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SOCIAL CONTROL THROUGH TAXATION OF ESTATES AND TRUSTS

Percy W. Phillips

The foundation of taxation rests upon the necessity of the Government to obtain revenues for the exercise of its governmental functions. In its proper form, taxation should be a contribution or exaction from the citizens or their property for the purpose of producing the needed revenue, but as no tax can be levied without some effect upon both those who are taxed directly and those who ultimately bear its burden, the social and economic effect of any tax must necessarily be considered in its imposition. As taxes increase in amount, so do their social and economic repercussions until it often becomes a question whether a tax is levied to raise revenue or to accomplish some other purpose.

The control which may be exercised through taxation has always been a matter of the greatest concern. It received much consideration at the time of the framing of the Federal Constitution and is dealt with in practically every state constitution. The power to tax has been recognized as the power to destroy. It has not been lightly given and should not be lightly exercised.

Probably there has never been a time in the history of this nation when the social and business repercussions of taxes have been so heavy or as deserving of attention as at the present time. In an era of unrest and of consequent experimental, irresponsible, and poorly considered legislation, there is an increasing necessity for public interest and study to determine the effect of the taxing statutes upon the revenues, the necessity for and the desirability of the social or economic objectives sought to be accomplished, whether the legislation is accomplishing its purpose, and whether there may not be other effects more injurious than any benefits which may result.

Until comparatively recent years the field of taxation of estates passing by death was exercised only by the states. The Federal Government had invaded that field only to produce emergency revenues, to be abandoned as soon as the emergency had passed. In recent years the federal attitude has changed. It has not only entered this field for revenue and social reform purposes; it has preempted it to the extent of leaving the states with only slight discretion in the formation of any state policy. The first step in this direction was taken in the Revenue Act of 1924, when it was provided that inheritance or estate taxes levied by the states might be used as a credit to reduce the amount of the federal estate tax to the extent of 25% of the federal tax. The stated purpose of this provision was to require the states to impose taxes equal to the amount of the credit. In 1926, the amount of the federal credit for death taxes paid to the states was increased to 80% of the federal levy and has since remained at 80% of the tax levied under that statute. The natural effect has been to compel the states to exact from deceased residents the full amount of the credit. Since 1932, the federal levy has been increased by an "additional' estate tax which is superimposed upon that levied under the 1926 Act but no part of which may be offset by credit for any amount paid to the states. This tax is so high that the practical effect has been that few states care to impose any tax in excess of 80% of the federal estate tax under the Revenue Act of 1926.

After allowing an exemption of $50,000, the federal estate tax rises at progressive rates. At $1,000,000 the rate is 28% against which 6.4% may be taken as a credit for death taxes paid to the states. At $5,000,000 the federal rate is 50% and the credit for state taxes is 12%. At $10,000,000 the maximum federal rate of 60% is reached, of which 16% may be taken as a credit for state taxes.

The full effect of such substantial taxes has never been accurately measured, but some of the more obvious results have been observed. Since no man may devote his whole effort and fortune to building up a substantial business without the assurance that at his death it will have to be liquidated or sold to pay taxes, individual enterprise has been discouraged. Earnings which would normally be used in the business are withdrawn to buy life insurance, to buy marketable securities, or allowed to remain in cash, in anticipation of the date when an estate tax will have to be paid. Businesses have been incorporated and a market established for their securities. Family holdings have been divided even unto the third and fourth generations. For without foresight the present estate tax will, with one death or at most two successive deaths, completely obliterate the work and savings of several generations or the life efforts of any successful individual.

The estate tax has created a special hardship upon the individual or family type of business which is not easily liquidated or sold to pay taxes. The effort to escape the effect of business disintegration upon death by a division of the ownership of the business between members of the family by gifts *inter vivos,* brought the gift tax into existence as a supplement to the estate tax. The presence of the gift tax has undoubtedly decreased the splitting up of the family type of business but has by no means stopped it.

The existence of these high rates of estate and gift taxes has undoubtedly had its effect in increasing the number and duration of trusts. For example, if a decedent dies leaving his property to his children they will, in turn, pay an estate or gift tax upon the capital value thereof when they pass it on to their descendants. If, on the other hand, the decedent leaves his property in trust for one or more lives with remainder over, no estate or gift tax attaches during the duration of the trust or until the remainderman makes a transfer by gift or by death. The effect has been to increase the use of trusts postponing the ultimate disposition of property to the greatest extent permitted under the statutes of perpetuity of the various states. In fact some states have so amended their statutes as to permit substantial extensions of the time when an ultimate disposition of trust property, subject to estate tax, takes place.

Under the federal taxing statutes, trusts are taxed as individuals for the purpose of the income tax. The trustee is a taxable entity, who, under the ordinary trust, must report all profits or gains which are received as corpus and all income which, under the terms of the trust, is to be accumulated. The beneficiary of the trust reports as a part of his individual income any part which is distributed or distributable to him. The savings in income tax are such that the use of trusts providing for the accumulation of income during infancy, and beyond that time when the state law permits, are increasing. The normal effect is to place greater control of property in financial institutions which act as trustees of such trusts; and to turn over a substantial amount of wealth and control to young persons as they reach their majority which normally would have been retained in the hands of older and more experienced persons.

With estate taxes ranging to 60%, individual federal income taxes to 79%, with a federal tax on corporations which makes it impossible to build up a business by ploughing back the earnings, with all kinds of state taxes on business in addition to those of the Federal Government, no person or family may hope today to build up or retain any substantial fortune. Whether this is desirable or undesirable as a social accomplishment, its effect upon the business of the country may not be overlooked. It has served to discourage individual enterprise and risk, for there is less incentive to risk substantial sums where the Government takes the bulk of the profits and does not share losses. It has decreased the marketability of any business, for no one wishes to purchase any business which he or his executors may later have to sell or liquidate to pay taxes. It has driven money into tax exempt investments and out of business enterprise. It has increased the amount of money which remains idle in the banks and the demand for sound conservative bonds, even though the yield be low. It has encouraged the growth of corporate partnership and other multiple-interest forms of business as against individual ownership, especially in the case of a business of any substantial size. It has served to make the Government a substantial partner in every business and, if continued, threatens to reach the point where, to pay income and death taxes, many businesses will be forced into disastrous liquidation. It has served to take over for current expenditure by the Government, capital which normally would have been reinvested in building up the business of the country.

The avowed purpose of these taxes is not merely to raise revenues for strictly governmental purposes, but to shift the wealth of the nation from those who have to those who have not. It is pertinent to inquire, however, whether the result has been a shift of the wealth or its destruction by current expenditure. The real wealth of our country is represented by its land, natural deposits, buildings, foreign trade and industry of its citizens. May these be appropriated by government and expended to meet current needs, with inadequate provision for their replacement, without permanent and irreparable damage?

From what source will capital come in future years to carry on our present business and particularly, to permit the development of new fields of endeavor? With wealth largely confiscated and any growth discouraged, what is the source of future revenues for the State and Federal Governments? Has this nation reached the point where further growth is impossible; where it is necessary to expend all income and part of our capital in an unsuccessful effort to maintain our present standard of living? Or is it still possible, under a proper scheme of taxation and regulation, to encourage savings, investment, development, and employment, to the end that this country may be assured of further progress and a better standard of living for its people?