4-1-1982

The Estate and Gift Tax Changes of 1981: A Brief Essay on Historical Perspective

Edward A. Zelinsky

Follow this and additional works at: http://scholarship.law.unc.edu/ncl

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/ncl/vol60/iss4/4

This Comments is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
ESSAY

THE ESTATE AND GIFT TAX CHANGES OF 1981: A BRIEF ESSAY ON HISTORICAL PERSPECTIVE

Edward A. Zelinsky†

In 1981 Congress made several important changes in the federal estate and gift taxes: the annual gift tax exclusion was increased, an unlimited marital deduction was adopted, the unified credit was increased and the maximum tax rate was reduced. Some have characterized these changes as revolutionary and have predicted that they foreshadow the abolition of the federal transfer taxes. In this Essay, Professor Zelinsky argues that these changes, while significant, are not precedent-shattering and will not lead necessarily to the repeal of the transfer taxes. Professor Zelinsky demonstrates that the changes in the annual gift tax exclusion and the unified credit can be characterized as a reaction to inflation, that the unlimited marital deduction will result generally in the postponement rather than the avoidance of taxes and that the reduced tax rates are not at historically low levels. In fact, by reducing the percentage of the population that is affected by the taxes, the changes may limit the incentive of Congress to abolish the federal transfer taxes.

I. INTRODUCTION

The future of federal estate and gift taxation has become the subject of intense political and academic debate in recent years.1 This debate assumes increased significance as a result of the estate and gift tax changes adopted in the first session of the Ninety-seventh Congress.

As part of the Economic Recovery Tax Act of 1981 (ERTA),2 the Ninety-seventh Congress made four major changes in the federal transfer taxes.3 First, the annual gift tax exclusion was increased from $3,000 per donee to

† Associate Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. B.A. 1972, Yale College; J.D. 1975, Yale Law School; M.A. 1975, M. Phil. 1978, Yale University.


3. ERTA made changes in the federal estate and gift taxes in addition to the changes discussed in this Essay. See id. §§ 421-442 (codified in scattered sections of I.R.C.). While undoubt-
$10,000 per donee. Second, Congress adopted an unlimited marital deduction, removing all restrictions on the amount a taxpayer may give or bequeath to a surviving spouse free of federal transfer taxes. Third, the unified credit available to each taxpayer has been scheduled for increases over a five-year period, culminating in 1987 in an effective exemption from the federal estate tax of all taxable estates valued at less than $600,000. Finally, for taxable estates over $2,500,000, the maximum estate tax rate will be reduced over a three-year period, from seventy percent to fifty percent.

To one with even a cursory knowledge of the federal estate and gift levies, these changes appear to reduce radically the scope of transfer taxation by the federal government. For many supporters of the 1981 alterations, these changes represent the first step in an effort to abolish the federal estate and gift taxes altogether.

As part of the current debate about federal transfer taxation, an important historical observation must be made about the estate and gift tax changes adopted by the Ninety-seventh Congress: in the context of the sixty-five-year history of the federal estate tax, the 1981 changes, while significant, are not without precedent. The contemporary effort to abolish federal transfer taxation properly can trace its origins to the early part of this century. Continuously since then, there have been opponents of federal estate and gift taxation. They have consistently argued, with varying degrees of success, that federal transfer taxation is unfair, that it destroys family enterprises and that it creates disincentives for savings and investment. Opponents of the federal estate and gift levies at times have occupied positions of influence in the federal government and have succeeded in mitigating the perceived harshness of the federal transfer taxes. We are now in such a phase: the estate and gift taxes are being restricted, their coverage lessened and their impact reduced.

Some opponents of the federal estate and gift taxes believe that the 1981 changes make repeal of these taxes inevitable. Some supporters of federal transfer taxation fear that this may be correct. I suggest that both sides be more circumspect. The estate and gift tax changes made by the Ninety-seventh Congress are not as revolutionary as either their sponsors or their opponents predict; in particular contexts and to particular groups, in my judgment these additional changes do not raise the broad, theoretical questions discussed herein.

4. The term "transfer taxes" is used in this Essay to refer jointly to the federal estate and gift taxes.

5. I.R.C. § 2503(b) (West Supp. 1981), as amended by ERTA, supra note 2, § 441(a).

6. See id. § 2056 (1976) (prior to repeal by ERTA, supra note 2, § 403(a)). See also id. § 2523(a) (West Supp. 1981), as amended by ERTA, supra, § 403(b).

7. Id. § 2010 (West Supp. 1981), as amended by ERTA, supra note 2, § 401(a). The increased unified credit may be used against the gift tax while the taxpayer is still alive. Id. § 2505(a); (b), as amended by ERTA, supra, § 401(b).

8. Id. § 2001(e)(2), as amended by ERTA, supra note 2, § 402(a), (b).

9. See references cited at note 1 supra.

10. See R. Paul, Taxation in the United States 134-40, 156-58, 380 (1954). The opponents of federal transfer taxation have attempted at times to mitigate the effects of such taxation by perpetuating avoidance techniques permitted by statute. Id. at 615-17.
ments would have us believe. In some respects the 1981 changes actually make further alterations of the estate and gift taxes less likely.

As a modest contribution to the continuing debate about federal transfer taxation, I will review in historical context the estate and gift tax changes made by the Ninety-seventh Congress. With the benefit of historical perspective, the 1981 changes do not look like precedent-shattering alterations of the federal transfer taxes. Rather, they appear to be only the current chapter of a long and continuing battle over the propriety of inherited wealth in American society.

II. THE ANNUAL EXCLUSION

The annual gift tax exclusion allows each taxpayer to give to others relatively small amounts on a yearly basis without transfer tax consequences.11 There is no limit to the number of donees with respect to which a taxpayer may utilize the annual exclusion or to the number of years in which the exclusion may be used. A grandfather, for example, every year may give money qualifying for the annual exclusion to each of his grandchildren regardless of their number.12

Until 1982 the exclusion permitted each taxpayer to give up to $3,000 per donee, free of all federal gift tax.13 The $3,000 annual exclusion, established in 1942, was designed to remove from the purview of the gift tax routine conveyances for weddings, holiday presents and other transfers "of relatively small amounts."14 In 1942 an exclusion of $3,000 per donee may have satisfied this purpose admirably. In that year annual board and room fees at Yale College were approximately $500.15 In the absence of the annual exclusion, the payment by a parent of this amount would have been a taxable gift.16 Thus, in its time the $3,000 exclusion guaranteed that the educational and similar payments by a typical professional family to or on behalf of its children had no gift tax implications.

If the $3,000 figure was satisfactory for this purpose in 1942,17 it obviously was outdated in 1981. In that year, annual board and room at Yale College cost $3,190.18 Technically, the payment of that amount by a parent in 1981

11. See I.R.C. § 2503(b) (1976) (prior to amendment from $3,000 to $10,000 by ERTA, supra note 2, § 441(b)).
13. I.R.C. § 2503(b) (1976) (prior to amendment by ERTA, supra note 2, § 441(b)).
16. See, e.g., Newman v. Commissioner, 222 F.2d 131, 133 (9th Cir. 1955); Commissioner v. Greene, 119 F.2d 383, 384 (9th Cir. 1941).
was a gift to the extent of $190. Expenditures for books, transportation and clothing, to continue the example, constituted additional gifts.

As a practical matter the Internal Revenue Service (IRS) rarely has assessed gift taxes for educational or similar routine transfers. Nevertheless, such transfers technically are gifts for purposes of the federal gift tax. The increase of the annual exclusion from $3,000 per donee to $10,000 per donee thus may be viewed as an updating of the 1942 figure to reflect current prices and living standards.

There is yet another sense in which the institution of a $10,000 annual exclusion is less revolutionary than first appears. Historically, the federal gift tax has been a junior partner of the estate tax—and a very junior partner at that. Until 1976 the gift tax rates were substantially lower than the estate tax rates. Moreover, prior to 1976 the federal estate tax rates were calculated without regard to a decedent's lifetime gifts. A wealthy individual could make gifts during his life, pay a relatively small gift tax to the federal government and thereby remove property from his estate. Thus, the gift levy, conceived as a complement to the estate tax, became a back route around the estate levy. Before 1976 lifetime gifts were a common technique for the avoidance of federal estate taxes.

In 1976 Congress strengthened the gift tax significantly. The gift tax rates were made equal to those of the federal estate tax. More important, the estate tax rates were restructured so that an individual's inter vivos transfers, to the extent not qualifying for the annual exclusion, increase the federal tax subsequently payable on his estate. The effect of the 1976 changes was to diminish substantially the taxes avoidable through lifetime transfers.

The Ninety-seventh Congress, through the increase of the annual exclusion, has restored the tax advantages of lifetime gifts to a significant extent. The estate and gift tax rates remain as adopted in 1976. However, the expansion of the annual exclusion allows a taxpayer and spouse to remove substantial amounts from their estates without incurring a federal gift tax and without increasing the estate tax ultimately due on their estates. Starting in 1982 a married couple may give $20,000 per year to each of their children, or a grandmother and grandfather may give $20,000 per year to each of their grandchildren.

20. Moreover, ERTA exempts tuition and medical outlays from the $10,000 limit. I.R.C. § 2503(e) (West Supp. 1981), as amended by ERTA, supra note 2, § 441(b). Hence, the education costs covered by the $10,000 annual exclusion are board, room, transportation, books, clothing, supplies and other non tuition outlays.
25. See id. § 2001(b).
Over the course of several years, systematic gifts on this order can remove substantial amounts from the donor's taxable estate.

In short, the historical significance of the annual exclusion depends upon the base from which the increase is viewed. In comparison to the situation that prevailed from 1976 to 1981, the increase of the annual exclusion is indeed a significant change, restoring at least partially the tax advantages of inter vivos gifts. From the perspective of the years 1943 through 1976, the increase of the annual exclusion appears to be a return to the junior status that the gift tax enjoyed during those years and a restoration of the tax advantages of inter vivos transfers. From the perspective of 1982, the increase of the annual exclusion looks like an overdue adjustment for inflation between 1942 and 1981.

III. THE UNLIMITED MARITAL DEDUCTION

The original purpose of the estate tax marital deduction was to equalize the treatment of surviving spouses in common-law property states with the estate tax treatments of widows and widowers residing in community property jurisdictions. From this perspective the unlimited marital deduction adopted by the Ninety-seventh Congress is indeed a revolutionary development. Today, the marital deduction no longer ensures a widow in a common-law jurisdiction the same estate tax burden as her community property counterpart. Rather, the marital deduction guarantees that neither need confront anything resembling a federal estate tax.

Before characterizing the unlimited marital deduction, however, it is useful to recall where this change originated. One influential source was a 1969 Treasury Department study that, while proposing the unlimited estate tax marital deduction, simultaneously advanced several of the reforms mentioned earlier, aimed at strengthening the gift tax. This background suggests that the implications of the unlimited marital deduction may be more complicated than first appear.

It must be remembered that the marital deduction does not forgive federal estate taxes: it generally postpones them until the subsequent death of the surviving spouse. A bequest or devise to a surviving spouse usually qualifies for the marital deduction only if such bequest or devise takes a form that ensures that the property bequeathed or devised will be taxed on the subsequent death of the surviving spouse.

29. This is accomplished through (1) the so-called "terminable interest rule" of I.R.C. § 2056(b) (West Supp. 1981), as amended by ERTA, supra note 2, § 403(d)(1) and (2) I.R.C. § 2044 (West Supp. 1981), added by ERTA, supra, § 403(d)(3)(A)(i).
The deferral of tax until the death of the surviving spouse is, of course, economically advantageous from the taxpayer’s perspective. If the estate of the surviving spouse is in a lower estate tax bracket than the estate of the first spouse to die, the marital deduction is beneficial to the ultimate recipients of the property eligible for the marital deduction.

As a general rule, however, the marital deduction does not remove property from the purview of the federal estate tax but rather shifts taxation from the time of the first spouse’s demise to the subsequent death of the surviving spouse. Insofar as the marital deduction affects the timing of taxability rather than taxability itself, removing limits from the deduction is less than revolutionary.

There is yet another sense in which the establishment of an unlimited marital deduction is less than momentous in its implications: proper estate planning often dictates forfeiture of part or all of the marital deduction. Typically, this will be the case when the estate of one spouse is substantially larger than that of the other spouse.

Let us assume, for example, a family in which the husband’s taxable estate is valued in 1987 at $750,000 and the wife’s taxable estate is valued at $2,500,000. In his estate plan our hypothetical husband can leave his entire estate to his wife. Because of the unlimited marital deduction, the husband’s estate will have no federal estate tax liability. A moment’s reflection, however, indicates that this is not a wise course of action. On the wife’s subsequent death the $750,000 that belonged to her husband will be added to, and taxed in, the wife’s estate, generating additional estate taxes of $375,000.30

Now let us assume that the husband’s estate plan eschews the marital deduction entirely and instead gives the wife a lifetime income interest in her husband’s assets. These assets will be taxable in the husband’s estate but not includable in the wife’s estate because a lifetime income interest from husband to wife (or vice versa) does not generate the marital deduction for the husband’s estate nor does it affect the wife’s estate.31 Under these circumstances the total federal estate tax attributable to the husband’s assets is $55,500.32 On the wife’s subsequent death no further taxes will be generated by the assets originally belonging to her husband. Hence, on these facts there is a federal estate savings of $319,500 realized by not using the marital deduction in the husband’s estate plan.

In summary, the unlimited marital deduction may be less than revolutionary in its implications. Since property eligible for the marital deduction is taxed on the subsequent death of the surviving spouse, expanding the marital

---

30. Starting in 1985, taxable estates in excess of $2,500,000 will be taxed at a marginal rate of 50%. I.R.C. § 2001(c) (West Supp. 1981), as amended by ERTA, supra note 2, § 402(a)-(b).

31. See id. § 2033 (1976). See also Dauphin Dep. Trust Co. v. McGinnis, 324 F.2d 458 (3d Cir. 1963); Frazier v. United States, 322 F.2d 221 (5th Cir. 1963).

32. In 1987 a taxable estate of $750,000 will generate federal estate taxes of $55,500 after the application of the unified credit, assuming that the unified credit is fully available to the decedent’s estate. See I.R.C. § 2001(c) (West Supp. 1981), as amended by ERTA, supra note 2, § 402(a)-(b); id. § 2010(a), as amended by ERTA, supra, § 401(a).
deduction in large measure increases the amount of estate tax that can be deferred, not the amount ultimately paid. Moreover, in many situations estate planners have used and will continue to use less than all of the marital deduction available.

IV. THE INCREASE OF THE UNIFIED CREDIT AND THE REDUCTION OF THE ESTATE TAX RATES

The increase of the unified credit and the reduction of the maximum federal estate tax rates33 force us to confront the fundamental question of federal transfer taxation: how extensive ought to be the coverage and impact of the federal estate levy?

The unified credit is today the means by which Congress exempts the bulk of estates from the federal estate tax. In 1981 the unified credit ensured that only taxable estates in excess of $175,625 paid federal estate taxes.34 By virtue of the actions of the Ninety-seventh Congress, increases in the unified credit gradually will enlarge the size of the maximum estate exempt from federal tax: by 1987, because of the unified credit, taxable estates of less than $600,000 will pay no federal transfer taxes.35

The Ninety-seventh Congress also reduced significantly the rates for estates exceeding $2,500,000. Prior to the Economic Recovery Tax Act of 1981, taxable estates over $2,500,000 were taxed at marginal rates from fifty-three percent to seventy percent.36 By 1985 the maximum rate will have been reduced for such estates to fifty percent.37

An important preliminary observation is that we do not know the value of the 1987 unified credit in terms of 1982 dollars. If the rate of inflation is zero between now and 1987, the ultimate increase of the unified credit will exempt from federal taxation estates that are in real terms almost three and one-half times greater than the largest exempt estate in 1981.38 On the other hand, if inflation averages ten percent annually between now and 1987, the ultimate unified credit will immunize from the federal estate levy estates that are, in real terms, approximately twice the size of the largest exempt estate in 1981.39 Thus, while the scheduled increase of the unified credit is substantial, the magnitude of that increase in real terms is something that we probably will not know until 1987.

33. Because the estate tax rates also are used for the gift tax, id. § 2502(a) (West Supp. 1981), as amended by ERTA, supra note 2, § 442(a), the rate reduction mandated by ERTA applies to the gift tax as well.
35. Id.
37. Id. § 2001(c) (West Supp. 1981), as amended by ERTA, supra note 2, § 402(a)-(b).
38. That is to say, $600,000 is nearly three and one-half times $175,625.
39. Assuming a ten percent rate of inflation, compounded annually, $600,000 in 1987 dollars would be worth $338,684 in 1982 dollars.
For purposes of this discussion, let us acknowledge that the scheduled increases of the unified credit exempt from federal taxation many previously-taxable estates. Let us further acknowledge that the decrease of the maximum estate tax rate from seventy percent to fifty percent reflects a significant mitigation of federal transfer taxation from prior levels. I shall leave to others the issue whether these changes are warranted as a matter of policy. Whether these changes create an unprecedented situation is a question I will address and answer in the negative.

Historically, the opponents and proponents of federal estate taxation have fought over the proper coverage and rates of the tax.\[40\] Each side at different times has exerted the upper hand. Those who would expand the coverage and impact of the tax have had an important but silent ally, inflation. Prior to 1977 inflation subjected to federal transfer taxation many previously-exempt estates because the rates and exemptions of the tax had not been altered between 1942 and 1976.\[41\]

The history of the tax, however, is not one-sided. During the 1920s opponents of the estate tax managed to restrict its coverage to a significant degree. At one point they succeeded in abolishing the gift tax altogether.\[42\] Only in 1932 did proponents of federal estate taxation establish rates of any significance.\[43\]

In short, the increase of the unified credit looks different depending upon the base year from which one looks. In retrospect, 1977 was something of a high water mark. Over seven percent of all estates paid federal estate tax in that year; the coverage of the federal estate tax has never been broader.\[44\] If one measures the unified credit adopted by the Ninety-seventh Congress against this standard, one indeed would conclude that the scope of the federal estate tax has been restricted significantly.

Let us suppose, however, that the relevant year for comparison is 1981, a year in which it is estimated that under three percent of all decedents' estates incurred federal estate tax liability.\[45\] Against this background the unified credit adopted by the Ninety-seventh Congress appears to be a refinement of the actions of the Ninety-fourth Congress, the Congress that introduced the unified credit and thereby reduced the scope of the federal estate tax from its high point in 1977. And if the relevant year of comparison is 1935 or 1940, the increase of the unified credit by the Ninety-seventh Congress looks like a restoration of the estate tax to its historic level of coverage.\[46\]

\[44\] See id. at 18. It must be remembered that the bulk of estate tax returns in 1977 reflected deaths in 1976, that is, prior to the effective date of the Tax Reform Act of 1976 and the institution of the unified credit. See I.R.C. § 6075(a) (1976); TRA, supra note 21, § 2001(d).
\[45\] Tax’n Comm., supra note 41, at 18.
\[46\] See id.
Similarly, the reduction of the maximum estate tax rate from seventy percent to fifty percent can be viewed from a number of historical perspectives. Prior to the Revenue Act of 1934, the highest federal estate tax bracket never exceeded forty-five percent; for part of this period, the maximum rates were as low as ten and twenty-five percent. Against this background a fifty percent maximum rate looks fairly high.

On the other hand, if the projected 1985 rates are measured against the 1981 rates, it appears that the impact of the estate tax has been reduced significantly by the Ninety-seventh Congress. If in 1981 a decedent left a taxable estate of ten million dollars, the resulting federal tax liability was $6,050,800 prior to the application of the unified credit. In 1985 a ten-million-dollar estate will incur $1,275,000 less in federal transfer taxes because of the reduction of the highest rates.

V. CONCLUDING OBSERVATIONS

It is too early to determine the ultimate implications of the estate and gift tax changes adopted by the Ninety-seventh Congress. The history of federal transfer taxation is a complex one, reflecting the ebb and flow of differing attitudes towards inherited wealth. It is undeniable that the opponents of the estate and gift levies have for the moment established the upper hand. It is premature, however, to conclude that the abolition of federal taxation is upon us.

American society always has been of two minds on the subject of transfer taxation. One current of thought, exemplified by the early proponents of a federal estate tax, has viewed inherited wealth as an evil to be combated by a democratic society through taxation. A contrary strain of opinion has viewed the accumulation and transmission of wealth as a necessary incentive for production and savings. From the latter perspective estate and gift taxation retards economic growth by diminishing the rewards for productive behavior.

The ebb and flow of these contradictory pulses has shaped the system of federal transfer taxation as we know it today. Indeed, at times these two impulses have manifested themselves simultaneously. For example, while the Ninety-fourth Congress reduced the scope of the federal transfer taxes, it introduced the unified credit into the tax law and thereby increased the number of estates exempt from the federal estate levy. Simultaneously, the Congress strengthened the federal system of transfer taxation in other respects by fortifying the gift tax and supplementing the estate and gift taxes to address gener-

47. Id. at 14-15.
49. See id. § 2001(c) (West Supp. 1981), as amended by ERTA, supra note 2, § 401(a)-(b). The 1985 estate also will incur lower estate tax liability because of the increase of the unified credit. Id. § 2010(b), as amended by ERTA, supra, § 401(a)(2)(A).
51. For one journalist's characterization of this view, see Kinsley, supra note 1. See also Tulley, supra note 1.
In a curious way the actions of the Ninety-seventh Congress may limit the incentive of future Congresses to abolish or restrict further the federal transfer taxes. Since there will be fewer taxable estates following ERTA, the potential constituency for abolition of the estate tax has been diminished in number. Because the final increase in the unified credit will not be effective until 1987, Congress has an excuse for not legislating further until then. It is not easy for Congress to pass tax legislation. With estate and gift tax relief occurring automatically over the next five years, Congress may choose to turn its attention to other matters.

Most important, the status of inherited wealth in a democratic society is a matter about which Americans traditionally have harbored fierce and contradictory attitudes. A Congressman may view constituents worth $200,000 as inappropriate candidates for the federal estate tax, as their wealth may reflect nothing more than long-term ownership of houses in major metropolitan areas. That same Congressman, however, may feel differently about taxpayers with assets of $700,000 or $7,000,000.

The opponents and proponents of the federal transfer taxes generally agree that these levies are aimed at the country’s economic elite. The principal disagreements have been, and likely will remain, the definition of that elite and the effects of taxation upon it.

In short, we do not know yet the ultimate consequences of the estate and gift tax changes made by the Ninety-seventh Congress because these consequences are yet to be determined. By focusing the federal estate and gift levies upon a wealthier, more restricted economic elite, the Ninety-seventh Congress, with unintentional clarity, has defined the future of the federal transfer taxes in essentially populist terms, that is, the propriety of large inheritances in a democratic society. Until America resolves its ambivalent attitude toward inherited wealth, it will not resolve its ambivalent attitude toward federal transfer taxation.

52. These changes were all part of the Tax Reform Act of 1976, supra note 21.