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FAULTY REVENUE SCORING: LIFE SUPPORT FOR THE DEATH TAX

In new revenue estimates, the Joint Committee on Taxation (JCT) has sharply increased its estimate of the tax loss to the federal government from rolling back the estate and gift tax. These revised estimates have led the House of Representatives to further stretch out the repeal process. The new JCT estimates of the cost of repeal of the estate and gift tax are wrong, based on highly selective behavioral assumptions leading to unwarranted concerns that repeal would increase income tax avoidance. The JCT should recognize that a well-crafted repeal of the death tax would reduce, not increase, opportunities for income tax avoidance, and would increase revenue by promoting saving and economic growth. The tax should be repealed sooner, not later.

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The change in the JCT's revenue scoring of estate and gift tax repeal came in response to a request from Rep. Charles Rangel (D-NY), ranking member of the House Ways and Means Committee, to estimate the tax cost of immediately repealing the estate and gift tax. According to Lindy Paull, the JCT's Chief of Staff, the new numbers are based on a "more detailed analysis of expected behavioral responses" that takes "into account a variety of specific behavior responses that have been called to our attention by practitioners and commentators."[1]

The JCT's chief of staff announced the change in a letter to John Buckley, Minority Tax Counsel to the Ways and Means Committee. Mr. Buckley claims that reducing or repealing the death tax would provide people with "obvious income tax avoidance techniques." To reflect the income tax spillover he claims would occur, he says that "any revenue estimate of a proposal that totally repeals federal estate and gift taxes should show a federal revenue loss *substantially in excess* of the revenues currently collected under the transfer tax system alone. [emphasis added]"[2]

In its revised numbers, the JCT accepts Mr. Buckley's position. After estimating that the death tax would collect $410 billion over the ten year period 2002-2011 under current law, the JCT then estimates that immediate repeal would cost $660 billion, which is more than 60% larger than what the tax brings in.[3] This is in spite of a large revenue raiser that the JCT assumed would accompany death tax repeal: a partial shift from stepped-up basis to carry-over basis for inherited assets.

With stepped-up basis, an heir's acquisition cost of an inherited asset for tax purposes is deemed to be its value as of the date of the decedent's death (or as of the date specified by the alternate valuation option). With carry-over basis, in contrast, if heirs ever sell inherited assets, they must find the decedent's basis and use that in capital gains calculations.[4] Current law provides for stepped-up

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basis on bequests (whether or not the estate owes death tax).

Legislative Impact So Far. The JCT's abrupt change in scoring has already had an impact on the legislative process. Last year Congress passed but President Clinton vetoed legislation that would have gradually phased down the estate and gift tax (H.R. 8, 106th Congress). Many had expected that when the plan was reintroduced this year, the slow phase-down schedule would be speeded up. After all, George W. Bush had criticized the death tax on moral and economic grounds during his election campaign and called for its abolition. Instead, as a direct result of the JCT's altered revenue scoring, Rep. Bill Thomas (R-CA), Chairman of the House Ways and Means Committee, felt compelled to offer a bill (H.R. 8, 107th Congress, Death Tax Elimination Act Of 2001) with an even slower (10 year) phase down.

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Last year's bill also had a revenue offset provision in the form of a partial shift from stepped-up basis to carry-over basis. It would have retained stepped-up basis for all assets until the death tax had been entirely repealed. Afterwards it would have provided stepped-up basis for a limited amount of assets: $1.3 million of any assets passing through an estate, plus $3 million of inter-spousal bequests. This provision would recapture some of the estate tax revenue through a capital gains tax while preventing future estates that are currently protected from the transfer tax by the unified credit from being more heavily taxed than under current law. On assets above the limits, heirs would have to use carry-over basis. Under both current law and last year's bill, carry-over basis applies to gifts of property made inter vivos (during a person's lifetime).

Applying carry-over basis to bequests would create huge administrative problems. Executors and heirs would have to spend enormous amounts of time searching for, pouring over, and trying to make sense of decedents' records. Even then, heirs often could not produce sufficient information to establish the carry-over basis of inherited property if the IRS challenged them to do so, either because the decedent did not save the needed records, because the decedent's records were incomplete, or because the knowledge required to understand the records died with the decedent. On assets held for many years, there may have been so many basis adjustments stretching over so long a time that even the original owner would be unable accurately to determine the basis.[5] Hence, substituting carry-over basis for stepped-up basis as the "price" for repealing the death tax would remove an enormously complicated tax but replace it with a different source of tax complexity.

Another advantage of stepped-up basis is that it is consistent with even-handed tax treatment of saving and consumption. Neutral tax treatment of saving is accorded to a few retirement vehicles, such as deductible IRAs, 401(k)s, and Roth IRAs. For the most part, however, the government taxes multiple times earnings that are saved. One of the added layers of tax on returns to saving is the capital gains tax. By protecting appreciated assets bequeathed at death from the capital gains tax, stepped-up basis acts like a partial Roth IRA and reduces the tax bias against saving.

Earlier this year there was much discussion about dropping the complex carry-over basis provision from the bill ending the death tax. After the JCT made estate and gift tax repeal look more expensive than previously thought, however, the debate ended. This year's bill includes the recapture provision, which would take effect once the death tax is entirely eliminated. In light of the JCT's criticism, the bill also contains a number of new anti-tax-avoidance provisions.

By scaling back the estate and gift tax very gradually, Rep. Thomas managed to keep the estimated 10-year revenue cost of his proposal, which easily won House approval, to $186 billion. The disadvantage of the slow phase down is that it also slows tax relief. The death tax strongly discourages saving and investment because it is a tax solely on saving — often the third or fourth layer of federal tax on saving. The easiest way to avoid the tax is to save and invest less and consume more. The death tax is also extremely complicated, which diverts time and money from entrepreneurship, business financing, and other productive activities to the non-productive activities of estate tax planning and compliance. H.R. 8 would bring some relief quickly, but most would not come until several years hence. With full repeal delayed for a decade, there is also the danger that a later Congress and President would feel differently about the death tax and decide to keep it on the books after all.

> ***[T]he mechanics of the [current] estate and gift tax ... generates a bias favoring early transfers, which reduces income tax collections when heirs are in lower income tax brackets than donors... Repeal of the transfer tax would have the opposite effect and tend to delay transfers and increase income taxes.***

This setback to death tax repeal is all the more disappointing because the JCT's new revenue scoring is fundamentally flawed. First, the JCT has made major analytical errors when it asserts that income tax avoidance would flourish if not for the estate and gift tax. Second, the JCT is looking only at some of the behavioral responses to the repeal, those that it assumes could raise the revenue cost, while ignoring other feedbacks that would lower the revenue cost by increasing income tax collections.

Would the Proposed Estate and Gift Tax Repeal Increase Income Tax Avoidance? Some advocates of the current transfer tax claim that its repeal would enable people to avoid income taxes on interest, dividends, profits and capital gains through the use of two main strategies. First, without the gift tax, people in higher tax brackets could give away large amounts of income-producing assets during their lifetimes without tax penalty, rather than passing them on later as bequests to beneficiaries in lower tax brackets. The beneficiaries would pay less federal income tax on the earnings than the donors would have paid had they kept the assets. Second, people might "game" the limited step-up in basis that would be allowed under the proposed death tax repeal by making sham transfers to avoid paying capital gains taxes. Let us examine each strategy in turn.

Case 1. Transfers to heirs in lower tax brackets. Would a reduced or zero transfer tax rate encourage people to pass assets more quickly to their heirs, who are often in lower income tax brackets? No. Although phasing out the transfer tax on gifts and bequests would lower the cost of transferring assets to heirs (as opposed to selling the assets and spending the proceeds on consumption during life), it would not provide any incentive to speed up the timing of the transfers because the same reduction in the transfer tax rate would also apply to assets retained until death and left as bequests. If the estate and gift tax were repealed, the transfer tax rate would drop to zero, whether the transfers were made now or later.

In fact, because of the mechanics of the estate and gift tax, the current transfer tax generates a bias favoring early transfers, which reduces income tax collections when heirs are in lower income tax brackets than donors. One reason to begin transferring assets early is to utilize fully the $10,000 annual gift tax exemption per recipient ($20,000 exemption if a couple makes the gift). Another reason is that transferring assets before they have appreciated much in value holds down the amount of taxable lifetime transfers and cuts the transfer tax that will eventually be due.

For example, suppose Ted Taxpayer has just acquired an asset that is expected to quadruple in value over the next fifteen years, say from $500,000 to $2 million. Giving it to Teddie Junior now will use up only $500,000 of the amount sheltered by the unified credit. Junior will have to pay capital gains tax on the increase in value at the 20% capital gains rate if he sells the asset for $2 million down the road. If, instead, Ted keeps the asset, it will be transferred at death with a stepped-up value of $2 million, and Junior will avoid the capital gains tax. However, the full $2 million will then be part of Ted's taxable estate, and if there are substantial other assets, the added $2 million may face a tax rate of 55% (or 80% if it goes to grandson Theodore III via a generation skipping trust). Without the estate and gift tax, and with some step-up allowed at death, Ted and Junior would have an incentive for Ted to hold onto the asset and continue to pay any taxes on dividends received in the meantime.

No wonder estate tax planners routinely advise clients to transfer assets sooner than the clients might like. Thus, with regard to inter vivos transfers to heirs, it is the estate and gift tax that hurts income tax collections. Repeal of the transfer tax would have the opposite effect and tend to delay transfers and *increase* income taxes.

Case 2. Sham transfers. If the transfer tax were eliminated and stepped-up basis were still allowed on bequests, would it become easy to avoid income tax by means of temporary, quickly reversed asset transfers to others? For example, what would prevent someone from manufacturing stepped-up basis in order to reduce capital gains tax by transferring assets to an elderly relative, friend, or associate with the understanding that the elderly person will transfer the assets back at death? Suppose a couple has a stock with a big gain that they would like to sell. Suppose they also have an elderly aunt who is in poor health. Some supporters of the transfer tax worry that, if the transfer tax were no longer in the way, the couple might avoid the capital gains tax by giving the stock to the aunt and having her give it back to them in her will with a stepped-up basis. They could then sell the stock with no gain and no gains tax.

> ***The JCT's concern over the sham transfer issue is itself a sham. [C]urrent transfer-tax law already ...contains an effective anti-tax-avoidance provision... H.R. 8 would strengthen this anti-tax-avoidance rule...***

The JCT's concern over the sham transfer issue is itself a sham. First, current transfer-tax law already contemplates this type of sham transfer and contains an effective anti-tax-avoidance provision: if transferred assets are returned within one year through a bequest, stepped-up basis is disallowed and carry-over basis applies. H.R. 8 would strengthen this anti-tax-avoidance rule by extending the period during which stepped-up basis is disallowed to three years. It would also strengthen current law by disallowing stepped-up basis in several other situations where sham transfers might occur.

Second, as a reality check, note that most people can already make moderately large sham transfers under current law without owing tax on the transfers. Nevertheless, such transfers do not appear to be widespread. For instance, the couple could make a tax free transfer of $20,000 in assets yearly to their aunt under the current gift tax exemption. They could also give her additional assets worth several hundred thousand dollars using some of their lifetime unified credit. She could then transfer all of it back to them in a bequest using her lifetime unified credit. Neither party would owe a gift or estate tax as long as the amounts are less than those sheltered by the lifetime unified estate and gift tax credit. (The parties would have to limit the amounts involved if the aunt had other assets that, coupled with the transfer, could push her estate into taxable territory, or if the couple was concerned about retaining some of their own lifetime credit to protect their future bequests to their children.) Nonetheless, one hears few reports of people temporarily transferring assets to "trusted" relatives, friends, or associates in order to reduce income taxes. Apparently, either the current safeguard provision is working well, or people are unwilling to take the other risks associated with such maneuvers.

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It is risky to give money to another person with only the vague promise that it will be returned at a later date, yet a well-documented transfer arrangement would be easy for the IRS to spot in an audit. (Sham transfers tend to be poorly documented because if the government found evidence of a revolving-door transfer, it would probably disallow the tax benefits of the transfer and might assess other penalties.) In the example, if the couple want to cash in the stock by a certain date and their aunt lives longer than expected, the transfer would do them no good. (And it would also do them no good if she dies within one year under current law or within three years under the stricter standard proposed in H.R. 8.) If the aunt has high medical bills or other large expenses, the stock, being her property, might be seized to pay those bills; the couple risk losing the stock permanently. Another major danger for the couple is that the aunt might decide that since the stock is in her name, she has a right to it and should be able to use it as she wants. She might spend some of it on her own consumption, or she might give the shares to another relative or friend whom she thinks is more deserving than the couple. (Friends and relatives who know about the stock might try to convince her of this.) Because the stock is legally in her name, the couple would have little recourse. Another barrier to the sham transfer is simply that the aunt might be uneasy about it and refuse to participate.

The JCT completely misses dynamic (i.e., growth) effects in its revenue estimates because its official revenue estimating methodology assumes that ... taxes never affect the aggregate levels of work, saving, investment, productivity, or economic output.

Finally, note that the step-up in basis under the proposed death tax repeal is capped, and consequently covers a smaller range of assets than the current step-up provision for estates. Therefore, although any cap on step-up is undesirable for reasons of tax neutrality and simplicity, the fact that the step-up in H.R. 8 is capped creates a further (unnecessary) limit on the potential for sham transfers. Thus, aside from all the other difficulties, the sham transfer would fail except for limited amounts of money in small estates. There is certainly no reason to expect an increase in tax avoidance under the proposed repeal compared to current law.

In general, risks unrelated to the transfer tax sharply limit the appeal of such income-tax-avoidance strategies. One of the few cases where risk can be tightly controlled is when parents give income-producing assets to minor children; the parents are still able fully to control the assets and income because they keep the books. The government responded to that opportunity for income tax avoidance with the kiddie tax.

In short, when other barriers are absent, the death tax is ineffective in preventing income tax avoidance, and when other barriers are present, the death tax is not needed as an enforcement device. Current law already has various provisions to discourage income tax avoidance, and H.R. 8 would strengthen them to ensure that income tax avoidance will not become a problem as the death tax is phased down and finally repealed.

The JCT is ignoring positive revenue feedbacks. Even while the JCT appears to be greatly exaggerating the size of one negative revenue spillover, it is arbitrarily excluding from its estimates positive revenue feedbacks from death tax repeal that some researchers have concluded would be very large. As mentioned above, one of the most effective techniques for minimizing transfer taxes when moving property to heirs is to make the transfers early. Because the younger heirs are usually in lower tax brackets than the donors, a side-effect of the transfer-tax-avoidance strategy is reduced income tax collections. The death tax may also increase donations to private foundations and other tax-exempt organizations because transfers to those organizations are not subject to the death tax. Since those organizations are exempt from the income tax, larger transfers to them shrink the income tax base. In a study of income-tax offsets caused by these efforts to avoid the death tax, Professor B. Douglas Bernheim concluded that the drop in income tax collections may roughly equal death tax revenues.[6] Professor Bernheim writes, "Although it is very difficult to estimate these effects precisely, in recent years true estate tax revenues may well have been negative."

> ***[S]ubstituting carry-over basis for stepped-up basis as the "price" for repealing the death tax would remove an enormously complicated tax but replace it with a different source of tax complexity.***

The JCT totally excludes from its estimate the faster economic growth that would result if the death tax were repealed and the boost in tax revenues that the faster growth would bring. The death tax slows the U.S. economy by discouraging work, saving, and investment and by diverting additional resources from productive activities into estate tax planning and compliance. Robbins and Robbins estimated that in the decade following repeal of the estate and gift tax, added growth from capital formation would offset about three-fourths of the static revenue loss and, long term, would increase total tax revenue.[7] The JCT completely misses dynamic (i.e., growth) effects in its revenue estimates because its official revenue estimating methodology assumes that while tax changes can affect individual behavior regarding realizations of capital gains, tax avoidance techniques, and the use of taxed items relative to nontaxed items in the case of excise taxes, taxes *never* affect the aggregate levels of work, saving, investment, productivity, or economic output. According to the JCT's official methodology, even a 100% tax would not dampen total economic activity one iota.[8] Because of that flawed assumption, the JCT ignores the most important aspect of scaling back or repealing the death tax, the growth dividend.

Bruce Bartlett, a former Deputy Assistant Secretary of the Treasury, accuses the JCT of looking for revenue spillovers "solely on the loss side of the government's tax ledger ... making the revenue loss for the government as big as it can be."[9] He calls this "Capitol Hill tax math: Count behavioral effects when it might mean losses in tax revenue, but not when it means gains."

Recommendations. The JCT's badly flawed revenue estimates should be a wake-up call to the House Ways and Means and Senate Finance Committees to demand better estimates. In the meantime, the JCT's flawed estimates should not deter Congress from repealing the death tax. Specifically:

• *Congress should repeal the death tax.* The death tax is a tax on saving which comes on top of prior levels of tax and which reduces productivity and growth. Getting rid of it would be good public policy even if the revenue cost were high, although studies like those by Bernheim and Robbins and Robbins suggest the revenue cost would actually be small; repeal might even be a revenue gainer. The revenue estimates from the JCT should not be an excuse for keeping the tax, particularly because the estimates are wrong. Rapid elimination of the death tax would be best, but if slavish devotion to arbitrary budget targets and JCT scoring prevent that, then a gradual phase-down, similar to that in H.R. 8, would be much better than doing nothing. If Congress fails to act, the harm caused by the death tax will only get worse as the prosperous baby-boom generation ages and millions of additional people begin altering their work, saving, and investment behavior to cope with the death tax. It is much easier to deal with the death tax now than after it has become a crisis affecting millions of additional families and businesses.

If Congress fails to act, the harm caused by the death tax will only get worse as the prosperous baby-boom generation ages and millions of additional people begin altering their work, saving, and investment behavior to cope with the death tax.

• *The JCT should correct the logical flaws and lack of balance in its new revenue estimates on the death tax.* The JCT should understand that well designed legislation eliminating the transfer tax need not open opportunities for income tax avoidance and would actually close down a good deal of income tax avoidance that now occurs. Members of Congress should ask the JCT to rescore a phase-down of the estate and gift tax with this in mind, taking into account enhanced anti-tax-avoidance provisions like those in H.R. 8. Also, the JCT should acknowledge in future revenue estimates that tax changes with strong incentive effects can alter economic growth; it should, at last, add dynamic (i.e., growth) effects to its revenue estimates. Given the importance of the issue, Congress should insist that the JCT not categorically exclude growth effects from its revenue estimates, as is now the case. Where the growth effects of tax changes are likely to be large, the JCT should consider them. For well over a decade some members of Congress have been calling on the JCT to use dynamic scoring, but the JCT responded that it needed more time for studies and even then could not act because not all economists agreed about the magnitude of growth effects. In view of how quickly the JCT moved to include controversial tax avoidance effects in its scoring, that explanation rings hollow.

The JCT's latest estimates are one-sided and wrong. The death tax should be eliminated as quickly as possible.

• *The JCT should end the secrecy in which it conducts revenue estimates.* One of the reasons the JCT and its staff wield so much power is that they guard the specific calculations behind each revenue estimate as though they were military secrets. That makes it harder for the public to spot errors, unless the errors are especially egregious, and more difficult for the public to calculate how the estimates would change if the errors were corrected. Sunshine in government should come, however belatedly, to the JCT, as it already has to many other parts of government.

Conclusion. The estate and gift tax, with sky-high marginal rates triggered by death, is the epitome of a pro-tax mentality. Last year a Presidential veto prevented it from being repealed. This year a new President supports death-tax repeal, but the Joint Committee on Taxation has raised a fresh obstacle with revised revenue estimates claiming the death tax is needed in order properly to enforce the income tax. The JCT's latest estimates are one-sided and wrong. The death tax should be eliminated as quickly as possible. Nor should the government seek to recapture some of the tax through a shift from stepped-up basis to carry-over basis. The rewards to the American people from repealing the death tax will be a simpler tax system, a stronger and more vibrant economy, and greater prosperity.

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Endnotes

1. Letter by JCT Chief of Staff Lindy Paull to House Ways and Means Committee Democratic Chief Tax Counsel John Buckley Regarding Estate and Gift Tax Estimates, March 26, 2001, reproduced by Bureau of National Affairs at www.bna.com.

2. John Buckley, "Transfer Tax Repeal Proposals: Implications For The Income Tax," *Tax Notes*, January 22, 2001, p. 539.

3. Lindy Paull Letter, *op. cit.*

4. For example, suppose a person buys a property for $100, makes $50 of improvements over the years, and when he or she dies, leaves the property to an heir. Suppose the property is worth $200 at that time. Under stepped-up basis, the heir's basis in the property would be $200. Under carry-over basis, the heir's basis would be $150. If the heir were to sell the asset for $200, he would have no capital gain and owe no tax if stepped-up basis applies, but would have a $50 gain and owe a capital gains tax under carry-over basis.

5. In the previous example, if the heir sold the property and had the decedent's records showing the original cost ($100) but did not have the decedent's records on improvements ($50), the heir would have to use a basis of only $100 under a carry-over basis regime to avoid possible problems with the IRS. That means paying capital gains tax on $50 of nonexistent capital gains if the heir ever sells the property. If the heir did not even have the records establishing the property's original cost, the heir under a carry-over basis regime might have to pay capital gains tax on the entire sale price ($200) with no subtraction for costs, which means paying capital gains tax on $150 of nonexistent capital gains.

6. B. Douglas Bernheim, "Does The Estate Tax Raise Revenue?" in *Tax Policy And The Economy*, vol. 1, ed. Lawrence H. Summers (Cambridge, MA: MIT Press, 1987), pp. 113-138.

7. Gary Robbins and Aldona Robbins, "The Case For Burying The Estate Tax," *IPI Policy Report*, No. 150, Institute For Policy Innovation, 1999, accessed at www.ipi.org.

8. In 1988 and again in 1994, then Senator Bob Packwood, the ranking member of the Senate Finance Committee, made this point by asking the JCT to estimate the effect of a 100% tax on all income above $200,000. The JCT dutifully produced estimates both times assuming that a 100% tax would have no negative effect on the work and saving behavior of the people whose income was being confiscated. The second time the JCT was embarrassed enough to write that the revenue would not, in fact, be realized in the real world, although that is how the JCT would score it, but the JCT was not sufficiently embarrassed to correct the methodology that had produced the absurd result. For more on this, see Daniel J. Mitchell, "How To Measure The Revenue Impact Of Changes In Tax Rates," *Backgrounder* No. 1090, Heritage Foundation, August 1996.

9. Bruce Bartlett, "Rangelnomics," *Wall Street Journal*, April 4, 2001.
