfer taxes would be phased–out over five years: a reduction of the top rate from 55 percent to 44 percent in the first year, dropping to 33 percent a year later, 22 percent the year after that, then 11 percent one year later, and then in one more year the tax rate drops to zero. A further proposal would also result in a wealth transfer tax elimination: a reduction rate in 2002 to 50 percent; to 45 percent in 2004; to 40 percent in 2005; to 35 percent in 2006; to 25 percent in 2007; to 15 percent in 2008; and no tax thereafter. Other proposals under consideration would reduce all brackets, including the entry–level brackets as well (presumably, the functional equivalent of increasing the unified credit).

Whether it is more accurate to view the estate tax as being imposed on the decedents or the inheritors, if assets are not sold during lifetime, there is no double tax. Most assets transferred by a decedent are entitled to a new income tax basis under section 1014(a) of the Internal Revenue Code (“Code”) in the hands of the inheritor equal to their estate tax values. The inherent profit is never subjected to income tax. They are subject to only one level of taxation: the estate tax. In an apparent acknowledgement of that, the prior Republican proposals provided for income tax basis to carryover from the decedent to the inheritors.

However, a proposal being circulated now would, in many cases, change the situation from an alleged double tax to a zero tax at least for descendants of a married couple. Widows and widowers would not only continue to receive property free of estate tax (as everyone would) but receive the automatic income tax free change in basis to the property’s value when the first spouse dies. Because most spouses in a first marriage die at about the same time, the inheritors of a married couple’s property will achieve the best of both possible worlds: no estate tax and a basis recently refreshed as of the time the first spouse dies. Indeed, the descendants need not even wait until the second parent dies. After the death of the first spouse, the surviving spouse can give the descendants the assets free of gift tax along with the surviving spouse’s new income tax basis.

Estimates have ranged to over one trillion dollars of revenue loss to the Federal government over a 20–year period on account of the repeal of the estate tax system with the actual amount of the loss dependent upon the speed of the phase–out. Carryover of income tax basis would have made up some portion of that loss but, as explained above, under at least one proposal, the step–up in basis would continue to be the rule because so many of the wealthy are married. (And don’t worry too much about second or third spouses: the proposal allows the use of a qualified terminable interest property (QTIP) type trust—not to secure the estate tax marital deduction, as that will not be necessary as there will be no estate tax, but to secure the step–up in basis.)
NEW PLANNING OPPORTUNITIES ON UNEXPECTED FEDERAL REVENUE LOSS ON ACCOUNT OF ELIMINATION OF GIFT TAX

Although the public perception is that only the estate tax would be eliminated, the two other wealth transfer taxes, the generation-skipping transfer tax and the gift tax, also would disappear. The estimated tax loss attributed to repeal includes the loss of revenue from in the generation-skipping transfer tax and the gift tax. However, the repeal of the gift tax will create planning opportunities in terms of state and federal income tax, resulting in a revenue loss that must also be included in the “price tag” of repeal.

Without gift tax, high-bracket taxpayers would be well advised to transfer their investments to relatives and trusted friends who are in a lower income tax bracket. For example, a parent wishes to sell appreciated stock. Rather than selling it herself, she could transfer it to a child who is in a lower tax bracket or has otherwise unused capital losses. The child could sell the stock, paying a lower tax than the parent would have paid. After an appropriate interval, the child could retransfer the sale proceeds to the parent. And, obviously, with repeal in place, neither the transfer nor the retransfer would generate a gift tax. Although the government might try to attack such an arrangement as ineffectual in shifting the tax burden from the parent to the child, the government would certainly not be successful under current law—assuming that the sale does not occur immediately after the transfer, the interval between transfer and retransfer is sufficiently long and there is no understanding or agreement calling for retransfer. Nor, in all likelihood, would the government be able to close this loophole effectively through legislation. Any statutory mechanism requiring that the gain be reattributed to the parent where the sale or retransfer occurs within some designated period of time after the transfer would create its own practical difficulties: If the period were not excessive, it would be easy to satisfy, and if it were made too long, it would be unfair to impose an increased tax on the parent merely because the child made an unrelated retransfer to the parent many years after the transfer.

Other strategies will be developed. For example, a taxpayer with trusted relatives or friends overseas may well give them almost all of his or her assets that produce portfolio income. The Federal withholding rate on U.S. source income paid to foreigners is only 30 percent, which is lower than the top Federal income tax rate on U.S. taxpayers. In fact, if the income is not U.S. but foreign source, the Federal government will collect no tax at all. The foreign recipients of gifts from Americans will not have to forego all U.S. investments to avoid U.S. tax. Currently, the United States does not impose tax on capital gains experienced by foreigners on U.S. investments (such as stocks in U.S. companies) other than American real estate. Interest on most American bonds also is exempt from U.S. tax if paid to a non-U.S. person. Hence, a wealthy American who invests in municipal bonds and has trusted foreign relatives may be able to convert to higher yielding taxable bonds but pay no tax. That concept will be so inviting to some that the least wealthy member of a family may be urged to expatriate. If that family member, at that time, has little income, he or she probably can establish quite easily that the expatriation was not tax motivated (see Section 877).

Taxpayers will also use trusts to reduce or eliminate income tax. Indeed, by eliminating the friction created by the gift tax, repeal will allow taxpayers more easily to create trusts that are not grantor trusts for income tax purposes but nonetheless are for their benefit. The income of a grantor trust is attributed directly back to the grantor as though the trust did not exist (section 671; Rev. Rul. 85-13, 1985-1 CB
A trust from which income or principal may be paid to the grantor is a grantor trust unless the payment requires the consent of an adverse party (see, e.g., Section 677(a)). An adverse party is one having a substantial beneficial interest in the trust that would be adversely affected by making the payment to the grantor. Under current law, any person who holds such an interest almost certainly would be making a taxable gift if he or she consented to the payment from the trust to the grantor. Once the gift tax is repealed, adverse parties will be used to avoid grantor trust status. The income can then be taxed to the trust as a separate and independent taxpayer or can be shifted to any of its beneficiaries. Indeed, the law permits the trustee to wait until after the close of the tax year to determine to which beneficiary or beneficiaries the trustee wishes to tax the income (section 663(b)). The trustee may make the income available to a beneficiary who is in a low (or no) income tax bracket, by “crediting” it to the beneficiary who then must report the income as his or her own (section 662(a)). If the income, in fact, is distributed to the beneficiary, he or she can return it to the original property owner. If it is only credited, the beneficiary may leave it in the trust and, after a time, the trustee may return it to the original property owner with the consent of that beneficiary (an adverse party). Neither the transfer trust nor the retransfer will be subject to gift tax.

Perhaps, an even better result can be effected by transferring assets to a foreign trust that, like a foreign person, is generally not subject to U.S. income tax. No American could be a beneficiary; otherwise, the income of the foreign trust will be taxed to the grantor under section 679 of the Code. The income may be accumulated in the trust tax free. The trustee may, from time to time, ask a beneficiary if he or she wishes income or property that otherwise would be distributed to the beneficiary to be paid to another. It would not be surprising if the beneficiary requested the trustee to give back to the grantor whatever trust assets the trustee would otherwise distribute to the beneficiary. (Section 684 imposes a gains tax if appreciated assets are transferred to a foreign trust if the trust is not a grantor trust. Hence, the taxpayer will transfer only unappreciated assets, such as cash, to a foreign trust that is designed not to be a grantor trust.)

Another option will be to create a trust described in section 678 of the Internal Revenue Code for another taxpayer who is in a relatively low tax bracket. Under that section, if a beneficiary has the right to withdraw the property from a trust but does not, all income may be taxed to the beneficiary even if, depending on the terms of the trust, the beneficiary loses the right to demand trust property or to receive any distributions in the future. Indeed, after the power to withdraw the property from the trust has disappeared, someone (even the trustee) could add the original property owner as a beneficiary. The income will continue to be taxed to the original beneficiary, even though the trust assets may ultimately be diverted to the original property owner.

To believe that taxpayers will not take such tax avoidance action is naïve. The so-called “spousal remainder trust” became a very popular tool among high income earners until legislation closed it down by the enactment of section 672(e). That section essentially treats a husband and wife as one person for purposes of the grantor trust rules. Prior to the amendment, the Code permitted a married taxpayer to create a short term trust, have the income earned during that period taxed to the property owner’s child (or someone else in a bracket lower than that of the grantor) and then have the property returned to the grantor’s spouse (effectively returning it to the grantor). What made this strategy feasible as a practical matter was the
elimination of the gift tax on transfers between spouses beginning in 1982. It was very popular and extensively used even though (because of gift–tax exposure with respect to the income interest given to the non–spouse) it could produce limited income tax savings. There is little question but that the potential to game the system through bracket–shifting made available by an across the board repeal of the gift tax will dwarf in scope the comparatively insignificant abuse unleashed by the introduction of the unlimited marital deduction. The Federal government no doubt will create new barriers to some of the income tax avoidance arrangements discussed after it has dismantled the gift tax hurdle that has served it so well to prevent such results for nearly 70 years.

THE BIGGEST LOSERS OF ALL: THE STATES

There will be many losers as a result of the elimination of the wealth transfer tax system. As suggested, charity will be a principal loser. Common estate planning arrangements, such as charitable lead trusts, that benefit both individuals and charity and may substantially reduce gift and estate tax will disappear, as will most direct bequests to charity at death—not to mention the decline in lifetime giving that, as suggested, will occur as well. Second, some married women (and men) will lose. A majority of states provide for a surviving spouse to receive a minimum share (typically, one–third) of the deceased spouse’s estate. However, the share only applies to assets owned at death (and, in some jurisdictions, those given away within one or two years of death.) Without gift tax, individuals who do not wish their spouses to share in as much property as they otherwise would will make gifts to trusts for themselves or to others prior to death. With repeal, the gift tax will no longer impede such planning (although the states could address this issue). It may well be that women will suffer the consequences of such a shift in planning more than men. However, the biggest losers of all of the elimination of the Federal wealth transfer tax system will be the several states.

First, every state, without exception, imposes a death tax equal to the state death tax credit. That credit, which reduces the gross Federal estate tax, dollar for dollar, up to the limit set forth in Section 2011, represents revenue sharing from the Federal government to the states and comprises about 20 percent of the total estate tax bills paid. It probably represents a loss in excess of $100 billion to the states in the next ten years. In some states, the state death tax credit is a significant part of the annual state budget. In New Hampshire, for example, it is 4.5 percent. In New York, Florida, and Connecticut it is over 2.5 percent. Some states might adopt independent estate tax systems, although that may be politically impossible. For some states, such as Florida, it cannot be done. That state’s constitution prohibits the imposition of an independent estate tax. Such states have no easy mechanism to replace the lost revenue.

Forty–three of the 50 states (along with the District of Columbia) will face an even more serious, additional revenue loss. Those 43 states (and the District) impose state income taxes. (Some state political subdivisions, such as New York City and Philadelphia, also impose an income tax and they also will be affected.) They will lose tremendous income tax revenue if the wealth transfer tax system is repealed. The reason is the simplicity with which individual taxpayers in one state may shift their income, under repeal, to others in states with lower or no state income taxes. The taxpayer does not even have to search for a trusted person in a lower Federal bracket, just one (or more) who resides in a jurisdiction without state (or local) income tax.
Indeed, it seems likely that individuals will create trusts that are not grantor trusts (relying on the adverse party technique discussion above) for income tax purposes with their portfolio assets and of which they are beneficiaries. The trusts will be created in jurisdictions that will not impose income tax on the trust’s income. Alaska, Delaware, Florida, Nevada, South Dakota, Texas, Wyoming, and Washington (State) appear to be excellent choices at this time. The trustee may accumulate current income in the trust, pay the current Federal income tax, and then distribute that income to the trust’s grantor in a later year. Little tricks will be developed to minimize income tax on the return of property to the grantor. For example, after four years of accumulating income, the trustee distributes all assets to the grantor on the first day of the fifth year. There will be no or minimal income for that one day so the grantor will include nothing, or almost nothing, in income. (Under current law, a beneficiary must include in income the trust’s income for the year in which the beneficiary receive trust assets, as a general rule. See Section 662. However, for U.S. trusts, no income of a prior year of the trust is included in the beneficiary’s income.)

To think individuals will not try to avoid state income tax once the barrier of gift tax is brought down is even more naïve than to think they will not try to reduce their Federal income tax by income shifting. Indeed, individuals will attempt to recharacterize what would have been earned income (e.g., salary) into passive income to try to effect a shift to others outside of the “home” state (Cf. Van Zandt v. Commissioner, 341 F. 2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965)). The IRS will have no incentive to try to attack such income shifting arrangements where the Federal revenue is not affected. Smart taxpayers will arrange their affairs so the IRS receives no less (and possibly arrange it so the Federal government gets a little more) but the states receives nothing.

WHAT CAN BE DONE TO AVOID THE LOSS OF STATE DEATH AND INCOME TAX REVENUE?

As indicated earlier, the states, perhaps, can be convinced that the loss of state death tax will not be significant or they (other than Florida and perhaps a few others) can pass new death tax systems so their revenue will not be eroded.

The loss of state income tax on passive income is more serious for two reasons. First, it represents a much larger portion of the revenue to most states. Second, the states probably cannot pass and enforce laws that would cause residents of their states to report income on assets given to others. Special throwback rules (cf. Sections 665–668 prior to 1997), special attribution of income rules, special state grantor trust rules, state anticipatory assignment of income rules and other special provisions designed to prevent erosion of state income tax on passive income will be very difficult for a single state to enforce. (It should be noted that the reduction in state income tax will reduce the Federal income tax deduction under section 164 and thereby increase Federal income taxes.)

An alternative would be for the Federal government to adopt a surcharge on passive income, such as gains, dividends, and interest and allow a dollar for dollar state income tax credit, functioning as the state death tax credit under Code Sec. 2011 has operated. Individuals would have less or no incentive to try to avoid the state income tax on such income. It would seem fair that if the Federal government believes it is beneficial to eliminate the wealth transfer tax system, it alone should bear the revenue loss burden and not shift a significant portion of the cost to the states.
In turn, a state income tax crediting system has other ramifications. One is the inability of a state to determine how much income tax to impose. Jurisdictions such as California and Oregon probably cannot be assured of the same high level of state income tax they have imposed in the past. Also, depending upon the exact structure of the crediting system, it may cause different kinds of income to be subjected to different rates of tax. In addition, it is unlikely the Federal government will provide any level of subsidy to localities (such as New York City) with a crediting system. Those political subdivisions are even less prepared to fight the shifting of passive taxable income. They will have to turn to other forms of taxation, such as sales taxes, effecting a regressive shift in the tax burden. Perhaps most important, any surcharge on passive income could prove to be problematic in terms of efficiency. To the extent that such a surcharge results in the imposition of an aggregate tax on income from savings that is higher than that currently imposed by the states, taxpayers could respond by saving less.

SAVING THE FAMILY FARM AND RETAINING THE TAX

Under current law, an individual can own a farm or other closely-held company worth more than $2 million and pay no death tax at all on account of the estate tax exemption equivalent under section 2010 and qualified family owned business interest exclusion under section 2057 combined reaching $1.3 million and special use valuation of farm and certain other business use real estate under section 2032A (that can exclude another $760,000 in value). For a married couple, the value can exceed $4 million and, in some cases, be even greater (see section 2031(c) relating to certain conservation easement real estate).

Given that the objective of the estate tax is to make the distribution of the tax burden more progressive and that it is important therefore for the tax to fall on the wealthy, a compelling case can be made for a substantial upward revision in the amount of the exemption (or exemption equivalent) available to farmers, owners of closely held business interests and other taxpayers as well. And, certainly, the generation skipping tax exemption should be concomitantly increased.

In sum, in our view, the loopholes and deficiencies inherent in current law can be fixed. Indeed, we believe strongly that reform must be undertaken. We believe just as strongly, however, that repeal would be the wrong remedy.