TO BURY FEDERAL TRANSFER TAXES WITHOUT FURTHER ADIEU

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I. Introduction

The current federal transfer tax system[1] does not work well. Tax scholars are currently arguing about its fate. Some scholars argue that federal transfer taxes should be strengthened and used as a revenue source.[2] Others argue that federal transfer taxes cannot possibly raise significant amounts of revenue, but instead should be strengthened and retained to bolster overall progressivity.[3] Still others argue that federal transfer taxes should be completely abolished because they fail to achieve their goals.[4] Despite the disagreement over the fate of the transfer tax system, scholars universally agree that the current transfer tax system does not work well.[5]

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1 For purposes of this Article, the term "federal transfer tax system" includes subtitle B of Internal Revenue Code of 1986, as amended (the "Code")—i.e., the estate tax, the gift tax, and the generation-skipping transfer tax.

2 *E.g.*, G.P. Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?*, TR. & EST., Oct. 1978, at 598.

3 *E.g.*, Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983).

4 Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215, 1218 (1985); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539 (1993); Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991); Robert B. Smith, *Burying the Estate Tax Without Resurrecting Its Problems*, 55 TAX NOTES 1799, 1811 (1992).

Australia has already repealed its transfer tax system. *See* William H. Pedrick, *Oh to Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX LAW. 113 (Fall 1981). Likewise, Canada has repealed its transfer tax system. Thomas A. Robinson, *The Federal Wealth Transfer Taxes—A Requiem?*, 1 AM. J. TAX POL'Y 25, 43 (1982).

Significantly, Representative Christopher Cox (R-California) introduced H.R. 2717 on July 23, 1993, which would repeal the estate and gift tax and the tax on generation-skipping transfers.

5 *E.g.*, Robinson, *supra* note 4, at 43 ("Also clear from the history of the wealth transfer taxes is the simple fact that while the taxes are sound in theory, they have not worked well in practice."). Professor Robinson stops just short of calling for transfer tax repeal, however. Instead, he argues for their retention so that we may better un-

This Article will examine the main arguments both for repealing and retaining the federal transfer tax system. I conclude that the federal transfer tax should be repealed. In support, the Article argues that the transfer tax system does not raise a significant amount of revenue, nor does it decentralize wealth. In addition, it is neither cost-effective, fair, economically neutral, nor simple. Furthermore, the transfer tax system interferes with capital formation and job creation and does not increase overall progressivity in the tax system, provide an important signaling effect, nor churn the economy. Finally, it is not morally imperative.

The repeal of the federal transfer tax system likely will stimulate capital and job creation and obviate the need for a revenue substitute. The Article, however, also recognizes that a revenue replacement proposal is necessary in the current political environment. Accordingly, the Article evaluates some current revenue replacement proposals and suggests some alternatives. However, this Article's aim is not to develop new revenue sources. It is simply to show that the federal transfer tax system is not cost-effective and should be repealed.

Before discussing arguments for repealing or reforming the federal transfer tax system, a brief history of the tax is appropriate. Federal transfer taxes began in 1916 in the form of an estate tax.[6] The tax was originally designed to meet the revenue needs of World War I, although it was continued after the war.[7] Wealthy individuals soon discovered that they could avoid this tax through inter vivos gifting.[8] In response, Congress enacted the gift tax in 1924.[9] Until 1976, changes in this transfer tax system primarily consisted of rate adjustments.[10]

In 1976, Congress dramatically reformed the transfer tax system.[11] First, Congress unified the estate and gift tax by establishing one tax table for lifetime and deathtime transfers.[12] Second, Congress established a unified credit against the estate and gift tax.[13]

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derstand their utility, especially in light of the fact that so few estates—one percent—are affected by the tax. *Id.* at 43-44.

6 REGIS W. CAMPFIELD ET AL., THE TAXATION OF ESTATES, GIFTS AND TRUSTS 1991-1993 3 (1991).

7 Dobris, *supra* note 4, at 1216-17.

8 Henry J. Aaron & Alicia J. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, NAT'L TAX J., June 1992, at 119, 133.

9 *Id.*

10 *Id.*

11 CAMPFIELD ET AL., *supra* note 6, at 6-8.

12 *Id.*

13 *Id.*

That credit is currently $192,800, which effectively shelters $600,000 of wealth transfers from transfer taxation.[14] Third, Congress established a tax on generation skipping transfers.[15] Finally, Congress adopted a carryover basis for inherited property.[16] Congress retroactively repealed carryover basis in 1980.[17]

The tax changed significantly again in 1981.[18] The 1981 reforms increased the existing per donee annual gift tax exclusion from $3,000 to $10,000.[19] The reforms also established an unlimited marital deduction so that property may pass between spouses without incurring transfer tax.[20] Finally, the 1981 reforms reduced the top marginal rate from seventy percent to fifty percent by 1985.[21] The top rate, however, was subsequently frozen at fifty-five percent, where it remains today.[22]

II. ARGUMENTS FOR THE ABOLITION OF FEDERAL TRANSFER TAXES

A. *Federal Transfer Taxes Cannot Possibly Raise Meaningful Amounts Of Revenue*

One chief purpose of federal transfer taxes is to raise revenue.[23] However, Table 1 (reproduced below) indicates that federal transfer taxes currently raise approximately $11 billion annually, less than one percent of the government's total federal receipts. Table 1 also indicates that this is not an aberration: In the past thirty years, federal transfer tax revenue has not exceeded 2.33% of total federal receipts. Federal transfer taxes do not raise a significant amount of revenue.

Absent wealth confiscation, the federal transfer taxes never will raise significant amounts of revenue.[24] Estimates are that dece-

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14 I.R.C. §§ 2010, 2505 (West 1988).

15 CAMPFIELD ET AL., *supra* note 6, at 7-8.

16 *Id.* at 7.

17 *Id.* The chief concern with a carryover basis was that devisees would have a difficult time determining the value of the inherited property because decedents do not keep detailed records for most assets—e.g., a stamp collection. For an excellent discussion of this concern, see Donald Samelson, *Carryover Basis: The Greatest Fiasco in Federal Taxation History*, 59 TAX NOTES 703 (1993). For the opposing view, see Lawrence Zelenak, *Taxing Gains at Death*, 59 TAX NOTES 287 (1993).

18 CAMPFIELD ET AL., *supra* note 6, at 8.

19 *Id.*

20 *Id.*

21 *Id.*

22 *Id.* The rate has been frozen at 55% as a deficit reduction measure.

23 Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX. L. REV. 223, 225 (1956); Gerald R. Jatscher, *The Aims of Death Taxation*, *in* DEATH, TAXES, AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT 40, 41 (1977).

24 *E.g.*, Dobris, *supra* note 4, at 1217-18. Dobris states that "not enough property is

dents transfer only $150 billion in net assets per year.[25] Professor Michael Graetz has expressed the view that, without wealth confiscation, which is politically infeasible, the highest possible effective rate on wealth transfers would be twenty percent.[26] Thus, an effective tax rate of twenty percent on wealth transfers would raise only $30 billion, which would still be less than 2.2% of total federal revenues.

Furthermore, the $600,000 exemption equivalent for wealth transfers, whether during lifetime or at death, indicates that the intended tax base for the federal transfer tax is wealthy individuals. In 1991, only 53,576 federal estate tax returns were filed for decedents with estates exceeding $600,000.[27] These decedents had a combined total gross estate of $90.9 billion.[28] Thus, even if every dollar that a decedent in this target group transferred was confiscated by the government (a political impossibility), transfer tax revenues still would not reach nine percent of total federal revenue. If Graetz's theoretical maximum effective tax rate was applied to this base, estate tax revenues would only be $18 billion. Even Graetz, in his article praising the estate tax, concludes that "[a] tax on deathtime transfers of wealth will thus not serve as a major source of federal revenues."[29] Simply put, federal transfer taxes will never meet their chief goal of raising revenue.[30] The fact that a tax has never met its chief goal of raising revenue and is clearly incapable of ever meeting that goal is a strong argument for its abolition.

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transferred to use a transfer tax as a source of revenue, especially if the rates are not confiscatory." *Id.*

25 Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 72 (1990); Graetz, *supra* note 3, at 269 (stating that in the early 1980s, decedents transferred approximately $120 billion annually).

26 Graetz, *supra* note 3, at 269 ("With any substantial exemption, plus exclusions for certain amounts of property passing to surviving spouse or charities, a higher average effective rate seems unrealistic. The inherent limitation on bequests as a source of revenue cannot be overcome by even a dramatic structural revision of estate and gift taxes, such as converting to an inheritance or accessions tax, or taxing gifts and bequests as income to the recipient...."). *But see generally* Ascher, *supra* note 25 (advocating wealth confiscation as a solution to America's deficit crisis).

27 Barry W. Johnson, *Estate Tax Returns, 1989-1991*, STAT. OF INCOME BULL., vol. 12, no. 4, Spring 1993, at 76.

28 *Id.*

29 Graetz, *supra* note 3, at 270. *But see* Verbit, *supra* note 2, at 609-11 (arguing that transfer taxes could be a good revenue source).

30 *See* Eisenstein, *supra* note 23, at 225 (arguing that raising revenue was the tax's chief goals).

TABLE 1

Year	Total Federal Receipts ($billions)	Transfer Tax Receipts ($billions)	Transfer Tax Receipts as a % of Total Federal Receipts
1959	90.6	1.4	1.55
1960	97.0	1.8	1.86
1961	99.0	2.0	2.02
1962	107.2	2.1	1.96
1963	115.5	2.2	1.90
1964	116.2	2.6	2.24
1965	125.8	2.8	2.23
1966	143.5	3.0	2.09
1967	152.6	3.1	2.03
1968	176.8	3.1	1.75
1969	199.6	3.6	1.80
1970	195.2	3.7	1.90
1971	202.6	4.6	2.27
1972	232.0	5.4	2.33
1973	263.7	5.1	1.93
1974	294.0	4.8	1.63
1975	194.8	4.9	1.66
1976	339.9	5.6	1.65
1977	384.0	7.2	1.88
1978	441.2	5.2	1.18
1979	504.7	5.5	1.09
1980	553.0	6.5	1.18
1981	639.0	6.9	1.08
1982	635.4	7.5	1.18
1983	660.0	5.8	0.88
1984	725.8	6.0	0.83
1985	788.6	6.4	0.81
1986	827.2	7.0	0.85
1987	913.8	7.2	0.79
1988	972.3	7.6	0.78
1989	1,059.3	8.9	0.84
1990	1,107.4	11.6	1.05
1991	1,122.2	11.0	0.98

Source: Department of Commerce, Bureau of Economic Analysis as cited in Richard E. Wagner, Federal Transfer Taxation: A Study in Social Costs 22-23 (1993).

B. *Federal Transfer Taxes Cannot Decentralize Or Redistribute Wealth*

Federal transfer taxes also aim to decentralize or redistribute

wealth.[31] Empirical data, however, indicate that federal transfer taxes have had no discernible effect on wealth concentration. For example, Professor Verbit found that "the latest data indicate that the top five percent of the population hold 43.5% of personally owned wealth, that the top .5% hold twenty-two to twenty-four percent, and that this latter concentration has remained the same since 1949."[32] Verbit concluded that "the only available data reveal no discernible redistribution or deconcentration of personally held wealth since 1949. *A fortiori* transfer taxes have had no discernible impact on personal wealth distribution or concentration since 1949."[33]

Verbit's conclusion is bolstered by recent data from estate tax returns. An analysis of estate tax returns by the Internal Revenue Service found that in 1986, the richest 1.6% of the population held 28.5% of the personal wealth in the United States.[34] A later analysis performed by the IRS found that in 1989, "the Nation's 'top wealthholders' (those with gross assets of at least $600,000) represented less than two percent of the adult population.[35] Their net worth was $4.8 trillion and accounted for between twenty-five and thirty percent of the personal wealth in the United States."[36] This analysis also found that the number of top wealthholders in the United States actually grew 38.5% between 1982 and 1989.[37] The value of these top wealthholders' net worth increased 77.6% in that same time period.[38] This rate more than doubles the increase in Gross Domestic Product during this time.[39] Furthermore, people with a net worth of at least $5 million grew from 53,000 in 1982 to 109,000 in 1989.[40] This is a 133% increase in wealth in a seven-year period.[41] In short, the IRS studies indicate that wealth concentration is increasing, not decreasing, despite the federal transfer

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[31] Jatscher, *supra* note 23, at 51; Verbit, *supra* note 2, at 598; *see* S. REP. No. 144, 97th Cong., 1st Sess. 124, *reprinted in* 1981 U.S.C.C.A.N. 105, 226.

[32] Verbit, *supra* note 2, at 601.

[33] *Id.*

[34] Marvin Schwartz & Barry Johnson, *Estimates of Personal Wealth, 1986*, STAT. OF INCOME BULL., vol. 9, no. 4, Spring, 1990, at 63.

[35] Barry W. Johnson & Marvin Schwartz, *Personal Wealth, 1989*, STAT. OF INCOME BULL., vol. 12, no. 4, Spring 1993, at 105. This study defines a top wealthholder as someone with $600,000 or more in gross assets. "Gross assets" includes the value of all the person's assets and is not reduced for indebtedness.

[36] *Id.*

[37] *Id.* at 109.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.* at 110.

taxes.[42]

A June 1992 study by Henry Aaron and Alicia Munnell agrees.[43] Their data, reproduced in Table 2 below, show that the wealth holdings of the top 0.5% and 1% of wealthholders has actually increased from 1962 to 1989. Aaron and Munnell conclude that "perhaps the most important fact to be gleaned from the estate tax data is that they provide no evidence of deconcentration in the holdings of wealth (W1) during the postwar period and hint that concentration may even have begun to increase after 1962."[44]

Even Professor Graetz, in his article praising the estate tax, admits that "the estate tax has done very little to dilute the greatest concentrations of wealth. The portion of total wealth held by the richest one percent of wealth-holders has remained remarkably stable. They possessed roughly one-fourth of the national wealth in every year from 1958 to 1972."[45] Thus, each scholar who has studied the empirical data, even those favoring the estate tax, has reached one unmistakable conclusion: federal transfer taxes do not decentralize wealth.

Redistributing wealth is often stated as another goal of the federal transfer tax system.[46] While this goal seems identical to the decentralization of wealth goal, some scholars draw a distinction between the two.[47] The same studies and empirical data cited above, however, indicate that wealth has not been redistributed since the inception of the federal transfer taxes.[48] Thus, federal transfer taxes do not achieve their goal of decentralizing or redistributing wealth.

This conclusion is an argument for the repeal, not the reform, of the transfer tax system.[49] One of the tax's central aims is wealth decentralization and redistribution. That goal has never been met.

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42 The argument that wealth concentration would be even greater without federal transfer taxes is addressed in the second half of this Article. *See infra* notes 205-19 and accompanying text.

43 Aaron & Munnell, *supra* note 8, at 123-30.

44 *Id.* at 125.

45 Graetz, *supra* note 3, at 271.

46 Jatscher, *supra* note 23, at 51; Verbit, *supra* note 2, at 598.

47 Jatscher, *supra* note 23, at 51.

48 Scholars proposing reform might believe that redistributing wealth is an admirable goal and that the tax should not be abandoned simply because it has not yet achieved this. *But see* Dobris, *supra* note 4, at 1218. Professor Dobris posited that the federal transfer tax "does not function in a meaningful way to redistribute wealth in order to enhance the quality of life for persons with less wealth. Indeed it might be said that no politically acceptable transfer tax system can obtain such a result." *Id.* (footnotes omitted).

49 *Id.* at 1219. Dobris addresses this same argument and contends, as I do, that "it

Furthermore, it never will be met. Empirical data prove that the tax cannot possibly raise a significant amount of revenue without wealth confiscation.[50] If the tax cannot raise a significant amount of revenue from "wealthy" Americans, then it cannot possibly have a significant effect on wealth centralization and distribution. The argument for its repeal is bolstered by the fact that the tax cannot at present, or ever, meet its goal of decentralizing wealth.

TABLE 2[51]

SHARES OF NET WORTH HELD BY TOP WEALTHHOLDERS, 1962-1989

Percent of Population	1962	1983	1986	1989
0.5	24.8	24.3	23.9	28.8
1.0	32.2	31.5	31.7	37.1

C. *Federal Transfer Taxes Are Not Cost-Effective*

1. Federal Transfer Tax Reform Costs Are Too High

The federal transfer tax should be abolished because the costs of constantly reforming the system are prohibitively high,[52] and the taxes constantly seem to be under revision. For example, major changes in the estate tax occurred in 1942, 1948, 1951, 1954, 1976, 1981, 1984, 1987, and 1990.[53] Each time the transfer tax is altered, Congress must formulate a proposal, debate the changes, entertain lobbyists, hold hearings, interpret the new law, and educate the private and public sectors about the law.[54] This process involves costs which, while not precisely calculable, are likely substantial.

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is legitimate to call for the abolition of something that is not working, and has not worked, to achieve one of its important purposes." *Id.*

50 For a discussion of the tax's revenue-raising deficiencies, see *supra* notes 23-30 and accompanying text.

51 Aaron & Munnell, *supra* note 8, at 126.

52 *See* Dobris, *supra* note 4, at 1220-23 (explaining the direct and indirect costs attendant to the federal transfer tax). I am not suggesting that any tax system which has high reform costs should be repealed. Instead, I am arguing that this tax system does not have enough positive attributes to outweigh its high reform costs. It raises relatively little revenue, does not significantly affect wealth concentration, is not fair, and interferes with the economy. Thus, its high reform costs cannot be justified.

53 CAMPFIELD ET AL., *supra* note 6, at 4-8; *see* Ronald D. Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 TAX LAW. 343, 349 n.19 (1989) (citing the August 1988 American Bar Association meeting which called upon Congress to acknowledge the need for stability in the federal transfer tax system).

54 *See* Dobris, *supra* note 4, at 1220-21 (asserting that this process involves substantial costs).

Two things are certain: one, if the transfer tax is continued, the constant reform will continue; and two, if the transfer tax is repealed, no additional reform costs will be incurred.

This constant reform of the transfer tax system also wastes taxpayers' money and resources.[55] Admittedly, no estate tax plan will reap a reward until the taxpayer dies.[56] In times of constantly changing transfer tax laws, however, an estate plan quickly becomes obsolete and must be reformulated several times before death.[57] For example, imagine a taxpayer who, in 1975, at the age of thirty-five, paid an estate planner to devise a plan of disposition. By 1993, when the taxpayer is fifty-three, the five most recent transfer tax changes may have forced him to change his estate plan five times. If transfer tax reform continues at its current pace and the taxpayer lives his expected lifetime, he may be forced to pay an estate planner to amend his plan another five times.[58] Again, while the costs to this taxpayer and those like him are not quantifiable, they likely are significant. A transfer tax system that raises precious few dollars and does not meet its own goals is not worth this cost. Thus, the high cost of constant federal transfer tax reform provides another justification for its abolition.

2. Federal Transfer Tax Compliance And Enforcement Costs Are Too High

The federal transfer tax's high compliance and enforcement costs are another justification for its repeal.[59] The Treasury Department budgeted $6.7 billion in 1992 for the enforcement of the entire federal tax code.[60] Unfortunately, this figure is not broken down by the category of tax, but by function—i.e., enforcement

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55 *See* Aucutt, *supra* note 53, at 344. Aucutt does not advocate the repeal of the transfer tax system, but does state that it is a close question. *Id.* at 344-45. As a practitioner, he questions whether transfer taxes "are worth the trouble" in light of the frequent changes in transfer tax law. *Id.* at 345.

56 *Id.* at 345.

57 *Id.*

58 Contrast this to income tax advice. While a taxpayer might have to seek income tax advice each time the income tax laws are changed, at least the taxpayer sees some benefit to the advice on the current year's income tax return. However, if the transfer tax laws change, then the estate planning advice is obsolete and the taxpayer never receives a benefit.

59 This argument is presented in several articles on the federal transfer tax. *See, e.g.*, Dobris, *supra* note 4, at 1221 (arguing that enforcing taxpayer compliance generates substantial direct costs that cannot be justified by a system which raises so little revenue).

60 James L. Payne, *Unhappy Returns: The $600-Billion Ripoff*, 59 POL'Y REV. 18 (1992) (stating that the budget was $6 billion in 1990).

and assistance, processing returns and taxpayer assistance, and administration and management.[61] Thus, it is not possible to determine precisely the costs of administering the transfer tax system.[62] However, if one assumes that enforcement costs vary in proportion to the amount of revenue that a tax collects, then it would seem that the federal transfer tax enforcement costs—less than $67 million—are negligible.

However, a study by James L. Payne, the director of Lytton Research and Analysis, finds that most operating costs of the tax system are borne by the private sector and thus are never reflected in the IRS's budget.[63] Payne systematically analyzes over thirty types of burdens that the tax system places on taxpayers.[64] While he concludes that some of these costs are simply not quantifiable, he does cite studies and surveys that quantify several costs.[65] For example, he cites three IRS supervised studies of tax compliance burdens that conclude that individual tax compliance costs alone amounted to 8.8% of individual tax revenue in 1985.[66] He also quantifies tax litigation costs, tax avoidance costs, and labor costs.[67] Payne concludes that the costs to taxpayers of complying with the entire tax system are sixty-five percent of tax revenue raised.[68]

Compliance and enforcement costs for transfer taxes are arguably higher than Payne's average sixty-five percent calculation.[69]

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61 Smith, *supra* note 4, at 1805-11 (arguing that cost effectiveness is a strong justification for repealing the federal transfer taxes).

62 *Id.* at 1809.

63 Payne, *supra* note 60.

64 *Id.*

65 *Id.*

66 *Id.*

67 *Id.*

68 *Id.* Payne provides the following table to explain his calculation:

OVERHEAD COSTS OF THE U.S. FEDERAL TAX SYSTEM

	As a % of net tax revenue	Amount (in billions of dollars) 1985	1990
Governmental costs	.61%	$4.0	$5.8
Business and Individual compliance costs	24.43	159.4	232.2
Economic disincentive costs	33.20	216.6	315.6
Other private sector burdens, including costs of enforcement, forced collections, litigation, avoidance, and evasion	6.78	44.2	64.5
Total	65.02	424.2	618.1

69 *See* Smith, *supra* note 4, at 1801-04.

The transfer tax system is arguably more complex than the income tax system.[70] While many individuals regularly prepare their own income tax returns, they rarely can prepare estate tax returns without expert assistance.[71] This expert advice is costly. The transfer tax system also generates more estate planning costs relative to the revenue it raises than the income tax.[72] Because all IRS estate tax agents are attorneys, and therefore are paid more than other IRS agents, it is also reasonable to assume that the IRS's enforcement costs per dollar of revenue generated for transfer taxes exceeds that of the income tax.[73] In addition, the IRS must hire high-priced valuation experts to litigate estate tax audit controversies. In short, the transfer tax system's complexity and the requisite level of expertise (on both sides) arguably makes it more expensive (relative to the revenue raised) than the income tax system.

Using the conservative (for transfer tax purposes) sixty-five percent estimate, the federal transfer tax's 1992 private sector costs were $7.5 billion. Considering that transfer taxes raise only $11 billion per year, this statistic shows that the transfer tax system is netting only $3.5 billion annually. This lack of cost-effectiveness is a compelling argument for its repeal.

The direct transaction costs of the federal transfer tax system are also too high.[74] A 1973 study of estate tax returns indicated that the total attorneys' fees which could be deducted were $1,218,450,000.[75] This was thirty percent of the total estate tax rev-

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70 *Id.* at 1803, 1811.

71 *See* Aucutt, *supra* note 53, at 344.

72 *Id.* at 345.

73 Galvin, *supra* note 4, at 1419. Galvin would "wager that a time and effort study by the Service of the transfer tax system would demonstrate that greater productivity could be achieved if [the] same resources [that are allocated to the transfer tax system] were allocated to income tax administration." *Id.* This makes sense. The IRS is using presumably some of its best and brightest agents (they must be bright if they can figure out the transfer tax system) to collect a mere $11 billion. This is a classic example of the government inefficiently using its resources. These bright agents could be more efficiently used if they were used to tackle problems in the income tax system. *See* Dobris, *supra* note 4, at 1222.

Similarly, society is wasting some of its best assets by employing bright, talented estate planners to find holes in the transfer tax system. These estate planners spend their lives finding ways to legally avoid transfer taxes for their clients. Once they have found the proverbial "hole in the dike," the government then plugs the hole and the process begins again. It is a shame that such talent is being wasted on such a meaningless task. If transfer taxes were repealed, estate planners could use their intellect to make a greater difference in society rather than to make a temporary hole in the dike.

74 *See* Verbit, *supra* note 2, at 601.

75 *Id.* Verbit aptly cites a Lewis Eisenstein quote: "While it—estate and gift tax

enue collected in 1973.[76] Considering that the federal transfer tax system has become much more complicated in the past twenty years, it is safe to assume that these costs have increased. Furthermore, taxpayers regularly have to pay valuation experts to properly report a decedent's assets on the estate tax returns and accountants to maintain the decedent's tax records after death.[77] The transfer tax system's high direct transaction costs (in relation to the revenue that it raises) strengthens the argument that the transfer tax system is not cost-effective.

Federal transfer taxes also may indirectly cause revenue loss and higher enforcement costs in the income tax system.[78] Transfer taxes, designed to decentralize wealth, are targeted at the wealthy.[79] The general public presumably knows this. Through legal estate planning, however, most of this targeted wealth passes without being taxed. For example, in 1986 $123 billion of wealth was transferred, but only $36 billion appeared on estate tax returns.[80] Only $7 billion was actually paid in estate taxes.[81] This is less than six percent of the wealth transferred. This type of legalized tax avoidance might anger the general public, who likely cannot understand the difference between legal tax avoidance through estate planning and illegal tax evasion.[82] In addition to causing resentment among the general public, this might make them more apt to try illegal tax evasion—figuring that "if the rich can do it, I can too."[83] Ultimately, this could cost the treasury money in lost revenue and increased enforcement costs.[84] While this indirect cost is not completely quantifiable, it does support the notion that transfer taxes are not cost-effective and thus should be repealed.[85]

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law—helps to support many lawyers, it does relatively little to support the Government." *Id.* at 610 n.84 (citation omitted).

76 *Id.* at 610.

77 *See* Dobris, *supra* note 4, at 1221.

78 *See id.* at 1224 for a discussion of this indirect cost.

79 *See* Verbit, *supra* note 2, at 598.

80 *See* Aaron & Munnell, *supra* note 8, at 134.

81 RICHARD E. WAGNER, THE CENTER FOR THE STUDY OF TAXATION, FEDERAL TRANSFER TAXATION: A STUDY IN SOCIAL COST 23 (1993) (citing a Department of Commerce table totalling federal transfer tax receipts).

82 *See* Dobris, *supra* note 4, at 1224-25.

83 *Id.*

84 *See* Graetz, *supra* note 3, at 268. Professor Graetz notes that there is an increase in evasion, avoidance, delinquency, and abusive sheltering of taxes. *Id.* at 268 n.60 (citation omitted). He also states that many middle class taxpayers are achieving their tax reduction through tax fraud. *Id.* Finally, he notes that there is a "compliance gap" of $75-100 billion. *Id.*

85 Some might contend that the middle class and poor would be more distraught

D. *Federal Transfer Taxes Do Not Meet Any Of The Basic Tax Policy Criteria For A Worthwhile Tax*

1. The Federal Transfer Tax System Violates The Fairness Principle

The federal transfer tax system's unfairness supports the argument for its repeal. One of the basic goals of a tax system is fairness.[86] Fairness is typically subdivided into two components: horizontal equity and vertical equity.[87] Horizontal equity requires that similarly situated taxpayers should be taxed alike.[88] Thus, horizontal equity dictates that the transfer tax system taxes two individuals who have identical amounts of wealth and who make identical transfers the same. The federal transfer tax system does not meet this goal.

A simple example clearly illustrates the lack of horizontal equity in the transfer tax system. Consider two taxpayers, A and B, each of whom has $5 million that he wants to transfer to his child, C and D respectively. A does not visit an estate planner and simply leaves his child, C, $5 million in cash when he dies. The estate tax on this transfer will be $2,275,800.[89] B, however, visits an estate planner. B creates an irrevocable life insurance trust and gifts $10,000 tax-free to this trust each year.[90] The trust then uses these gifts to purchase a $5 million life insurance policy on B's life, naming D as the beneficiary. When B dies, the life insurance policy is

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if the federal transfer tax system were repealed than if it were to continue in its leaky state. I disagree. I believe that it angers middle-class taxpayers to watch rich taxpayers pay their high-priced income tax planners to avoid income tax. Average taxpayers are then further infuriated to watch these rich taxpayers pay their high-priced estate planners to devise complicated schemes to avoid transfer taxes. If the transfer tax were repealed, the average taxpayer would not have to withstand this second round of agony. If the transfer tax system is replaced with an increased income tax and capital gain tax rate on rich taxpayers, then the average taxpayer will be happier because higher rates are not as easily avoided.

86 WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 19 (8th ed. 1990); DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 1 (Nov. 1984) (hereinafter "TREASURY DEPARTMENT REPORT").

87 KLEIN ET AL., *supra* note 86, at 19.

88 *Id.*

89 I.R.C. § 2001 (West 1988). From the tax table, the calculation is: $1,025,800+($2,500,000 x 50%)=$2,275,800. I am ignoring the $192,800 unified credit for purposes of simplicity.

90 I.R.C. § 2503 (West 1988). This section provides a $10,000 annual per donee exclusion from the gift tax. Using a "Crummey" power, these gifts will be treated as "present interests" and thus may use the $10,000 annual exclusion. *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

not includable in B's estate and thus no transfer taxes are paid.[91] Furthermore, the life insurance proceeds are not taxable to D.[92] Thus, A and B, two similarly situated taxpayers, transferred the same amount of money but were taxed differently under the transfer tax system. Therefore, the transfer tax system violates the principle of horizontal equity.[93]

The federal transfer tax system also violates the principle of vertical equity. The principle of vertical equity states that people with a greater ability to pay taxes should pay a higher percentage of their income in taxes.[94] Thus, vertical equity dictates that people who transfer a greater amount of wealth should pay a higher proportion of their wealth in taxes. The federal transfer tax system does not meet this fairness goal. Instead, people who have greater amounts of wealth to transfer simply have a greater incentive to visit an estate planner to avoid the transfer taxes.

A simple modification of the previous example illustrates this point. Assume that A transferred $4 million in cash to C while B, using the irrevocable life insurance trust recommended by his estate planner, transferred $5 million in cash to D. A would pay more transfer taxes than B even though A transferred less property than B. This violates the principle of vertical equity because B, with a greater ability to pay transfer taxes than A, paid less taxes than A. Thus, the federal transfer tax system violates the principle of vertical equity.

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91 I.R.C. § 2042 (West 1988). Because B retains no "incidents of ownership" in the life insurance policy, it is not included in his estate at death. *Id.*

92 I.R.C. § 101 (West 1988).

93 In addition to violating horizontal equity, this also punishes those taxpayers who fail to visit an estate planner. It does not seem fair to me that a tax system should punish taxpayers for not seeing a lawyer before giving money to their children. *See* Aaron & Munnell, *supra* note 8, at 138 (averring that federal transfer taxes are "penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners").

I want to emphasize that I do not think that the federal transfer tax system should be repealed simply because it is inequitable. Portions of the income tax are inequitable and I do not think that the income tax system should be repealed yet. Instead, I am arguing that the transfer tax system does not have enough positive attributes to outweigh its inherent unfairness. It does not raise a large amount of revenue, it does not have a significant effect on wealth centralization, it is not cost effective, and it interferes with the economy. It is also unfair. Thus, it should be repealed because its negatives outweigh its positives and it cannot be adequately repaired.

94 KLEIN ET AL., *supra* note 86, at 20.

2. The Federal Transfer Tax System Violates The Principle Of Neutrality

The federal tax system's interference with the efficient allocation of resources in society supports the argument for its repeal.[95] The principle of economic neutrality states that an ideal tax system should interfere with private economic decisions as little as possible.[96] It is based on the assumption that the free market economy results in the ideal allocation of resources.[97] Thus, this tax policy goal conveys the idea that an optimal tax system is neutral towards private decisions so as not to interfere with the ideal allocation of resources achieved by the market.[98]

The federal transfer tax system violates the principle of neutrality by discouraging savings and investment that are needed for economic growth.[99] The transfer tax system taxes savings that are transferred.[100] Taxpayers are aware that savings are heavily taxed at transfer.[101] This knowledge gives taxpayers a negative incentive to save and a positive incentive to consume.[102] However, savings is

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95 WAGNER, *supra* note 81. Wagner's study of the social costs of the transfer tax system focuses on the economic effects of the tax. He uses econometric models to show that the transfer tax system actually costs America revenue, jobs, and economic growth. He analyzes the transfer tax system from a supply sider's perspective.

96 *See* TREASURY DEPARTMENT REPORT, *supra* note 86, at 13.

97 *Id.*

98 *Id.*

99 *See* Dobris, *supra* note 4, at 1222; WAGNER, *supra* note 81, at 5-10; PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 154-62 (12th ed. 1985) (stating that savings and investment, in general, is essential for economic growth). *But see* Graetz, *supra* note 3, at 279 ("[E]mpirical findings suggest that technological advances and population growth, rather than increases in savings, have accounted for the bulk of economic growth.").

100 To the contrary, if one consumes all of one's wealth before one dies, then one transfers no wealth at death and pays no estate tax.

101 *See* Dobris, *supra* note 4, at 1222.

102 *See* Stephen J. Entin, *Clinton's Proposed Estate Tax Rate Increase: A Deadly Budget Gimmick*, *in* IRET BYLINE, No. 112 1 (Institute For The Research on the Economics of Taxation, Apr. 12, 1993). This article explains that taxpayers pay no transfer tax if they consume all of their wealth. Taxpayers only incur transfer taxes when they save wealth and transfer it to another. Thus, they have an incentive not to save.

Federal transfer taxes are also a form of double taxation. Every dollar making up an estate (or a gift) has been taxed or will be taxed under the income tax system. Typically, income is taxed when first earned. If it is then consumed, it is free from further federal tax. If it is saved, then the returns on those savings are taxed again. However, if those savings are never consumed, then the estate tax taxes them again when they are transferred at death—a potential third layer of tax. Milton Friedman is reputed to have commented that federal transfer taxes send a bad message to savers: "That it is O.K. to spend your money on wine, women, and song, but don't try to save it for your kids." Well said.

a positive good because it is a tool of capital formation.[103] Thus, transfer taxation, by discouraging savings and investment, is undesirable.

Professors Dobris, Wagner, and Graetz all acknowledge this argument against the transfer taxes.[104] Graetz, however, argues that the amount of money raised by transfer taxes is too small to have a significant impact on saving and investment (and therefore capital formation).[105] Graetz states that its impact on savings is dwarfed by other taxes and by monetary policy.[106] However, Graetz fails to recognize that while the revenue *collected* from the tax is insignificant, the amount of money *affected* by the tax is very significant. One cannot judge the economic effect of a tax based on the amount of revenue that it generates. The transfer tax system creates a disincentive to save for taxpayers with billions of dollars in wealth. This disincentive exists regardless of whether those taxpayers ultimately pay the tax or pay an estate planner to avoid the tax. In fact, one could even argue that the tax raises so little revenue because of the perverse incentive that it creates to consume instead of save.

Professor Wagner advances the proposition that transfer taxes are bad because they discourage savings and investment a step further by showing that transfer taxes lower productivity, employment, and output.[107] His argument goes as follows: (1) federal transfer taxes discourage savings; (2) this reduction in savings, in turn, reduces the creation of capital; (3) this reduction in capital reduces wages and employment because labor is less productive when the capital stock with which it works decreases; and (4) the lower wages and employment reduce Gross Domestic Product.[108] Wagner created an econometric model based on this analysis, which reached startling conclusions. His model simulated the economy from 1971-91 without a federal transfer tax. The model

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[103] *See* SAMUELSON & NORDHAUS, *supra* note 99, at 154; WAGNER, *supra* note 81, at 5-10;Dobris, *supra* note 4, at 1222.

[104] *See* WAGNER, *supra* note 81, at 5; Dobris, *supra* note 4, at 1222; Graetz, *supra* note 3, at 279.

[105] Graetz, *supra* note 3, at 279.

[106] *Id.*

[107] *See* WAGNER, *supra* note 81, at 5-10.

[108] *Id.* at 10-11. Wagner explains these economic effects in detail. For example, he uses the variable law of proportions to show that decreasing the capital-labor ratio results in a decrease of the demand for labor. His economic analysis is beyond the scope of this Article. Suffice it to say that his proposition supports the argument that federal transfer taxes interfere with the efficient free-market system. Because I am not an economist, I cannot pass judgment on his econometric analysis. I do, however, agree with his general proposition that transfer taxes reduce savings and interfere with the efficient functioning of the economy.

shows that, as of 1991, without the federal transfer tax: (1) Gross Domestic Product would be $46.3 billion higher; (2) 262,000 more jobs would exist; and (3) capital would be $398.6 billion higher.[109] The results are provided in Table 3 below.

TABLE 3
Economic Growth Without Transfer Tax, 1971-1991

Year	Change in GDP ($billions)	Change in Jobs (thousands)	Change in Capital ($billions)
1971	2.6	20	25.3
1972	7.7	72	72.9
1973	13.6	147	124.5
1974	17.7	215	170.2
1975	22.5	269	209.8
1976	25.9	316	229.3
1977	29.8	352	255.4
1978	33.1	375	277.4
1979	34.4	378	291.6
1980	34.2	353	305.5
1981	36.9	336	325.6
1982	35.4	308	333.1
1983	37.4	297	333.1
1984	39.3	299	329.5
1985	38.6	285	318.8
1986	38.0	268	311.4
1987	37.6	260	308.2
1988	39.2	252	318.9
1989	41.9	250	336.9
1990	44.3	248	366.5
1991	46.3	262	398.6

(Changes in GDP are annual; changes in capital stock are cumulative.)[110]

Wagner also simulated the economic consequences of eliminating the federal transfer taxes in 1993 for the remainder of this century. The model predicts that eliminating federal transfer taxes in 1993 would: (1) increase Gross Domestic Product by $79 billion more by the year 2000 than it would be with the tax; (2) increase the stock of capital by $639 billion more than the amount projected for the year 2000; and (3) create 228,000 more jobs than if the transfer tax remained (through the labor productivity enhanc-

[109] *Id.* at 17.
[110] *Id.* (citation omitted).

ing effect of a larger stock of capital).[111] Wagner's conclusions are provided in Table 4 below.

TABLE 4
Economic Growth Without Transfer Tax, 1993-2000

Year	Change in GDP ($billions)	Change in Jobs (thousands)	Change in Capital ($billions)
1993	6.6	12	64.5
1994	19.3	44	180.8
1995	33.2	84	301.4
1996	45.6	128	401.6
1997	57.5	171	492.6
1998	65.7	203	547.7
1999	73.0	225	595.8
2000	79.2	228	638.9

(Changes in GDP are annual; changes in capital stock are cumulative.)[112]

Wagner explains the theory behind this forecast as follows:

> The elimination of the tax (without its replacement by other taxes) would have increased the after-tax rate of return on the then existing stock of capital. The higher net return would have induced an increase in private saving and investment above the levels that actually occurred, and these higher levels would have persisted until the after-tax rate of return had fallen back to its long-term trend value. The larger stock of capital would have increased the amount of capital used with labor services throughout the economy, thereby increasing the productivity of labor, hence the demand for labor services. In turn, this would have led to an increase in employment and in real wage rates, hence an increase in aggregate labor income.[113]

Wagner's study and his conclusions are, at the very least, compelling evidence that federal transfer taxes are interfering with the functioning of an efficient free-market economy. While no one, including Wagner, can precisely quantify the adverse economic effects of the

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[111] *Id.* at 18.

[112] *Id.* at 19.

[113] *Id.* at 16. For a full description of the assumptions of the econometric model that Wagner uses, see Appendices I and II to his study. *Id.* at 42-49. Basically, the model characterizes the economy through four relationships: (1) the production sector; (2) the household sector; (3) the marginal tax rates on the factors of production and consumption; and (4) expectations about the future. The model is extraordinarily complex: it considers over 5,000 investment series, has more than 20 capital classifications, and includes historical income from 1954-87.

transfer tax, it is clear that such adverse effects exist and thus that the tax violates the principle of neutrality.[114]

Proponents of the "Theory of Second Best" (hereinafter "Second Best") might argue that the tax's violation of economic neutrality is not necessarily bad.[115] Second Best states that if a constraint is introduced into a general equilibrium situation which prevents the attainment of Pareto optimality, then the optimal equilibrium can be achieved only by departing from other Pareto conditions.[116] In other words, if a tax (a constraint) is introduced into an efficient economy, then the only way to reach the optimal level of output in that economy is to have another tax offset the first tax's inefficient effects.

For example, assume there are two goods in society, A and B, and a tax is imposed on good A.[117] This tax on good A interferes with the Pareto optimal level of consumption for goods A and B by raising the price of good A relative to the price of good B. This also amounts to a subsidy of good B, because good B's price is reduced relative to good A's. Second Best states that the only way an optimum equilibrium can again be achieved, given the fact that there is a tax on good A, is to impose a tax on good B.[118] This new optimal equilibrium is the second best position attainable given one tax.[119]

Second Best further posits that:

> It is not true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled. It follows, therefore, that in a situation in which there exist many constraints which prevent Paretian optimum conditions, the re-

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114 No study has yet responded to Wagner's analysis. While Wagner acknowledges that some economists might reach different quantitative conclusions than he did, he states that his qualitative theory of the transfer tax interfering with savings and investment is widely accepted. The quantitative differences are primarily due to the econometric model used. For example, Wagner notes that the CBO uses an old-fashioned Keynesian model which would produce smaller economic effects of repeal than his model. Telephone Interview with Richard E. Wagner, Professor, George Mason University (Nov. 10, 1993).

115 R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. OF ECON. STUD. 11 (1956). A British economist, James Meade, developed this theory but it was Lipsey and Lancaster who popularized the notion.

116 *Id.*

117 This example is modeled after an example given by Professor McCloskey in DONALD N. MCCLOSKEY, THE APPLIED THEORY OF PRICE 313 (2d ed. 1985).

118 *Id.*; Lipsey and Lancaster state it as follows: "Then all that can be said in general is that given the existence and invariability of this tax, a second best optimum can be achieved by levying some system of taxes and subsidies on all other commodities." Lipsey & Lancaster, *supra* note 115, at 12.

119 Lipsey & Lancaster, *supra* note 115, at 12.

> moval of any one constraint may affect welfare or efficiency either by raising it, by lowering it, or by leaving it unchanged.[120]

This can be illustrated by returning to the previous example. Assume that a tax was also imposed on good B. Proponents of Second Best would then argue that it is not necessarily better to remove the tax on good B if there is still a tax on good A. Second Best suggests that federal transfer taxes are a constraint on optimal output that should not necessarily be removed. Second Best would posit that eliminating the federal transfer tax system (a constraint) will not necessarily lead to a more efficient economy because there is more than one constraint (i.e., other taxes and inefficiencies) in the American economy. Thus, Second Best would state that removing the transfer tax constraint "may affect welfare or efficiency either by raising it, by lowering it, or by leaving it unchanged."[121] Professor McCloskey best summarizes Second Best's application to tax policy: "In short, the correct strategy for a society trying to do as well as it can given that it cannot attain the first-best position of no taxes at all is to achieve the second-best position attainable. This may well involve imposing taxes, not eliminating them."[122]

The problem with Second Best is that it is not practical.[123] Perhaps Second Best is correct in stating that, given one tax, the optimal level of output (the second best position) is only achieved if an equal tax is imposed on everything else.[124] It may be true that only then are the true marginal costs and valuations of goods left undisturbed.[125] However, this theory only works if "everything" is taxed.[126] Everything must include marketed and unmarketed commodities (i.e., sleep, thought, recreation, etc.).[127] As Professor McCloskey points out, if only marketed commodities are taxed, "then the taxes on vacuum cleaners, supermarket food, and psychoanalysis would amount to subsidies on unpaid housekeeping labor, backyard gardening, and transcendental meditation, and society would be pushed away from its optimal output of marketed and nonmarketed commodities."[128]

Applying this reasoning, Second Best's argument against transfer tax repeal fails. America's tax system does not and cannot practically

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120 *Id.*

121 *Id.*

122 McCLOSKEY, *supra* note 117, at 313.

123 *Id.*

124 *Id.*

125 *Id.*

126 *Id.*

127 *Id.*

128 *Id.*

tax "everything." Thus, one cannot say that the only way to reach the optimal level of output in the economy is to have the transfer tax offset another tax's inefficient effect. It simply does not follow that the transfer tax system is returning marginal costs and valuations of goods to their true values. Too many goods remain untaxed and cannot possibly be taxed for this to be true. Thus, Second Best, while interesting, fails to provide a compelling reason not to repeal federal transfer taxes.

Second Best thus does not refute Professor Wagner's theory that transfer taxes inappropriately interfere with the economy. Some still may quibble with Wagner's assumptions, some may quibble with his data, some may quibble with his model, and some may quibble with the magnitude of his economic effects.[129] That is fine. But even if Wagner's model is not completely accurate, it serves to illustrate an undeniable fact: federal transfer taxes discourage savings and investment and that is bad, especially in our economic state. America simply cannot afford a tax which does not raise a significant amount of revenue, does not effectively decentralize wealth, does not redistribute wealth, is not very cost-effective, but does interfere with the economy.

3. The Federal Transfer Tax System Violates The Goal Of Simplicity

The federal transfer tax system's complexity supports the argument for its repeal. An important goal of a tax is simplicity.[130] It is universally agreed that the federal transfer tax system is too complex.[131] The annual $10,000 per donee exclusion from the gift tax

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[129] To date, no one has challenged Wagner's study. *See supra* note 114.

[130] *See* TREASURY DEPARTMENT REPORT, *supra* note 86, at 15; Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1269. Professor McCaffery defines simplicity in terms of "technical complexity," "structural complexity," and "compliance complexity." *See id.* at 1269-72. Technical complexity refers to the purely intellectual difficulty in understanding the meaning of a tax law. *Id.* at 1271. Structural complexity refers to the difficulty in applying a tax law to one's own affairs. *Id.* Compliance complexity refers to the difficulty in complying with the tax. *Id.* at 1272.

Applying McCaffery's definitions to the federal transfer tax system shows that it is indeed complex. As a student of transfer taxation, I can personally attest to the fact that it is intellectually difficult to understand transfer tax laws. Furthermore, the prevalence of estate planners shows that transfer taxes are also structurally complex.

Also noteworthy is that McCaffery concludes that a complex tax system is not needed to ensure equity and efficiency—i.e., that trade-offs are not always necessary. *Id.* at 1318-19.

[131] *See, e.g.*, Task Force on Transfer Tax Restructuring, American Bar Association, *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395 (1988) (hereinafter "Task Force Report"); Harry L. Gutman, *A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653, 660 (1988).

for gifts of present interests in property[132] exemplifies this complexity. This exclusion was originally created as an administrative device "to obviate the necessity of keeping an account of and reporting numerous small gifts."[133] In short, it was enacted to ensure that taxpayers would not be required to file gift tax returns for their Christmas and birthday gifts. Instead, the annual exclusion has spawned massive amounts of litigation and complex tax avoidance schemes.[134] Most of the litigation involves the complex issue of what constitutes a "present interest."[135] Even the American Bar Association's 1988 "Report on Transfer Tax Restructuring" (hereinafter "ABA Report") acknowledged that the annual exclusion "has led to complex rules and serious tax avoidance."[136]

The federal transfer tax system's complexity makes it impossible for the average citizen to understand his own estate plan. The ABA Report acknowledges this sad fact by stating that "one of the chief complaints about the present system is that it complicates estate planning, wills, and trust instruments, perhaps unduly."[137] The ABA report attaches a typical will clause to its report and concludes that "a testator, even if above average intelligence, is unlikely to understand, or if he was once told, to remember, all that such a will clause is intended to accomplish."[138]

The federal transfer tax system's complexity also makes it disingenuous.[139] Each taxpayer should be able to determine his annual tax contribution to the government.[140] This determination is

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132 I.R.C. § 2503(b) (West 1988).

133 *See* Gutman, *supra* note 131, at 657-58 (quoting S. REP. No. 665, 72d Cong., 1st Sess. 41 (1932)).

134 *See id.* at 658.

135 *See, e.g.*, Stark v. United States, 477 F.2d 131 (8th Cir.), *cert. denied*, 414 U.S. 975 (1973); Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962); Georgia Ketteman Trust v. Commissioner, 86 T.C. 91 (1986); Estate of Kolker v. Commissioner, 80 T.C. 1082 (1983).

136 Task Force Report, *supra* note 131, at 401. The ABA recommended redefining "present interest" to exclude property subject to a lapsing power of appointments. It also suggested capping the amount that could be excluded on a per donor basis. Finally, it advocated a de minimis per donee exclusion for small gifts. *Id.* at 401-04.

In my opinion, these reform suggestions do not solve the problem. Even if this proposal were adopted, there would still be litigation over the "present interest" requirement. It does not make sense to me to simplify a complex tax area by adding more complex restrictions. Estate planners will simply find other holes in the proverbial dike. That is what they are paid to do. I suggest that we not perpetuate this wasteful game with complex reforms.

137 *Id.* at 396.

138 *Id.*

139 *See* Smith, *supra* note 4, at 1811.

140 *Id.*

critical because it gives citizens an opportunity to make informed voting decisions in supporting or opposing candidates or tax proposals.[141] The federal transfer tax system, as shown above, is so complex that it is extremely difficult for one to determine one's own transfer tax contribution. Furthermore, because the estate tax is based on the value of one's assets at death, it is literally impossible for one to calculate the tax that one will owe at death.[142] Thus, the federal transfer tax system is disingenuous because its complexity conceals from citizens the amount of their tax.

Furthermore, the tax is so complex that generalist attorneys struggle to understand it. Not only does this lead to malpractice lawsuits, but it also does not make sense to enact a tax that even smart people cannot understand.[143] Those who call for its reform, rather than its repeal, to alleviate its complexity overlook one essential fact: it has been reformed at least nine times since 1942 and each time it has become more complex.[144] Taxpayers, the political system, and the tax system can only tolerate a limited amount of complexity.[145] It seems unwise to waste that complexity on a tax system that raises little revenue, does not decentralize wealth, does not redistribute wealth, is not cost-effective, and is not economically neutral. The transfer tax system's overwhelming complexity also supports the argument for its repeal.

E. *Federal Transfer Taxes Alter The Composition of Individual Investment Portfolios*

The repeal of the federal transfer tax will also foster investment in riskier ventures, which in turn will spur economic growth. Many trusts are created simply to avoid estate taxes.[146] The trustees of these trusts typically invest conservatively in an attempt to preserve the trust's corpus.[147] By eliminating the estate tax, the amount of money held in trusts will decrease and thus people will

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141 *Id.*

142 *Id.*

143 *See* Dobris, *supra* note 4, at 1225 (arguing that the estate tax "is so complex that estate planning is becoming, or soon will be, a fertile ground for malpractice suits against lawyers. That is, the practice is too complex for the garden variety lawyer. This is unwholesome and inefficient. We should not have a death tax system which is a trap for the unwary."). *See also* Gerald P. Johnston, *Legal Malpractice in Estate Planning—Perilous Times Ahead for the Practitioner*, 67 IOWA L. REV. 629, 636-43 (1982).

144 *See generally* Aucutt, *supra* note 53, at 345.

145 *See* Dobris, *supra* note 4, at 1224.

146 *See id.* at 1223-24 for an excellent presentation of this argument.

147 *Id.*

be free to invest in riskier activities.[148] One commentator concludes that "[p]utting money outright in the hands of people who are likelier to be more adventurous investors may lead to the creation of new wealth by way of riskier investing."[149]

Some might contend that most trusts created for estate planning purposes are created by rich people who give trustees broad investment powers.[150] These trusts are set up for the purpose of seeing that wealth passes to a younger generation.[151] Thus, the trustee will aggressively seek investments with substantial appreciation possibilities so that the younger generation can receive even more wealth.[152] This counterargument fails to acknowledge that trustees are necessarily more risk-averse than a typical investor because they are charged with a fiduciary duty to protect the trust's assets. An individual investor would be more willing to invest in a risky new business venture than a trustee, because the trustee would not want to risk losing the assets that he is bound to protect. Thus, the elimination of the transfer taxes likely will result in fewer trusts and riskier investment activities.

One popular estate planning technique—combining a charitable remainder trust with an irrevocable insurance trust—illustrates how the federal transfer tax system dictates individual's investment decisions and thereby alters the composition of investment portfolios. This estate plan is typically recommended for individuals with estates exceeding $600,000 ($1,200,000 if married) who own highly appreciated capital assets that they would like to transfer tax-free. It works as follows: (1) the transferor transfers the highly appreciated capital asset (house, stock, bonds) to a special kind of irrevocable trust called a charitable remainder trust ("CRT"); (2) this charity-owned CRT then sells the appreciated asset, but pays no capital gains tax because the charity is tax-exempt; (3) the charitable trust reinvests the property in income-producing property and passes this income stream to the transferor; (4) the trust gives the assets remaining at the transferor's death to a charity and, thus, the transferor receives a charitable deduction for the present value of this remainder interest; (5) the transferor takes the income stream from the CRT and makes tax-free gifts to another trust—the irrevocable insurance trust ("IIT"); (6) the IIT uses this income stream to purchase life insurance on the transferor's life equal to the value of

148 *Id.*
149 *Id.* at 1223.
150 *Id.* at 1224.
151 *Id.*
152 *Id.*

the original capital asset transferred into the CRT; and (7) upon the transferor's death, the transferor's family receives tax-free insurance proceeds equal to the value of the assets originally transferred. The following example illustrates this method:

> G owns XYZ stock worth $5,000,000. G paid $500,000 for this stock several years ago. If G sells the stock, G will pay capital gains tax on the $4,500,000 gain. If G does not sell the stock and leaves it to G's family, then it will be included in G's estate and subject to estate taxes. After talking to an estate planner, G donates the stock to a CRT. G receives a charitable deduction for the present value of the stock's remainder value. The CRT then sells the stock, but pays no capital gains tax. The CRT then invests the proceeds in bonds yielding six percent. The CRT pays this income stream to G for the remainder of G's life. G then creates another trust, an IIT. Using part of the CRT's income stream (as well as the tax savings from the charitable deduction), G gifts money to the IIT. G uses his annual exclusion to avoid gift taxes on this gift. The IIT purchases a life insurance policy on G's life with a face value of $5,000,000. When G dies, the $5,000,000 worth of bonds in the CRT passes to the charity. At the same time, the insurance policy in the IIT pays G's family $5,000,000 cash. The cash payment is income tax-free to G's family and is not includable in G's estate. G's $5,000,000 worth of XYZ stock has effectively been replaced by $5,000,000 of tax-free cash.

This estate plan is irresistible to many taxpayers because of its tax-avoidance capabilities. Some of its benefits include: (1) It provides the taxpayer with a charitable deduction for a portion of the assets transferred to the CRT; (2) the taxpayer avoids capital gains tax on the transferred asset; (3) the value of the appreciated asset is not decreased by taxes so that the donor receives an income stream from the asset based on its full value, not its value less taxes; (4) the life insurance proceeds are not includable in the transferor's estate and thus escape estate tax; (5) the transferor's estate is not diminished by estate taxes; (6) the transferor retains an income stream during his lifetime; and (7) the transferor can fulfill a charitable inclination without disinheriting his family.

While these benefits are wonderful for the taxpayer, they illustrate that the transfer tax system gives taxpayers an incentive to make investment decisions that they otherwise would not make.[153] For ex-

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153 A slight change in this example also illustrates that the transfer tax can create liquidity problems for taxpayers with closely held businesses. Assume that G did not own $5,000,000 worth of XYZ stock, but instead owned a business worth $5,000,000. If G simply transferred this business to his children upon his death, then the children

ample, G in the example above had no desire to sell his XYZ stock. He was motivated to sell it simply because he could avoid taxes if he did so. Furthermore, the CRT only invested in bonds because they produced a steady income stream that could be used to fund the other tax-avoiding trust, the IIT. Finally, the IIT did not choose to invest in life insurance because it was the most profitable investment, but because it helped to avoid estate taxes. Thus, the federal transfer tax system, rather than the market, forced each one of these investment decisions. This is inefficient. The repeal of the federal transfer tax system would obviate the need for such estate planning tools and return investment decision making to its rightful place—the market.

III. Arguments Against The Abolition Of Federal Transfer Taxes

A. *The Federal Transfer Tax Is A Source Of Revenue That Should Not Be Abandoned In a Debt Crisis*

One argument for keeping federal transfer taxes is that, given America's massive debt, it cannot afford to lose any source of revenue.[154] America's national debt is almost four trillion dollars and is increasing by more than one billion dollars per day.[155] The interest alone on that debt will top $310 billion in 1993.[156] Likewise, for the first time in America's history, interest will be the largest federal expenditure in 1994.[157] Each American man, woman, and child owes sixteen thousand dollars towards this mountain of debt.[158] These startling statistics, some would assert, provide a compelling argument for maintaining the transfer tax system and its $11 billion revenue source.

While federal transfer taxes clearly do raise some revenue, this

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might have to liquidate the business in order to pay the estate tax of $2,275,800 (I.R.C. § 2001). While I.R.C. § 6166 attempts to mitigate these liquidity problems, it is often not enough. Thus, taxpayers with closely-held businesses often use this estate plan and simply donate their business to the CRT, which then liquidates the business to fund the IIT. The estate tax's interference with private economic decisions rears its ugly head again.

154 *See generally* Jatscher, *supra* note 23, at 41; Verbit, *supra* note 2, at 609-11 (arguing that Congress should restore revenue raising as the primary goal of federal transfer taxes).

The justification for President Clinton's recent increase in the transfer tax rates is "the need for all taxpayers to contribute to the current deficit situation." *See* Entin, *supra* note 102 (citation omitted).

155 138 Cong. Rec. S7733-35 (daily ed. June 19, 1992) (statement of Sen. Heflin).

156 *Id.*

157 *Id.*

158 *Id.*

feature alone is not a compelling justification for continuing the tax. All taxes raise revenue, yet not all taxes are justifiable. Simply put, one should not use revenue raising blinders in evaluating a tax, but instead should evaluate a tax's broader ramifications. The revenue that transfer taxes raise is relatively insignificant (less then one percent of the federal budget) while its costs are significant (estimated at sixty-five percent of the revenue raised).[159] The tax's complexity renders everyone but transfer tax specialists incapable of understanding it.[160] The tax is avoidable and thus serves only to punish those who do not pay high-priced estate planners.[161] The tax interferes with efficient economic decision-making and is a drag on the economy.[162] Thus, just because the tax raises $11 billion in a debt-ridden economy, it is not necessarily worth keeping. Surely there must be a simpler, more efficient, and less costly method for the federal government to raise $11 billion.[163]

Most important, Wagner's econometric analysis demonstrates that repealing the burdensome federal transfer tax system will boost the economy and thereby increase tax revenues.[164] Theoretically, then, no revenue substitute would be needed if the transfer tax was repealed. Practically, however, all proposed tax bills must be "revenue neutral."[165] Accordingly, a proposal to repeal federal transfer taxes must be accompanied by a proposal for an alternative revenue source.[166]

A recent scholarly debate between Professors Charles Galvin and Robert Smith addressed the issue of replacing transfer tax rev-

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159 *See* discussion *supra* notes 23-30 and 52-85 and accompanying text.

160 *See* discussion *supra* notes 130-45 and accompanying text.

161 *See supra* note 93 and accompanying text.

162 *See* WAGNER, *supra* note 81, at 26; *see also* discussion *supra* notes 95-129 and accompanying text.

163 The government does not need to raise $11 billion to replace the revenue from the federal transfer tax. The government should calculate the tax's costs and subtract those from the $11 billion figure to determine the tax's net revenue. A new tax should only replace this net revenue figure. Of course, in estimating revenue from a new tax, the government should only consider the potential net revenue.

164 WAGNER, *supra* note 81, at 18-20.

165 *See, e.g.*, Omnibus Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 6401, 104 Stat. 1388 (1990).

166 *But see* WAGNER, *supra* note 81, at 26. Wagner argues that repealing the federal transfer taxes, which have such great social and economic costs, will eventually generate more revenue for the government. As the discussion of his proposals above indicates, Wagner believes that repealing the transfer tax will create jobs for taxpayers which, in turn, will cause those taxpayers to pay more taxes. While I cannot vouch for Wagner's econometric model, I fully support his reasoning. It is a shame that Congress does not truly consider the economic effects of its taxes when determining what "revenue neutral" means.

enues with an alternative revenue source.[167] While both agree that the federal transfer tax system should be abolished, they disagree on how to replace the revenue.[168] Galvin argues that the revenue should be replaced by one or both of the following changes in the income tax system: (a) the recognition of gain (or loss) at the time of gift or at death; or (b) the inclusion in income of gifts, devises, bequests, or inheritances by the recipient—i.e., repealing I.R.C. §102.[169] Under proposal (a), an income tax would be imposed on the gains.[170] This tax would be paid by the transferor if the transfer were made during lifetime and by the estate if the transfer were made at death.[171] Under proposal (b), the recipient would simply include the value of lifetime gifts and testamentary transfers in gross income and pay income tax on those amounts.[172]

Galvin asserts that recognizing gain (or loss) at the time of gift or death comports with the basic income tax principle that taxes should be imposed on those who earn income.[173] Thus, he argues that this proposal attributes gain or loss to the proper taxpayer.[174] Galvin supports his alternative proposal—repealing I.R.C. §102—by stating that in a pure accretion system based on the Haig-Simons definition of income, the receipt of gifts and bequests should be a taxable event.[175] Galvin projects that either proposal will more than compensate for the $11 billion revenue loss from the transfer tax repeal.[176] Finally, Galvin notes that America is moving towards a comprehensive tax base that more nearly conforms to the Haig-Simon principles, and that his proposals are

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167 *See* Smith, *supra* note 4; Galvin, *supra* note 4.

168 *Id.*

169 Galvin, *supra* note 4, at 1414. Like Galvin, Professor Lawrence Zelenak also proposes taxing gains at death. Zelenak, *supra* note 17, at 287. *But cf.* Samelson, *supra* note 17, at 703 (criticizing Zelenak's proposals as understating valuation problems and liquidity problems if gains were taxed at death).

Professor Marjorie Kornhauser also has written an excellent article on the constitutional implications of taxing gifts as income. Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 54-55 (1992) (proposing, among other things, repealing I.R.C. § 102 and thus including gifts in the donee's income).

170 Galvin, *supra* note 4, at 1414-15.

171 *Id.*

172 *Id.* at 1416-17.

173 *Id.* at 1418.

174 *Id.*

175 *Id.* at 1419.

176 *Id.* Galvin projects that recognizing gains and losses on lifetime and deathtime transfers—alternative (a)—will raise $14.5 billion. He projects that repealing I.R.C. § 102 would produce $18 billion in revenue.

compatible with that concept.[177]

Smith argues that Galvin's gain recognition proposal would generate too many valuation contests and that it would perpetuate the transfer tax system's liquidity problems.[178] He also feels that it would unnecessarily intrude on taxpayers' investment decisions and, if not restricted, broaden the tax base so much as to be politically infeasible.[179] Similarly, Smith argues that Galvin's accession tax proposal would produce valuation disputes and liquidity problems, interfere with investment decisions, and incur resistance from the middle class.[180]

Smith instead proposes raising rates on ordinary and capital gains, adopting a carryover basis for testamentary transfers, and structuring the rate increases to impose the tax burden on the wealthy.[181] Smith's proposal would increase capital gains rates six percent and would increase ordinary income rates three percent for taxpayer's with adjusted gross income exceeding $200,000.[182] Galvin replies that it would be more practical and fair to force a few taxpayers to recognize gains and losses at the time of a transfer than to impose a tax rate increase on many thousands of taxpayers.[183] Galvin also criticizes Smith's carryover basis proposal by arguing that: (1) it violates the principle that income should be taxed to the person who earns it; (2) it is not administratively feasible to trace the basis of all assets transferred;[184] and (3) it reopens the opportunity to abuse generation-skipping transfers to defer tax indefinitely.[185]

Both proposals have merit and would likely be an improvement over the current system because neither proposal is as complicated, unfair, economically inefficient, or costly as the current transfer tax quagmire. However, few proposals could possibly be worse than the current system, and both of these proposals seem

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177 Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith*, 56 TAX NOTES 951, 951-52 (1992).

178 Smith, *supra* note 4, at 1801-02.

179 *Id.* at 1802.

180 *Id.* at 1804.

181 *Id.* at 1804-05.

182 *Id.* at 1807. Smith projects that this rate increase would produce $11.5 billion in revenue—more than replacing the $11 billion that current transfer taxes generates.

183 Galvin, *supra* note 177, at 953. *See also* Charles O. Galvin, *More Reasons to Bury the Estate Tax*, 59 TAX NOTES 435 (1993) (arguing that his proposal would have many advantages if America adopted a consumption tax).

184 In 1976, an attempt was made to give heirs a carryover basis in inherited property. It was retroactively repealed in 1980 in the face of an uproar over tracing problems. *See* Samelson, *supra* note 17, at 703.

185 *Id.*

unnecessarily complex. Galvin's proposal does indeed perpetuate valuation and liquidity problems inherent in the current system. Smith's proposal, as Galvin notes, does have significant valuation concerns. There must be a better way to raise $11 billion.

The ideal revenue replacement proposal would: (1) raise $11 billion from the wealthiest Americans; (2) be simple to understand; (3) be horizontally and vertically equitable; (4) be as economically neutral as possible; and (5) be politically feasible. These requirements necessarily eliminate any additional tax system from consideration because legislators, taxpayers, professors, students, and IRS agents would all have to learn a new tax system. That inefficiency is precisely what one is trying to avoid by repealing the current transfer tax system.

One revenue-replacing proposal that merits consideration is the creation of a new income tax bracket for taxpayers with adjusted gross incomes of $500,000 or more. In addition, as Smith suggests, capital gains tax rates could be increased on these individuals. In 1991, there were 170,395 income tax returns filed by taxpayers with adjusted gross income of $500,000 or more.[186] Those taxpayers reported an aggregate adjusted gross income of $201,343,252,000.[187] Thus, the average adjusted gross income per return was $1,181,626.53. A higher tax bracket on these individuals, coupled with higher capital gains tax rates on them, could raise the required $11 billion.[188]

This proposal satisfies the ideal criteria listed above. First, it raises $11 billion from the wealthiest Americans—those with an AGI of $500,000 or more. Second, it is extremely simple to understand because it merely amends the existing income tax brackets listed in I.R.C. §1 and the capital gains tax rates. Third, it is horizontally equitable because similarly situated taxpayers, those earn-

186 Edward B. Gross, Jr., *Individual Income Tax Returns, Preliminary Data, 1991*, STAT. OF INCOME BULL., vol. 12, no. 4, Spring 1993, at 6. There were 118,840 tax returns filed by taxpayers with AGI's between $500,000 and $1 million. There were 51,555 tax returns filed by taxpayers with AGI's exceeding $1 million.

187 *Id.*

188 Currently, the highest marginal rate is 39.6%. I.R.C. § 1 (West 1988). I am uncertain what the proposed marginal rate for taxpayer's with AGI's of $500,000 or more would have to be to raise $11 billion. I believe it would be approximately 45%. The precise number is not important for my purposes. I do not aim to calculate the precise rate which would produce the desired revenue. Instead, I propose to show how a simple change in the current tax rate structure could produce the $11 billion. Again, I want to emphasize that I do not believe that a full $11 billion needs to be raised when the transfer tax is repealed. Shortly after repeal, saving and investment will increase, capital will be created, jobs will be created, and, thus, new taxpayers will join the tax rolls and produce revenue for the treasury.

ing $500,000 or more, are taxed similarly. It is also vertically equitable because those with a greater ability to pay taxes do pay more taxes. Fourth, it is arguably more economically neutral than the existing system, because although it discourages extremely high-income taxpayers from working and interferes with capital formation (as do all progressive income taxes), it would not create a massive disincentive to create capital. Finally, it is politically feasible because middle-income taxpayers will not bear any of the tax burden of the repeal, and the new higher tax rates on the wealthy are harder to avoid. Likewise, ultra-wealthy Americans will be pleased because: (1) they will never have to pay their high-priced estate planners, accountants, and appraisers to devise a scheme to avoid transfer taxes; (2) they will never have to pay a federal transfer tax; and (3) they can be secure that their wealth will pass to their loved ones undiminished.

There are other proposals to replace the $11 billion in lost revenue without the adverse effects of the transfer tax system.[189] The point of this Article is not to devise the best revenue-replacing method. Rather, it is to show that the transfer tax system is a colossal waste of time and money and that simpler, fairer, more efficient methods of raising that money do exist. Which is the best revenue replacement method is a topic for another paper. That decision, as Professor Galvin aptly notes, must be compatible with the overall tax system, and thus necessarily hinges on the direction of income tax reform. One thing, however, should be clear: better revenue sources do exist to replace the $11 billion allegedly lost from the transfer tax repeal.

B. *Repealing The Federal Transfer Taxes Will Make The Overall Tax System More Regressive*

Another argument against repealing federal transfer taxes is that they are a mechanism for achieving progressivity, and thus without them the overall tax system will become more regressive.[190] This argument requires three logical steps, according to Professor

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189 *See* Donaldson, *supra* note 4, at 540 (suggesting an accessions tax). Other possible proposals include eliminating Social Security payments to taxpayers making over a threshold amount, or simply increasing sin taxes.

190 Graetz, *supra* note 3, at 273. Graetz theorizes that "[t]he principal reason, therefore, to revise the estate tax is to rescue this mechanism for achieving progressivity, and perhaps to rescue progressivity itself, from both short- and long-term threats." *Id.*; *see also* CAMPFIELD ET AL, *supra* note 6, at 20 (quoting William Pedrick, *Through the Glass Darkly: Transfer Taxes Tomorrow*, 19 INST. ON EST. PLAN. ¶ 1902, ¶ 1902.2 (1985) (asserting that "the estate and gift taxes have and can contribute significantly to the progressive nature of our revenue system—of taxing on the basis of ability to pay")).

Graetz, its chief proponent: "(1) a judgment that progressivity in taxation is just and therefore good; (2) a view that the estate tax can and should play an important role in achieving progressivity; and (3) a conclusion that progressivity should not be abandoned because of the adverse impact of progressive taxation in general (and the estate tax in particular) on capital formation."[191]

A close examination of estate tax data indicates that Graetz's conclusion is implausible. First, assume that Graetz is correct and that progressivity is a good thing (although it is an "uneasy case").[192] Graetz then claims that the estate tax plays an important role in achieving progressivity.[193] This could not possibly be true because federal transfer taxes affect an extremely small percentage of the population and raise precious little revenue.

For example, there were only 53,576 federal estate tax returns filed with gross estates at or above the $600,000 filing requirement in 1991.[194] Those taxpayers ultimately paid $9,100,290,000 in estate taxes.[195] In contrast, there were 114,926,084 income tax returns filed in 1991.[196] Those returns reported an adjusted gross income of $3,471,537,352,000 and incurred a total tax liability of $470,113,987,000.[197] Thus, estate tax revenue was approximately two percent of income tax revenue in 1991.[198] A tax that affects such a small number of taxpayers (less than 0.5% of income tax filers) and raises so little revenue in comparison to income taxes cannot possibly affect the progressivity of the overall tax system. Even if Graetz is right and estate taxes promote progressivity in the

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191 Graetz, *supra* note 3, at 273.

192 *See id.* at 274 n.103 (citing W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953)). Graetz defends progressive taxation by questioning the central premise of progressive taxation detractors. That premise, he argues, is that earnings in a market economy are not only a necessary concession to economic efficiency but are the morally appropriate rewards to either the owner of capital or the laborer. These individuals conclude from that premise, Graetz contends, that income and wealth are manifestations of merit and should not be taxed to fund spending on public goods or redistribution. Graetz asserts that the market's distribution is not ethical, fair, nor just because: (1) the rewards depend on factors beyond an individual's control; (2) production is based on the joint use of resources provided by different people, not just one person; (3) some share of total market return can be ascribed to society, not to an individual; and (4) many returns to capital and labor are affected by accidents or luck. *Id.* at 273-76.

193 *Id.* at 285.

194 Johnson, *supra* note 27, at 76.

195 *Id.* at 91.

196 Gross, *supra* note 186, at 16.

197 *Id.* at 16, 22.

198 I arrive at this figure by dividing $9,100,290,000 into $470,113,987,000 (0.01936).

overall tax system, he overstates the effect, which could only be negligible. That negligible effect surely is not a justification for maintaining a tax system which does not raise significant amounts of revenue, does not effectively decentralize wealth, does not effectively redistribute wealth, is not cost-effective, is not easily understandable, but does interfere with the economy.

C. *The Federal Transfer System Provides An Important Signaling Effect That Wealthy People Are Being Taxed*

Some might argue that federal transfer taxes should not be repealed because they foster the important perception that the tax system is fair.[199] The premise of this argument is that federal transfer taxes provide a backstop to the federal income tax system by taxing wealth that escapes the income tax.[200] Some argue that it is essential to taxpayer morale that wealthy individuals who have escaped the income tax cannot escape the transfer tax.[201] Thus, according to this argument, the amount of revenue that the transfer tax system generates is irrelevant. The important thing is that the tax provides a signaling effect to the public that wealthy people are paying their fair share of taxes.[202]

This argument misreads the signal that the federal transfer tax system sends to the public. Presumably, the public knows that the federal transfer taxes are avoidable. Bookstore shelves are packed with books such as *How To Save A Fortune On Your Estate Taxes*.[203]

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199 *See generally*, Daniel Shaviro, *Perception, Reality, and Strategy: The New Alternative Minimum Tax*, TAXES, Feb. 1991, at 91. Shaviro criticizes the alternative minimum tax's goal of "establish[ing] a public perception that the federal income tax fundamentally had become fair." *Id.* at 98. Similarly, one could argue that a purpose of federal transfer taxes is to establish a public perception that the federal income tax is fair by taxing wealth that escaped the income tax.

200 This argument presumes that the public wants wealth to be taxed. I do not think that they do. Americans are an optimistic group and believe that they will one day be wealthy. Graetz, *supra* note 3, at 285. It is the American dream. When they achieve that dream, they do not want to give their wealth to the government. George McGovern learned this lesson the hard way. *Id.* In his 1972 campaign, he proposed to confiscate inheritances above $500,000. Verbit, *supra* note 2, at 615 n.70. His proposal was met with a "national cry of outrage." *Id.* (citation omitted). Even his press spokesman acknowledged "it would wipe out the dream factor—every slob in the street thinks that if he hits the lottery big, he may be able to leave half a million to his family; it wipes out dreams." *Id.* (citation omitted). Likewise, in 1982, 64% of Californians voted to repeal the state's inheritance tax. Graetz, *supra* note 3, at 285. Simply put, Americans do not want their wealth taxed. As a result, I think that a tax which signals Americans that their wealth is being taxed is a bad thing.

201 *See generally* Shaviro, *supra* note 199, at 95.

202 *Id.* at 95-96.

203 *See generally* BARRY KAYE, HOW TO SAVE A FORTUNE ON YOUR ESTATE TAXES (1993).

Newspapers are filled with advertisements for free seminars on avoiding estate taxes. The public must know that wealthy people use high-priced estate planners to avoid transfer taxes. Thus, the signal that the public receives from an avoidable transfer tax system is that the system is unfair because the wealthy can avoid taxes through expert counsel. A taxpayer might be angered by this avoidance and, in response, be less likely to comply with the income tax.[204] Furthermore, as mentioned above, unsophisticated taxpayers, not understanding the difference between tax avoidance and tax evasion, might attempt to evade taxes through illegal means. Thus, the transfer tax system, instead of providing a healthy signaling effect, might actually decrease taxpayer compliance.

D. *Wealth Concentration Would Be Even Greater Without The Federal Transfer Taxes*

Another argument opposing transfer tax repeal is that wealth concentration would increase without transfer taxes.[205] This theory contends that transfer taxes have been effective in reducing wealth concentration, but that the effect is masked by other forces.[206] There are two parts to this theory. The first is that wealth has a natural tendency to increase wealth inequality because wealthy people save more.[207] The fact that wealth concentrations have remained relatively static, the theory asserts, indicates that the transfer tax is effectively offsetting this natural tendency.[208] The second part of this theory is that social forces (such as the tendency of wealthy people to intermarry) naturally increase wealth concentration.[209] Thus, the theory concludes, because wealth concentra-

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204 *See* Dobris, *supra* note 4, at 1224.

205 *See* Verbit, *supra* note 2, at 602. Verbit explains this argument but ultimately rejects it. He concludes that "[t]he most that can be said, therefore, is that *but for* the present transfer tax system, the percentage of wealth in the hands of the top five percent of the population would be increasing at an additional rate of less than 0.5% per year." *Id.* at 607.

206 *Id.* at 602.

207 *Id.* Verbit explains this theory extremely well. Basically, he shows how proponents of this theory argue that savings rates increase as income and wealth increase. They argue that this increased savings lays a foundation for a second layer of wealth inequality. They believe that capital, the product of this increased savings and investment, grows faster than capital produced through labor. Thus, the rich get richer. *Id.*

208 *Id.* As Verbit asserts, proponents of this theory find the constant percentage of wealth held by the richest Americans a cause for celebration, not despair.

209 *Id.* at 607. Verbit cites to an empirical study on Alan Blinder's theory of how mating habits relate to the disposition of the family fortune. *Id.* (citation omitted).

tion has been relatively stable, transfer taxes have been an effective offset to these natural social forces.[210]

Both of these theories, while interesting, are misguided. If either of these arguments were true, then one should find that wealth concentration was increasing before the advent of the transfer taxes.[211] One should also find that the implementation of the transfer taxes slowed the natural tendency of wealth becoming more concentrated. Neither of these suppositions is true. Actually, the decline in wealth concentration came before collections from the transfer tax system were significant.[212] For example, the largest drop in wealth concentration occurred between 1926 and 1933.[213] In 1926, transfer tax receipts were $60 million; they fell to a paltry $29.6 million in 1933.[214] During this same period of insignificant transfer tax collections, wealth held by the top 0.5% plummeted from 30% to 25%.[215] Thus, the largest drop in wealth concentration occurred before transfer taxes were significant. Likewise, wealth held by the richest 0.5% of the population has actually increased to 28.8% despite transfer taxes.[216]

Furthermore, this theory is flawed because transfer tax collections are too small to have a significant effect on wealth concentration. As stated earlier, the top wealthholders, representing less than two percent of the American population, hold more than $4.8 trillion in wealth.[217] Federal transfer taxes collect approximately $11 billion annually.[218] Thus, federal transfer tax collections amount to 0.23% of the top wealthholder's wealth.[219] One cannot seriously argue that but for a transfer tax system affecting 0.23% of

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210 *Id.* at 607-08.

211 Remember that these theories conclude that transfer taxes do affect wealth concentration, but that the effect is simply masked by other forces. Thus, my point is that *if* they are correct, then wealth concentration would be increasing were it not for wealth transfer taxes. I want to reiterate my position that I do not believe that transfer taxes affect wealth concentration.

212 Verbit, *supra* note 2, at 602-04. Verbit uses a chart to indicate the "Share of Wealth Held by Richest 0.5 Percent of Population" in order to show that the major decline in wealth concentration occurred before estate tax collections became significant. *Id.* at 602.

213 *Id.* at 606.

214 *Id.* While the fall in revenue coincided with the Great Depression, it also resulted from revisions in the rate structure by then Secretary of the Treasury Andrew Mellon. *Id.*

215 *Id.*

216 *See* discussion *supra* notes 31-51 and accompanying text.

217 *Id.*

218 *See* discussion *supra* notes 23-30 and accompanying text.

219 I arrive at this figure by dividing $11 billion into $4.8 trillion (.00229).

the top wealthholder's wealth, that wealth concentration would be significantly different than it is today.

E. *The Federal Transfer Tax Fosters Dynamic Mobility And Helps Churn The Economy*

Some argue that the federal transfer tax system is worth keeping because it helps to churn the economy.[220] Proponents of this theory argue that the transfer tax system helps to make society more open to economic opportunity because it helps to prevent "economic status being determined from birth."[221] Thus, it gives those of modest means an incentive to become wealthy which, in turn, churns the economy.[222] Professor William Pedrick best summarizes this theory:

> Families that pay substantial transfer taxes may bring home to the inheriting generation that there is work to be done if the family fortune is to be restored. And opening new places on the Forbes honor roll should spur those whose goal is generation of great wealth. So the estate and gift tax can be seen as the handmaiden of the dynamic economy accelerating the "churning nature" of our economy.[223]

This theory overstates the deconcentration effect of the tax and misconstrues its incentives. First, transfer taxes do almost nothing to ensure that economic status is not determined at birth. As discussed above, empirical evidence shows that transfer taxes at best have a negligible effect on wealth concentration.[224] Thus, they cannot possibly open new places on the Forbes honor role. Second, the argument that heavily taxing wealth transfers creates a greater incentive for people to work hard and become wealthy is backwards. Families coming home to the inheriting generation with less wealth after substantial transfer taxes does not instill in their children the notion that one must work hard to keep one's wealth. Instead, it makes the children ask why one would work so hard if the fruits of one's labor will be taken away. Essentially, then, substantial transfer taxes create a disincentive to work, not an incentive.

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220 CAMPFIELD ET AL, *supra* note 6, at ¶ 1133 (quoting William Pedrick, *Through the Glass Darkly: Transfer Taxes Tomorrow*, 19 INST. ON EST. PLAN. ¶ 1902, ¶ 1903.1 (1985)).

221 *Id.*

222 *Id.*

223 *Id.*

224 *See* discussion *supra* notes 31-51 and accompanying text. This is not a controversial assertion.

F. Federal Transfer Taxes Are A Moral Obligation Of The Wealthy To Assist The Poor

Professor Pedrick also justifies the transfer tax system by arguing that it is morally imperative.[225] He argues that "there is a moral obligation on the affluent to assist the poor—through tax policies designed to carry out that obligation."[226] Pedrick cites to the First Draft of the U.S. Bishop's Pastoral Letter on Catholic Social Teaching and the U.S. Economy.[227] The Letter advocates a progressive tax system and argues that everyone has a "right to have a share of earthly goods sufficient for oneself and one's family" and that this "establishes a strong presumption against inequality of income or wealth as long as there are poor, hungry, and homeless people in our midst."[228] Pedrick concludes by rhetorically asking: "Do not accepted moral principles call for continuing and strengthening the death tax system?"[229]

No, they do not. While a moral obligation to help the poor clearly exists, it does not follow that transfer taxes fulfill that obligation. Even if the government should be legislating morality by redistributing wealth (and that is a debatable proposition), transfer taxes are an ineffective method of doing so. As shown above, transfer taxes not only do little to redistribute wealth, but they interfere with capital formation and therefore with job creation.[230] As Wagner's econometric model illustrated, repealing the transfer tax reform would most benefit the poor by creating more jobs.[231] If the government truly wants to meet a moral obligation to help the poor, then it need only step aside and let the free market work.

IV. CONCLUSION

The federal transfer tax should be repealed. The federal transfer tax does not raise significant amounts of revenue, does not decentralize wealth, does not redistribute wealth and is not cost-effective, horizontally or vertically equitable, economically neutral, nor simple. It interferes with capital formation and job creation. Furthermore, despite its proponents' impassioned arguments, it

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225 CAMPFIELD ET AL, *supra* note 6, at ¶ 1133 (quoting William Pedrick, *Through the Glass Darkly: Transfer Taxes Tomorrow*, 19 INST. ON EST. PLAN. ¶ 1902, ¶ 1903.2 (1985)).

226 *Id.*

227 *Id.*

228 *Id.*

229 *Id.*

230 *See* discussion *supra* notes 95-129 and accompanying text.

231 *Id.*

does not significantly increase progressivity in the tax system, it does not provide an important signaling effect, it does not churn the economy, and it is not morally imperative.

While some argue that America's debt crisis means that America cannot afford to repeal the tax, the truth is that America cannot afford to keep the tax. Econometric models show that the transfer tax costs America thousands of jobs, millions in capital creation, and billions in Gross Domestic Product. Furthermore, those models show that repealing the tax will actually *increase,* not decrease, federal revenues through increased capital and job creation. Even if one rejects that argument, the revenue can be replaced with fairer, simpler, and more economically neutral taxes. The tremendous direct and indirect costs that the tax imposes are not worth the relatively little revenue that it raises. America can no longer afford the federal transfer tax system and its deleterious effects.