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Income and transfer tax integration: Historic policy links for wealth transfer tax restructuring

Edward J. Gac

Sharon K. Brougham

"INCOME AND TRANSFER TAX INTEGRATION: HISTORIC POLICY LINKS FOR WEALTH TRANSFER TAX RESTRUCTURING"

by
Edward J. Gac
University of Colorado
and
Sharon K. Brougham
University of Colorado

The process of tax reform remains unfinished business in the U.S. in spite of the enactment of the Revenue Code of 1986. Because that legislation was intended to be revenue-neutral, the on-going need to find additional deficit-reducing revenues are being passed on to the next occupant of the White House, Mr. Bush. Any increase in revenue must be politically palatable to a populace which continues to perceive the present structure as flawed and slanted in favor of those who can afford tax avoidance techniques. Revenue enhancement measures, in the post '86 TRA era, must therefore be "sold" with the representation that they are equitable and base-broadening. In addition, they must somehow "square" with campaign promises not to *raise* taxes. From that perspective, "restructing" can be argued to be distinguishable from new taxes in that it is primarily only a "shifting" within an already established tax structure. A primary target of possible base broadening is the U.S. wealth transfer tax structure, currently made up of the estate, gift and generation-skipping taxes. The American Bar Association (A.B.A.) has submitted its *Report on Transfer Tax Restructing* to the U.S. Treasury Department as its answer to the need for tax policy improvement in this area of the law. This report is found in the Winter, 1988 volume of the *A.B.A. Tax Lawyer* at page 393. An underlying assumption of that report is the continued retention of the dual taxation of individuals: income and wealth transfers. It is the contention of this author that the process of base-broadening, coupled with revenue enhancement, would be better served by the integration of wealth transfers into a unified income tax structure.

Historic Policy Links Between Income and Wealth Transfer Taxes

The reforms proposed by the A.B.A. will not redress the most basic flaw in the present system: that we have allowed historic policy link between income and wealth transfer taxes to become bifurcated into a dual system of taxation on individuals. Income and estate taxes originally traversed a common path in that both were originally used as temporary measures to finance wartime expenditures. Though never enacted jointly, the estate tax was always adopted shortly after the income tax and repealed at about the same time the income tax was being declared unconstitutional prior to the Sixteenth Amendment in 1913. World War I, however, marked a dramatic change in that neither tax was repealed after that war. Congress sought a more consistent and permanent means of raising revenues so as to be better prepared for future con-

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flagrations. From that time on, the original common bond began to loosen and the income tax started to become *the* major source of revenue, far outpacing the revenues generated by the estate tax.

One of the reasons for this disparate treatment of the two taxes was that Congress shifted its policy emphasis away from just raising revenue alone. Each tax was retailored to meet certain common *social* as well as *revenue* goals. These goals were as inherently linked as the revenue needs which gave birth to both taxes in the first place. They were both adopted to achieve some measure of wealth redistribution. The income tax was intended to prevent the undue accumulations of wealth while the estate tax was intended to prevent tax-free intrafamilial transfers of dynastic wealth. Whereas the income tax grew dramatically in raising revenues, the wealth transfer tax structure failed abysmally its social goal as a "trustbuster." While the effectiveness of the income tax is less easily analyzed, its social goals having been so dramatically expanded beyond redistribution, a consensus could no doubt be reached that it can be a significantly more effective *tool* for such purposes. For example, consider the effectiveness of an annual income accounting/reporting requirement versus the generational reporting done in estates.

In addition to being linked in their roles as permanent revenue sources and redistribution tools, the income and wealth transfer taxes are inherently linked in their object of taxation. . .the individual. While all taxes are ultimately borne by individuals, the income, estate and gift taxes have the most widely recognized impact, by far. Few Americans give much consideration to, or spend much time planning for, excises, tariffs or even payroll taxes. They may lament their reported increases and notice their impact on their wallets, but seldom take any direct action. Such is not the case with either the income or wealth transfer taxes. A great deal of time, money and effort is spent by individuals with the sole purpose of reducing the impact of these two forms of individual taxation. The fact that they are two tax structures — the duality of the present system — aggravates the impact and dramatically increases the ultimate cost of compliance for both government and taxpayer alike.

The failure to recognize the common bonds of revenue raising and wealth redistribution between the income and wealth transfer taxes has condemned most efforts at estate and gift reform to mere "loophole closing" within a "secondary" tax structure. However, rather than merely closing existing loopholes, these reforms have most often generated only *more complex* techniques of legal tax avoidance. This is the concern with the approach taken in the A.B.A. report. That report does include a number of positive steps such as a flat tax rate, portability between spouses of a new and higher exemption and clarification of the "completed transfer" rules. But like water finding its own level, can creative responses resulting in continued tax avoidance be far behind?

The Income-Wealth Transfer Tax Integration Proposal

The proposals listed herein are an outgrowth of recent study by this author and Ms. Sharon K. Brougham, M.T., C.P.A., who is a doctoral accounting student at the University of Colorado at Boulder. The scope of this article does not allow for full elaboration so only key highlights of the study are listed. The overall intent is to update prior discussions on estate-income tax unification and to foster further debate as to the efficacy of retaining the present dual-track system of taxation on individuals. It is not, however, intended to be the finite blueprint of tax reform. The full study is scheduled to be published in the Akron Tax Law Journal along with the A.B.A. Report.

In general, basic integration can be achieved by repeal of the present wealth transfer taxes coupled with an amendment to the income tax which would include the receipt of all gifts and bequests on the taxable income of the transferee. This would shift the incidence of taxation from the transferor to the transferee. While this is a radical departure from historical U.S. tax practice, it would finally provide the official matching of tax incidence with the "emotional" incidence already in place in the minds of most lay taxpayers. The average taxpayer who inherits property certainly feels it is he or she who is paying the tax out of *their inheritance* rather than the estate. The average taxpayer does not recognize the estate as a truly separate taxpaying entity. Even those taxpayers who handle the probate of their ancestor will argue it is they, not the estate who have paid the tax. By the time the estate tax return is filed, title and possession of the decedent's property have often passed; the property is "theirs;" "they" write the check; it is "their" bank balance which decreases. Integration will match tax incidence with the person who already emotionally and ultimately bears the tax.

We would favor continued exclusion from taxation of reasonable amounts of gifts and bequests. Such exclusions should favor those least able to bear the burden of the tax. In addition, administrative convenience would dictate that small transfers not be encumbered with undue reporting requirements. Congress should set exclusions based on a balancing of revenue versus vertical equity but it would be expected that a larger segment of the population would be impacted due to the increased revenue needs to deficit reduction. A beneficial offsetting aspect of new inclusions would be that they would be taxed at lower income tax rates as compared to the current wealth transfer rates which top out at 55%.

In addition, current unlimited deductions for qualified transfers to spouses and charities should be retained. Expansion of certain types of qualified transfers should even be encouraged. For example, the U.S. needs an enhanced "payment-in-kind" structure so as to prevent forced liquidation of national treasures in order to pay taxes. At the present time, such arrangements can only be made by a special act of Congress. We would also favor continued deductions for qualified payment of the taxpayer's childrens' school and medical expenses. On the other hand, where any transfer goes "tax free" we would limit the cost basis of the transferee to the carry-over basis of the transferor. Basis otherwise would be "bought" up to fair market value at the time of transfer due to the income tax having been paid on the transfer by the transferee.

Perhaps the greatest area of technical concern is the integration of the two tax structures with regard to transfer into or out of trusts. The most equitable treatment, in theory, is called the "pure conduit" approach. Under this theory, transfers of corpus into trusts would be ignored for tax purposes and be taxed as though they had been constructively received by the beneficiary. This theory has enormous problems in the "real world" due to attribution from multi-beneficiary trusts and has been rightly labeled "Tax Reform by Frankenstein." We would propose, however, an *elective pure conduit approach* wherein all gifts and bequests actually *received* from a trust would be taxed. So as to not discriminate against transferees who have legitimate needs for trust asset management, such as minors or those with diminished capacities, those individuals should be given an elective provision to treat the trust as a conduit. This would allow them to use their personal exclusions at the trust level without generally imposing complex attribution or record keeping costs. To preclude the creation of multiple trusts which could seek to use the exclusion provisions to escape all taxation, the exclusions should not be made available to trusts. Undistributed income would continue to be attributable to the trust and reported by it as income on its fiduciary income tax return.

Finally, the taxation of bequests would create liquidity problems and these should be addressed in any integration proposal. Benefits to alleviate liquidity problems should be made available based on need, not on the form of property received as is the current case under I.R.C. Section 2032A. Our plan would call for a forward-averaging provision so as to smooth out the tax impact of a one-time only large bequest.

Conclusion

The present dual individual federal tax structure has long proven itself to be neither fair, understandable, nor efficient. The current season of fundamental tax reform, started with the Tax Reform Act of 1986, now provides our government with a unique window of opportunity to turn away from patch-work repairs of the wealth transfer tax structure and toward a reunification of the historically-based common bonds between income and wealth transfer taxation. Recent history has shown that Congress is not only capable but willing to undertake "radical" changes in the Internal Revenue Code for the sake of better tax policy. Just three years ago, who would have guessed that capital gains would be repealed or that tax benefits for homeowners would be curtailed. Perhaps the time is right for going back to basics and reuniting the mutual policy goals of the original income and estate taxes. TRA '86 began the process of returning to both economically and procedurally sound tax policy. The time is ripe for Congress to finish the job. The worthwhile goals of the original wealth transfer tax structure should now be accomplished through the income tax.

KISTLER NAMED EDUCATOR OF THE YEAR BY MASSACHUSETTS SOCIETY OF CPAs

The Massachusetts Society of Certified Public Accountants, Inc. and the American Institute of Certified Public Accountants named Linda H. Kistler, CPA, educator of the year in Massachusetts. This award is given for an educator's significant teaching contributions to accounting education and for contributing to the profession through professional activities. The Massachusetts Society honored Ms. Kistler at its annual Recognition Banquet in October.

Currently serving as Dean of the University of Lowell's College of Management Science for 1988-89, Ms. Kistler has served as full professor there since 1974.

Ms. Kistler is an active member of the MSCPA, AICPA, American Accounting Association, Academy of Accounting Historians and American Woman's Society of CPAs. She served on the MSCPA Board of Directors from 1982-84 and 1979-81 and was the Society's first female director and second female officer.

A proficient writer, Ms. Kistler has coauthored three books and authored nearly 70 articles, consulting reports and research monographs since 1966. She has served extensively in university, college and department committees, and has attained a national reputation in financial accounting, professional examinations, accounting history and microcomputer applications.