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THE ESTATE TAX NON-GAP: WHY REPEAL A “VOLUNTARY” TAX?

Paul L. Caron* & James R. Repetti**

INTRODUCTION

Over thirty years ago, George Cooper wrote a seminal article arguing that the estate tax¹ at that time was largely voluntary.² Many academics still use the voluntary tax rhetoric even though Congress has closed many of the avoidance techniques that Cooper had identified.³ For example, Jeffrey Kinsler stated, “United States citizens are not required to pay estate and gift taxes! In fact, the only people who should pay such taxes are those wishing to donate money to the U.S. government.”⁴ Similarly, Edward McCaffery noted that “the system is so racked with exceptions, exemptions, and exclusions that hardly anyone actually pays any wealth transfer tax.”⁵ And J.D. Trout and Shahid Buttar pegged the effective estate tax rate at five percent in 1988, noting that “[u]ltimately, for political argument, if not scholarly publication, estate taxes can be considered ‘voluntary.’”⁶

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1. In this article, we use “estate tax” as a shorthand way to refer to the three federal wealth transfer taxes: the estate tax, gift tax, and generation-skipping tax.

2. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

3. See Daniel W. Matthews, *A Fight to the Death: Slaying the Estate Tax Repeal Hydra*, 28 WHITTIER L. REV. 663, 703 (2006) (“Repeal advocates often cite Cooper’s article for the proposition that the estate tax is voluntary.”).

4. Jeffrey S. Kinsler, *A Comparative Proposal to Reform the United States Gift Tax Annual Exclusion*, 30 VAND. J. TRANSNAT’L L. 951, 952 (1997).

5. Edward J. McCaffery, *Tax Policy Under a Hybrid Income Consumption Tax*, 70 TEX. L. REV. 1145, 1215 (1992).

6. J.D. Trout & Shahid A. Buttar, *Resurrecting “Death Taxes”: Inheritance, Redistributions, and the Science of Happiness*, 16 J.L. & POL. 765, 818 (2000); see also Mitchell M. Gans & Jay S. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759, 784 (2007) (“Currently, the valuation process saps the gift tax of its vitality and rele-

Yet this conventional wisdom that the estate tax is easily avoided today flies in the face of the nearly twenty-year political struggle over its repeal. Why have so many politicians, think tanks, and lobbyists devoted so much time, money, and effort to repealing a voluntary tax? As one of this Article's authors has previously noted:

Criticisms of the estate tax have often been contradictory and confusing. On the one hand, critics have argued that the wealth transfer tax raises little revenue, is easily avoided, and has no effect on concentrations of wealth. On the other hand, critics have argued that the transfer tax discourages savings and that payments of the estate tax financially burden family businesses. It is difficult to see how a tax that allegedly raises little revenue, is easily avoided, and has no effect on wealth concentration can at the same time impose a significant burden on savings and businesses.⁷

This Article argues that the voluntary tax metaphor is a rhetorical device that crumbles under scrutiny. The unprecedented repeal efforts over the past twenty years belie the notion that the estate tax is easily avoided. Indeed, many of the techniques described by Cooper simply no longer provide significant estate tax savings. The techniques that do work to lower the tax burden on an estate often do so by reducing the actual economic value of assets transferred to heirs. This Article also asserts that the voluntary tax metaphor has infected analysis of estate tax empirical data. We argue that commentators confuse the concept of the effective estate tax rate in examining the efficacy of the estate tax. When one correctly considers the effective estate rate, one finds that the estate tax imposes a significant burden on even the largest estates. Lastly, we analyze attempts to calculate the alleged estate tax "gap"—the tax liability that is not paid voluntarily and timely as a percentage of all revenues that should have been lawfully paid. Although such calculations are always difficult because of the lack of reliable data, we show that there are additional reasons to doubt studies that have reported a large estate tax gap. The studies have ignored the personal liability imposed on executors for unpaid estate taxes and the comparatively high estate tax audit rate. These factors suggest that the true estate gap may be small, a view that is corroborated by the IRS's audit results and one empirical study. We conclude that the estate tax is clearly not voluntary and is apparently more efficient than commonly thought in taxing transfers it was designed to reach.

I. ESTATE TAX RHETORIC: WHY REPEAL A "VOLUNTARY" TAX?

This Part briefly traces the history of the federal wealth transfer taxes and reviews the debate over whether the estate tax should be repealed. We conclude that rhetoric has replaced reason in this debate.

gates it to a largely voluntary tax.").

7. James R. Repetti, *The Case For the Estate Tax*, 86 TAX NOTES 1493, 1493 (2000).

The federal estate tax was enacted in its current form in 1916 to raise revenue during a time of war and to enhance the progressivity of the tax system.⁸ Soon thereafter, the estate tax came to be seen as an important tool to curb concentrations of wealth.⁹ For over seventy years, a rough consensus endured around the necessity for the tax, with intermittent skirmishes over the appropriate scope of the tax and its companion gift tax (enacted in its current form in 1932)¹⁰ and generation-skipping tax (enacted in its current form in 1986).¹¹

This estate tax consensus evaporated in the 1990s as disparate anti-tax advocates, initially from outside Washington, D.C. and later assisted by conservative think tanks and lobbyists, joined forces to turn large swaths of the public and Congress against the brilliantly re-cast “death tax.”¹² Although the tax affects less than two percent of decedents who die each year, a substantial majority of the public came to oppose the tax.¹³

But the anti-estate tax forces did not achieve total victory. In 1999,¹⁴ and 2000,¹⁵ Congressional votes to repeal the estate tax were overridden by President Clinton’s veto. President Bush endorsed estate tax repeal efforts in the 2000 campaign, and soon after assuming office in 2001 he signed tax legislation which increased the estate tax exemption amount and reduced rates through 2009,¹⁶ and then completely repealed estate and generation-skipping taxes (but not the gift tax) in 2010.¹⁷ Because of arcane Senate budget rules,¹⁸

8. Act of September 8, 1916, Pub. L. No. 64-271, 39 Stat. 756.

9. See, e.g., James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U. L. REV. 825, 825 (2001).

10. The gift tax was originally enacted in 1924 (Act of June 2, 1924, Pub. L. No. 68-176, 43 Stat. 253), repealed in 1926 (Act of February 26, 1926, Pub. L. No. 69-20, 44 Stat. 9), and re-enacted in its current form in 1932 (Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169).

11. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

12. MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* 13-14 (2005).

13. See, e.g., NAT’L PUB. RADIO ET AL., *NATIONAL SURVEY OF AMERICANS’ VIEWS ON TAXES* 15 (2003), <http://www.kff.org/kaiserpolls> (57% of respondents favored repeal of estate tax).

14. Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. (1st Sess. 1999).

15. Death Tax Elimination Act of 2000, H.R. 8, 106th Cong. (2d Sess. 2000).

16. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

17. The Act also replaced I.R.C. § 1014 (West 2009), which gives an heir who inherits property an income tax basis equal to the fair market value of the property at the date of the decedent’s death, with the new I.R.C. § 1022, which gives the heir an income tax basis equal to the decedent’s basis in the property. But this new carryover basis rule does not apply to the first \$1.3 million of appreciated property held at the decedent’s death, or to the first \$3 million of appreciated property passing to the decedent’s surviving spouse.

18. The Senate’s “Byrd Rule” requires a 60% majority to pass legislation that affects

the Act “sunsets” in 2011 and reinstates prior law, including the estate tax in effect in 2001. This budgetary sleight of hand allowed anti-tax forces to claim victory at having attained repeal (albeit for only one year) while mitigating the revenue loss by delaying the biggest increase in the exemption to 2009 and absorbing the full cost of repeal only for a single year (2010).¹⁹

Since the passage of the 2001 Act, annual congressional skirmishes over the estate tax have ensued between two camps: those who advocate complete repeal and those who wish to retain it in a revised form.²⁰ The House on several occasions has voted to make the estate tax repeal permanent,²¹ but the Senate has been unable to muster the sixty votes needed for passage.²²

Michael Graetz and Ian Shapiro examined how “such broad, diverse swaths of Congress and the voting public converge[d] to oppose a tax that only a tiny slice of the wealthiest Americans actually pay?”²³ Through a series of interviews of many of the participants they reveal the extent to which rhetoric has been shamelessly employed to promote repeal. Beginning in the early to mid-1990s, a loose coalition of anti-tax activists from outside Washington, D.C., with backing from eighteen wealthy families that contributed \$500 million,²⁴ began efforts to recast public opinion against the estate tax. Among the eighteen families were the Blethen (Seattle Times), Cox (Cox Enterprises), Dorrance (Campbell Soup), Gallo (E&J Gallo Winery), Johnson (Black Entertainment Television), Nordstrom (Nordstrom), and Walton (Wal-Mart) fami-

revenues beyond a ten-year period. Congressional Budget Act of 1974, § 313, 2 U.S.C. § 644 (West 2009). See also ROBERT KEITH, CONG. RESEARCH SERV., THE BUDGET RECONCILIATION PROCESS: THE SENATE’S “BYRD RULE” (RL 30862) (2008).

19. Budget rules permitted a total revenue loss of \$1.35 trillion in 2001-2010, and full estate tax repeal effective immediately would have absorbed from 1/3 to 1/2 of the amount available for all tax cuts. See Richard L. Schmalbeck, *Class War and the Estate Tax: Have the Troops Gone AWOL*, in LAW AND CLASS IN AMERICA 191 (Paul Carrington & Trina Jones eds., 2006).

20. See, e.g., Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 189 (2002) (footnotes omitted):

Virtually no one expects to see the estate tax in its current form spring back into force in 2011. Instead, the 2001 Act is best viewed as an unstable truce between two contending political camps: on one hand, the root-and-branch tax cutters who are determined to abolish the estate tax permanently, in several strokes if the goal cannot be achieved all at once; and on the other hand, skeptics who concede the need for estate tax reform but balk at outright repeal. Both camps have introduced bills staking out their respective positions, and the outcome of the battle over the future of the estate tax remains uncertain.

21. See, e.g., Permanent Death Tax Repeal Act of 2002, H.R. 2143, 107th Cong. (2d Sess. 2002); Death Tax Repeal Permanency Act of 2003, H.R. 8, 108th Cong. (1st Sess. 2003); Death Tax Repeal Permanency Act of 2005, H.R. 8, 109th Cong. (1st Sess. 2005)

22. See NONNA A. NOTO, CONG. RESEARCH SERV., ESTATE TAX LEGISLATION IN THE 110TH CONGRESS (RL 34374) (2008).

23. GRAETZ & SHAPIRO, *supra* note 12, at 253.

24. See SPENDING MILLIONS TO SAVE BILLIONS: THE CAMPAIGN OF THE SUPER WEALTHY TO KILL THE ESTATE TAX 1 (2006), <http://www.citizen.org/documents/EstateTax-Final.pdf>.

lies. Their success in mobilizing public sentiment against the estate tax was based in part on a series of studies from conservative think tanks purporting to show the deleterious effects of the estate tax.²⁵ But a more important element was the use of “myriad stories of estate tax trauma,”²⁶ to paint the “death tax” as an enemy of hard-working American families.

A succession of stories about small business owners, farmers, and others were publicized to illustrate the allegedly pernicious effects of the estate tax on core American values of thrift, hard work, entrepreneurship, and family.²⁷ Graetz and Shapiro painstakingly point out the inconsistencies, inaccuracies, and often outright lies in these stories.²⁸ Perhaps the most egregious example was the story of Chester Thigpen, an elderly grandchild of slaves whose Mississippi family tree farm was supposedly threatened by the estate tax but in fact was well under the threshold subject to the tax.²⁹

But the accuracy of the stories did not matter—the prevailing ethos was that the stories *could* have been true, so they deserved to be retold. The stories succeeded in painting estate tax repeal as a moral issue. Estate tax defenders failed to offer an effective response³⁰—initially incredulous at the mere possibility of estate tax repeal, they responded with ineffective dry, technical arguments.³¹ The result was that “[a]bsent contrary moral arguments or compelling personal stories, their scientific rationality had little allure for the public or their

25. Graetz and Shapiro credit WILLIAM BEACH, HERITAGE FOUNDATION, *THE CASE FOR REPEALING THE ESTATE TAX* (1996), <http://www.heritage.org/research/taxes/BG1091.cfm>, as laying the intellectual foundation for the repeal effort and for spawning dozens of additional think tank research papers over the ensuing decade. See GRAETZ & SHAPIRO, *supra* note 12, at 15, 94, 242.

26. Richard J. Kaplan, Book Review, 58 NAT'L TAX J. 831, 832 (2005).

27. Graetz and Shapiro dub these “stories from the grasstops” as opposed to the “grassroots.” GRAETZ & SHAPIRO, *supra* note 12, at 50.

28. *Id.* at 50-73.

29. *Id.* at 62-66.

30. *Id.* at 221-38 (Graetz and Shapiro nicely capture this ineffectiveness in the title of their chapter, “Stories Trump Science”).

31. Richard Kaplan asks, “[W]here were the counter-stories of spoiled brats inheriting outrageous sums and displaying no talent beyond self-indulgence? Curiously, Paris Hilton and her ilk never appeared as players in this drama.” Kaplan, *supra* note 26, at 834. Graetz and Shapiro noted that Ms. Hilton would serve as a potent symbol for the anti-repeal forces, and after the publication of the book she made frequent appearances in the public debate over estate tax repeal. GRAETZ & SHAPIRO, *supra* note 12, at 234; see, e.g., Jack Beatty, *Paris Hilton's Party: The Repeal of the Estate Tax and the Dawn of the United States of Aristocracy*, THE ATLANTIC, Apr. 29, 2005, available at <http://www.theatlantic.com/doc/200504/pp2005-04-29>; E.J. Dionne, *The Paris Hilton Tax Cut*, WASH. POST, Apr. 12, 2005, at A21; Editorial, *Paris Hiltonomics: The Estate Tax Made Her What She Is Today*, WALL ST. J., Apr. 17, 2005, at A12; see also Reginald Mombrun, *Let's Protect Our Economy and Democracy from Paris Hilton: The Case for Keeping the Estate Tax*, 33 OHIO N.U. L. REV. 61 (2007).

representatives in Washington.”³² Because their stories had succeeded in capturing the moral high ground,³³ the anti-tax advocates held out for full estate tax repeal and rejected offers of compromise to raise the exemption and lower the rates, even though most wealthy Americans (other than the super-rich) would have been better off with immediate reform rather than the future one-year repeal ultimately adopted.³⁴

Other commentators have also noted the increasing role of rhetoric in tax debates, which “seeks to persuade through bombast and confusion.”³⁵ Marjorie Kornhauser has criticized this trend, arguing that it undercuts democratic legitimacy.³⁶ Of course, the use of tax rhetoric divorced from reality did not originate in the estate tax repeal debate, but it may have reached its apogee there.

II. THE ESTATE TAX NON-GAP

Part of the estate tax repeal rhetoric embraced the notion that the tax is voluntary and easily avoided. Repeal proponents claim that the estate tax is voluntary by relying upon Cooper’s masterful, but dated, exegesis of estate planning devices employed in the middle of the twentieth century.³⁷ For example, Bruce Bartlett, a senior analyst with the National Center for Policy Analysis (“NCPA”), relied on Cooper’s article in declaring that “careful estate planning can virtually eliminate the tax.”³⁸

In this Part, we first refute estate tax opponents’ claims that simple estate planning techniques exist to easily circumvent the tax. We then examine effective estate tax rate calculations that show, contrary to the rhetoric, the tax ensnares even very large estates. Lastly, we analyze the widely disparate calculations of the estate tax “gap” and show that the low estimates of the gap are likely more accurate because commentators have ignored the personal liability

32. GRAETZ & SHAPIRO, *supra* note 12, at 234; *see also id.* at 238 (“What is surprising . . . is how little the Democratic political leadership seems to understand the political power of storytelling so long after Ronald Reagan turned it into an art form. George W. Bush pushed his proposals with his ‘tax families’ at his side. Democrats seem to be living in John Dewey’s fantasy world where science alone will move people to political action.”).

33. One of us has explored the power of stories to both explain and shape the development of the law. *See* TAX STORIES (Paul L. Caron ed., 2003).

34. GRAETZ & SHAPIRO, *supra* note 12, at 214-17.

35. Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 476 (1987).

36. Marjorie E. Kornhauser, *Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America*, 50 BUFF. L. REV. 819 (2002); Kornhauser, *supra* note 35; Marjorie E. Kornhauser, *The Rise of Rhetoric in Tax Reform Debate: An Example*, 70 TUL. L. REV. 2345 (1986); *see also* William Blatt, *The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy*, 51 TAX L. REV. 287 (1996).

37. Cooper, *supra* note 2.

38. Bruce Bartlett, *The End of the Estate Tax*, 76 TAX NOTES 105, 106-07 (1997).

of executors for unpaid taxes and comparatively high estate tax audit rate.

A. Estate Planning and the “Voluntary” Tax

Arguments that the estate tax can be easily avoided based on Cooper’s article are misplaced. Some of the estate planning devices discussed by Cooper are no longer available because of statutory changes.³⁹ For example, estate freezes that involve preferred stock recapitalizations can no longer transfer untaxed value to heirs by failing to make dividend payments on preferred stock held by the older generation.⁴⁰ Unless the preferred stock pays dividends, it is assigned a zero value, which means that the older generation is treated as having made a taxable transfer of all the value in the corporation. Similarly, qualified pension plans are no longer excluded from a decedent’s gross estate.⁴¹

Other devices such as minority discounts are still available that may enable taxpayers to reduce the value of assets for estate tax purposes. But these devices frequently entail a risk of real economic diminution in the value of assets transferred to heirs. In one technique, decedents may place property into family limited partnerships and transfer limited partnership interests to family members. Because such limited partnership interests do not usually permit participation in management, the value of the interest qualifies for a minority discount below the value of the underlying assets. The amount of the discount is calculated using a hypothetical buyer and seller dealing at arms-length. As a result, courts are not permitted to take into account the actual identity of the general partner who manages the family partnership. Thus, if the general partner is a relative of the limited partners and is solicitous of their interests, the court’s discount may be larger than reality would warrant. On the other hand, if the relationship among the general partner and limited partners becomes acrimonious, the discount may be smaller than the actual strained relationships would warrant. The result is that this is not a “sure fire” planning device. If the heirs holding partnership interests do not get along well, it is possible that the discount may be justified and in fact understate the diminished value of the property.

Planning with minority discounts will not create a risk of a real diminution in value, however, where the transfers are to a single person. For example, suppose that A decides to give all the shares in her corporation to one donee by

39. For an excellent detailed examination of Cooper’s estate planning devices, see Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, in RETHINKING ESTATE AND GIFT TAXATION 113 (William G. Gale, James R. Hines, Jr. & Joel Slemrod eds., 2001) [hereinafter RETHINKING ESTATES AND GIFT TAXATION].

40. PAUL R. MCDANIEL, JAMES R. REPETTI & PAUL L. CARON, FEDERAL WEALTH TRANSFER TAXATION 829-31 (5th ed. 2003) [hereinafter MCDANIEL, REPETTI & CARON].

41. *Id.* at 351-52.

transferring a portion of her shares each year for several years. Each transfer will qualify for a minority discount even though the donee will eventually hold a majority interest in the corporation at the time she is receiving the transfers.⁴² Moreover, there is no risk of a real diminution of value of the shares since the donee will not share control with others. But there are some tax risks associated with this strategy. If A dies before she has transferred a majority interest in her corporation, the shares she retains will be valued with a control premium. Moreover, A will have given up control of her business while she is still alive, something that many taxpayers find psychologically very difficult to do. If she seeks to retain de facto control after she has transferred the stock, the full value of the stock at the date of her death will be included in her gross estate.

Other devices, various forms of split interest trusts, also are not risk-free ways to transfer hidden value to heirs. For example, charitable lead trusts, discussed extensively by Cooper,⁴³ can be used to transfer value free of tax, but the circumstances in which that may occur are largely outside a decedent's control. A charitable lead trust involves the grantor transferring property in trust and then allocating the trust income interest to a charity and the trust remainder interest to an individual.⁴⁴ The value of the remainder interest, which is a taxable gift by the grantor to the individual at the time the trust is established, is determined by calculating the discounted present value of the interest paid to charity using a discount rate equal to 120% of interest rates (the "applicable federal rate" ("AFR")) published by the IRS pursuant to section 7520 of the Internal Revenue Code.

If the charitable organization's income interest is sufficiently high and is paid out for a sufficiently long period, the present value of the remainder interest will be zero and, therefore, no transfer tax will be owed. For example, consider a situation where 120% of the AFR used to value the interests in a charitable lead trust is 5.6%.⁴⁵ Suppose that the taxpayer contributes assets valued at \$1 million to a charitable lead trust that will pay 8.4375% of that amount to a charity every year for 20 years. In that case the remainder interest is assigned a value of zero, and no gift tax is due.

Some practitioners have described charitable lead trusts as "underused" estate planning devices.⁴⁶ We believe the reason for this underuse is that success in transferring untaxed wealth in a charitable lead trust is not certain. The re-

42. See, e.g., Internal Rev. Serv., Tech. Adv. Mem. 9432001 (Aug. 12, 1994). This technique is discussed in James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 431-34 (1995).

43. Cooper, *supra* note 2, at 207-10.

44. See MCDANIEL, REPETTI & CARON, *supra* note 40, at 582.

45. This example is from Martyn S. Babitz & Lisa Susanto, *Charitable Lead Trusts: A Useful, But Neglected, Planning Tool*, 34 EST. PLAN. 21, 22 (2007).

46. *Id.* at 25.

remainder person will receive property when the trust terminates only if the asset generates income (or appreciates in value) at a rate greater than 120% of the AFR. In the example above, if the asset only generates 5.6%, the remainder person will receive zero. If instead the asset generates a 7% return, that individual will receive \$410,704. A return of 10% would leave \$1,894,942 for the remainder person.

The charitable lead trust, therefore, entails a significant risk that the taxpayer will not pass any property to the remainder person.⁴⁷ The strategy works best when the AFR is low and taxpayer has assets that are likely to generate returns in excess of the applicable federal rate. At the time of Cooper's article, the interest rate used to value interests was arbitrarily fixed at 6%, which meant that value could be transferred to heirs untaxed so long as the asset generated a rate of return greater than 6%. During the 1980s, for example, when prevailing interest rates often exceeded 6%, the strategy was certain to transfer value to heirs. Currently, the AFR is adjusted every month in accordance with the interest rates on various federal debt obligations. The monthly adjustments track general market conditions and make it less certain that the assets will be able to generate a return greater than the AFR.

Other spit-interest trusts, which were commonly used prior to 1990, also permitted taxpayers to transfer value to heirs free of tax. Before the adoption of I.R.C. section 2702, taxpayers could make disguised transfers of wealth by retaining an income interest in property that they knew would not generate income, but the retained income interest was valued as though it paid income at the AFR.⁴⁸ Section 2702 eliminated this technique by valuing the retained interest at zero, unless income distributions are required regardless of whether the asset generates income.⁴⁹ The only exception is for "Qualified Personal Residence Trusts" ("QPRTs"). Special rules permit the value of an interest retained by a taxpayer in her principal residence and one other residence to be determined as though it generated income if certain qualifications are met.⁵⁰ But even QPRTs fail to eliminate all tax risk. If the value of the home declines, some or all the gift tax exemption used on creation of the trust to avoid gift tax liability will have been wasted. Moreover, if the grantor dies during the period of her retained interest, the fair market value at the date of her death will be included in her gross estate.

The result of these and other legislative changes since the publication of

47. See, e.g., CAROLYN M. OSTEN & MARTIN HALL, A MANUAL ON THE TAX ASPECTS OF CHARITABLE GIVING 366 (2d ed. 2000) ("It is important not to lose sight of the fact that a zero remainder may not only reflect the IRS calculation but also what is actually transferred to the family at the end of the lead term.").

48. MCDANIEL, REPETTI & CARON, *supra* note 40, at 834-38.

49. *Id.*

50. *Id.* at 838-39.

Cooper's article is that taxpayers now can reduce the value of assets subject to transfer tax in many instances only if they are willing to assume the risk that the reduction may be economically real and reduce the actual value of assets transferred to heirs or, alternatively, in narrow situations if they are willing to incur some tax risk.

B. *Effective Estate Tax Rates and the "Voluntary" Tax*

The current rhetoric about the voluntary nature of the estate tax has not been confined to confusion about the effectiveness of estate planning devices. It also has been employed to obfuscate the data. We explain below how the calculation of the effective estate tax rate reflects the rhetoric surrounding the estate tax debate.

In general, an effective tax rate is determined by dividing tax revenues by the tax base. The starting point for determining the estate tax base, the gross estate, represents the value of most interests in property held by the decedent at death. Several items are then subtracted from the gross estate to calculate the taxable estate. These items include expenses incurred in administering the estate, contributions to charities, and amounts left to the decedent's surviving spouse.

The reasons for such deductions vary. Because the estate tax seeks to tax items transferred by the decedent, Congress permits a deduction for the estate's expenses so that the tax is assessed only on amounts actually transferred to heirs.⁵¹ Congress enacted deductions for charitable bequests to encourage contributions to charity.⁵² The deduction for transfers to the surviving spouse (the marital deduction) reflects Congress's view that spouses should be treated as a single taxpaying unit, with estate tax deferred until the death of the surviving spouse. Viewed as a whole, the deductions evidence an intent of Congress to tax net transfers to recipients other than charities and spouses.

Proponents of repeal, in trying to make the estate tax appear as though it is easily avoided, calculate the effective rate by using the gross estate, not the taxable estate, in the denominator. For example, to support his assertion that the estate tax is voluntary, Bruce Bartlett stated that tax revenue collected in 1985 as a percentage of gross estates was 17.6% for gross estates between \$5-\$20 million, and 12.9% for estates over \$20 million.⁵³

But Bartlett's own calculations do not support his assertion that the tax

51. *Id.* at 515.

52. *Id.* at 558. For an excellent analysis of the role of a charitable deduction in the estate tax, see Miranda Perry Fleicher, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. 263 (2007).

53. Bartlett, *supra* note 38, at 106-08.

may be eliminated through simple planning. Estates with gross estates in excess of \$20 million still paid a significant tax in 1995 (12.9 % of their gross estates, according to Bartlett's calculation). In addition, Bartlett's calculations are misleading because he ignores the deductions from the gross estate that are permitted in calculating the taxable estate. He fails to mention that estates filing returns in 1995 with more than \$20 million in their gross estates reduced their estate tax liability by donating almost three times the percentage of their gross estates to charity than the smaller estates gave to charity: estates with \$5-\$10 million and \$10-\$20 million donated, respectively, 8.2% and 8.3% of their assets to charity, while gross estates in excess of \$20 million contributed 22.1% of their assets to charity.⁵⁴ In other words, large estates reduced their tax liability in 1995 by reducing the real value of assets that would pass to their heirs. This is hardly a clever estate planning device designed to pass more assets to heirs, but rather is an activity consistent with congressional intent for allowing the charitable deduction.⁵⁵

More recent data reflect a similar story. Set forth in Table 1 are the effective tax rates and charitable contributions for all estates reporting gross estates of \$5 million or more from 2002 through 2006.⁵⁶

54. According to data from the IRS, Internal Revenue Serv., SOI Tax Stats—Estate Tax Statistics, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html#2>, returns filed in 1995 for all gross estates with \$5-\$10 million assets reported \$11,653,648,000 in assets and contributed \$955,692,000 to charity (8.2% of the aggregate gross estate). Gross estates with \$10-\$20 million reported \$7,844,740,000 in assets and contributed \$652,453,000 to charity (8.3% of the total gross estate). Gross estates over \$20 million reported \$15,478,439,000 in assets and contributed \$3,419,253,000 to charity (22.1% of the gross estate).

55. Interestingly, there was little difference among the various size estates with respect to amounts bequeathed to the surviving spouse that qualified for the marital deduction. Estates with gross estates of \$5-\$10 million, \$10-\$20 million, and over \$20 million bequeathed, respectively, 36.36%, 40.64%, and 39.15% of their gross estates to the surviving spouse. Authors' calculations using data from IRS. *Id.* In general, we would expect larger gross estates to bequeath a greater percentage of the gross estate to the surviving spouse because the estate tax credit would shelter a proportionately smaller percentage of the larger estates. See MCDANIEL, REPETTI & CARON, *supra* note 40, at 698-99.

56. Authors' calculations using data from Internal Revenue Serv., *supra* note 54. As was the case with the 1995 data, *see supra* note 55, bequests to surviving spouses in the 2002-2006 data did not vary greatly with the size of the gross estate. For example, in 2002, estates with gross estates of \$5-\$10 million, \$10-\$20 million, and over \$20 million bequeathed, respectively, 39.24%, 40.63%, and 40.38% of their gross estates to the surviving spouse. The year with the greatest variation was 2003, in which estates with gross estates of \$5-\$10 million, \$10-\$20 million, and over \$20 million bequeathed, respectively, 36.56%, 39.88%, and 45.93% of their gross estates to the surviving spouse. As we discussed in *supra* note 55, we would expect larger estates to bequeath a greater percentage of the gross estate to the surviving spouse because the estate tax credit shelters a proportionately smaller percentage of the larger estates.

TABLE 1

| Year | Size of Gross Estate | Effective Estate Tax Rate (Revenue as % of Gross Estate) | Percent of Gross Estate Contributed to Charity |
|------|----------------------|--|--|
| 2002 | \$5 to 10 million | 16.64% | 7.40% |
| | \$10 to 20 million | 17.30% | 9.40% |
| | \$20+ million | 12.35% | 22.30% |
| 2003 | \$5 – 10 million | 16.69% | 6.67% |
| | \$10 – 20 million | 16.68% | 8.92% |
| | \$20+ million | 12.40% | 15.24% |
| 2004 | \$5 – 10 million | 16.76% | 6.76% |
| | \$10 – 20 million | 18.00% | 8.12% |
| | \$20+ million | 13.47% | 17.62% |
| 2005 | \$5 – 10 million | 15.99% | 7.03% |
| | \$10 – 20 million | 17.56% | 8.51% |
| | \$20+ million | 15.39% | 24.30% |
| 2006 | \$5 – 10 million | 15.23% | 6.05% |
| | \$10 – 20 million | 17.60% | 7.80% |
| | \$20+ million | 15.57% | 17.83% |

For 2002-2006, estates in excess of \$20 million generally had a slightly lower effective tax rate than smaller estates but also made much larger charitable contributions. The large estates made charitable contributions that, calculated as a percentage of gross estates, ranged from two to almost three times the contributions made by smaller estates. These calculations suggest that decedents with large estates are paying a lower effective tax rate because they are transferring a lower percentage of their assets to their heirs. In other words, large estates have a lower effective tax rate because, consistent with congressional intent, they make very large charitable contributions.

The failure to factor in charitable contributions raises a question about the use of effective tax rates to determine the efficacy of the estate tax. Bartlett and others calculate the effective rate by comparing revenues to the *gross estate*.⁵⁷ This approach in effect treats deductions allowed by Congress as part of the tax's ineffectiveness. A better perspective on the efficacy of the estate tax in achieving its policy goals is to compare revenues to the *taxable estate*, which excludes transfers that Congress has expressly determined not to tax. This approach suggests that large estates are generally paying a higher effective tax rate than smaller estates, after accounting for the deductions specifically autho-

57. See, e.g., JANE G. GRAVELLE, CONG. RESEARCH SERV., ESTATE AND GIFT TAXES: ECONOMIC ISSUES (RL 30600) (2007) (calculating estate tax burden by comparing tax revenue to net estate, defined as the gross estate less expenses).

rized by Congress. For the 1995 data used by Bartlett, we calculate effective tax rates of 36.48%, 40.14%, and 39.84% for estates with gross estates of \$5-\$10 million, \$10-\$20 million, and over \$20 million, respectively. For the years 2002 through 2006, the large estates in fact had a higher effective tax rate than smaller estates, as shown in Table 2.⁵⁸

TABLE 2

| Year | Size of Gross Estate | Effective Estate Tax Rate (Revenue as % of Taxable Estate) |
|------|----------------------|--|
| 2002 | \$5 – 10 million | 35.12% |
| | \$10 – 20 million | 39.50% |
| | \$20+ million | 39.91% |
| 2003 | \$5 – 10 million | 32.99% |
| | \$10 – 20 million | 36.95% |
| | \$20+ million | 38.06% |
| 2004 | \$5 – 10 million | 33.13% |
| | \$10 – 20 million | 38.00% |
| | \$20+ million | 39.95% |
| 2005 | \$5 – 10 million | 31.76% |
| | \$10 – 20 million | 38.84% |
| | \$20+ million | 42.94% |
| 2006 | \$5 – 10 million | 29.73% |
| | \$10 – 20 million | 38.06% |
| | \$20+ million | 43.99% |

Additional refinements are required for our calculations to capture accurately the effective estate tax rate. As discussed earlier, a common estate planning technique that may allow estates to transfer value to their heirs at a reduced tax rate is the minority discount.⁵⁹ It is very difficult to calculate the extent to which minority discounts are claimed on transfer tax returns. Barry Johnson, Jacob Mikow, and Martha Britton Eller analyzed 1998 estate tax returns and found that 6.3% of such returns claimed minority discounts, and that these discounts equaled 10.4% of the total assets reported on those returns.⁶⁰ The amount of the discount varied for different assets. They found that, on average, discounts of 36.3% were claimed for interests in limited partnerships and

58. Authors' calculations using data from Internal Revenue Serv., *supra* note 54.

59. See *supra* text accompanying note 42.

60. Barry W. Johnson, Jacob M. Mikow & Martha Britton Eller, *Elements of Federal Estate Taxation*, in RETHINKING ESTATES AND GIFT TAXATION, *supra* note 39, at 65.

29.8% for closely-held stock.⁶¹

Because of the lack of data, our calculations of effective tax rates do not take minority discounts into account. But Johnson, Mikow and Eller's conclusion that returns claiming a minority discount deducted on average 10.4% of all their assets confirms that such discounts are not eliminating the estate tax. Although it is possible that their estimates, which are dated, are lower than the amount of discounts currently claimed,⁶² discounts that are even twice as large would not eliminate the estate tax. Moreover, as noted earlier, some of the minority discounts may in fact be legitimate—that is, they may reflect a real decline in economic value transferred to heirs because of the shared control.

The same is true for the other devices for reducing value, split interest trusts, described above.⁶³ Data is not available showing the amount of transfer taxes avoided with the use of QPRTs, but in 2006, the largest estates (gross estates in excess of \$20 million) reported personal residences with a total value of \$1.45 billion, equaling 2.6% of the gross estate. Once again, the data belie the rhetorical claim that the estate tax is being eliminated for large estates.

C. *The Estate Tax Gap and the "Voluntary" Tax*

The current rhetoric about a voluntary estate tax has also affected the calculation of the estate tax "gap"—the tax liability that is not paid voluntarily and timely as a percentage of all revenues that should have been lawfully paid. Studies of the tax gap have varied significantly. A 1996 study by Edward N. Wolff reported a 76.8% estate tax gap.⁶⁴ His study estimated the amount of revenues that should have been collected by analyzing the 1992 Survey of Consumer Finance. In contrast, a 1997 study by James Poterba, using data from the 1995 Survey of Consumer Finance, estimates the tax gap to be less than 10%.⁶⁵ A

61. *Id.* A subsequent study that analyzed estate tax returns filed in 2000 also found that, on average, 30% discounts were claimed for closely held stock and 33% for limited partnership interests. CONG. BUDGET OFFICE, EFFECTS OF THE ESTATE TAX ON FARMS AND SMALL BUSINESSES 13 tbl.7 (2005).

62. *But see* Ted D. Englebrecht, Mary M. Anderson & Otto Martinson, *An Empirical Investigation of the Minority Interest and Marketability Discounts in Valuation of Closely Held Stock for Estate and Gift Tax Purposes*, 22 J. APPLIED BUS. RES. 89, 100-01 (2006) (reporting declining mean and median minority discounts applied by Tax Court to closely held stock in cases decided in three successive ten-year periods as, respectively, 21% and 17% in 1973-1982; 21% and 25% in 1983-1992; and 15% and 19% in 1993-2002).

63. *See supra* text accompanying notes 43-50.

64. Edward N. Wolff, *Commentary: The Uneasy Case for Abolishing the Estate Tax*, 51 TAX L. REV. 517, 521 (1996). He estimated that tax collections in 1993 should have been \$44.5 billion, while only \$10.3 billion had been collected. *Id.*

65. James Poterba, *The Estate Tax and After-Tax Investment Returns* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 3667, 1997).

subsequent study by Martha Britton Eller, Brian Erard, and Chih-Chin Ho reports that the significant variance between the Wolff and Poterba studies is attributable to assumptions about when individuals in the different data sets will die and how much of their wealth will be left as bequests to their spouses that qualify for the marital deduction.⁶⁶ They also report that an unpublished paper by Brian Erard, using data from completed IRS audits of 1992 estate tax returns, found the gap to be only 13%.⁶⁷

Eller, Erard and Ho argue that the 13% estate tax gap figure is low because it is based on tax revenues collected in settlement of the audits and, therefore, may not represent the full amount that should have been collected. (Apparently, they have little faith in the ability of the adversarial audit process to ascertain the correct liability.) Moreover, they assert that the audits could not capture tax revenues that escaped detection in the audit process.⁶⁸ They also contend that estate tax compliance is more problematic than income tax compliance because “a substantial portion of the income tax is subject to information reporting, withholding and document matching, [while] relatively little of the estate tax base is covered by these forms of independent verification.”⁶⁹

The most recent IRS and Treasury estimate of the tax gap is \$345 billion for the 2001 tax year.⁷⁰ Of this amount, \$8.1 billion is attributed to the estate tax—2.4% of the total tax gap.⁷¹ The \$8.1 billion estate tax gap translates into a 22.9% non-compliance rate for the estate tax, which is slightly larger than the noncompliance rate of the individual (20.9%) and corporate (18.5%) income taxes. The IRS classifies the certainty of its tax gap estimates in three categories—“actual amounts,” “reasonable estimates,” and “weaker estimates,” and places its estate tax gap estimate in the “weaker estimate” category. The IRS does not explain its calculation of the estate tax gap or the reasons for its low confidence level in its estimate.

66. Martha Britton Eller, Brian Erard & Chih-Chin Ho, *Noncompliance with the Federal Estate Tax*, in *RETHINKING ESTATE AND GIFT TAXATION*, *supra* note 39, at 380.

67. *Id.* at 385 (reporting results in Brian Erard, *Estate Tax Underreporting Gap Study: A Report Prepared for the Internal Revenue Service Economic Analysis and Modeling Group*, Order No. TIRNO-98-P-00406 (1999)).

68. *Id.*

69. *Id.* at 376.

70. INTERNAL REVENUE SERV. & U.S. TREAS. DEP'T, *REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE* 8 (2007); JAMES M. BICKLEY, CONG. RESEARCH SERV., *TAX GAP AND TAX ENFORCEMENT* (RL 33882) (2007); Internal Revenue Serv., *The Tax Gap*, <http://www.irs.gov/newsroom/article/0,id=158619,00.html>; *see also* U.S. TREAS. DEP'T, OFFICE OF TAX POLICY, *A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP* (2006); GOV'T ACCOUNTABILITY OFFICE, *TAX GAP: MULTIPLE STRATEGIES, BETTER COMPLIANCE DATA, AND LONG-TERM GOALS ARE NEEDED TO IMPROVE TAXPAYER COMPLIANCE* (GAO 06-208T, 2005).

71. The breakdown of the \$8.1 billion in estate tax noncompliance is \$2 billion nonfiling, \$4 billion underreporting, and \$2.1 billion underpayment.

What should one make of the wildly disparate estate tax gap estimates—76.8%, 22.9%, 13%, and 10%? We believe that the lower estate tax gap estimates may be justified for two reasons.

First, prior commentators on the estate tax gap may not have considered that the structure of the estate tax itself operates as a significant check on non-compliance. High estate tax thresholds and the personal liability of the estate's executor for unpaid taxes provide barriers to estate tax noncompliance that are not present in income tax noncompliance.⁷² An executor who hides value from, or claims excessive deductions on, an estate tax return and then distributes the estate's assets to heirs is personally liable for the estate's tax deficiencies. Consequently, there is a powerful disincentive to cheat unless the executor is the sole heir. If there are heirs in addition to the executor, she will incur potential liability for a benefit that she has not received.

Second, the disincentive to cheat on an estate tax return is especially strong given the comparatively high estate audit rate. In 1992, the IRS audited 19.2% of all estate tax returns,⁷³ compared to only 1.06% of all income tax returns.⁷⁴ The audit rate was even higher for larger estates: 26.5% for \$1-\$5 million estates and 48.6% for estates over \$5 million.⁷⁵ The overall estate tax audit rate for 2006 has decreased to 7.7% of all estate tax returns, and was 19.9% for estates over \$5 million,⁷⁶ due in part to reduced IRS staffing in the estate tax area.⁷⁷ In comparison, the overall income tax audit rate for returns filed in 2006 was 1.0%, and the audit rate was 2.0% for individuals with over \$200,000 in income and 9.3% for individuals with over \$1 million in income.⁷⁸

Given the high estate tax audit rates and the incentive for executors to be truthful where they are not the sole heir, we believe the lower estate tax gap estimates may be closer to the mark.

72. 31 U.S.C. § 3713 (2006) (imposing personal liability on the estate's executor for unpaid taxes due to the federal government); MCDANIEL, REPETTI & CARON, *supra* note 40, at 865-71.

73. Martha Britton Eller, *Audit Revaluation of Federal Estate Tax Returns, 1992*, 20 STAT. INCOME BULL. 100, 101 (2000).

74. TRANSACTIONAL RECORDS ACCESS CLEARINGHOUSE, IRS AUDIT RATES BY INDIVIDUAL AUDIT CLASS: NONBUSINESS AND BUSINESS RETURNS, FYS 1988 THROUGH 2001 (2002), available at <http://trac.syr.edu/tracirs/findings/national/ratesTab3.html>.

75. Eller, *supra* note 73, at 101.

76. INTERNAL REVENUE SERV. & U.S. TREAS. DEP'T, DATA BOOK 2007, at 23 tbl. 9 (2008), available at <http://www.irs.gov/pub/irs-soi/07databk.pdf>.

77. See David Cay Johnston, *I.R.S. to Cut Auditors*, N.Y. TIMES, July 23, 2006, at B1 ("The federal government is moving to eliminate the jobs of nearly half of the lawyers at the Internal Revenue Service who audit tax returns of some of the wealthiest Americans, specifically those who are subject to gift and estate taxes when they transfer parts of their fortunes to their children and others.").

78. INTERNAL REVENUE SERV., *supra* note 76, at 23 tbl.9.

CONCLUSION

Despite the accuracy of George Cooper's characterization thirty years ago, the evidence shows that the estate tax is clearly not voluntary today, unless one wishes to actually reduce the real value of assets transferred to heirs. Regardless of the methodology used to measure the effective estate tax rate, the estate tax imposes a significant burden on even the largest estates. Moreover, the lower range of estimates of the estate tax gap may be more accurate than higher estimates because of the personal liability of executors for estate tax deficiencies and the relatively high estate tax audit rate.

Only when we have an accurate view of the role that the estate tax currently plays can we make sensible decisions in charting its future. The incorrect notion that the estate tax is voluntary should not cloud analysis about its future.

