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History of the Estate Tax

For over 200 years, estate and gift taxes have served as a source of revenue for the United States federal government. Throughout this time, as political partisanships and economic climates have changed, laws surrounding estate and gift taxation have transformed.

Proponents of the estate tax contend that these taxes are a necessary source of federal funding as well as a means to prevent the concentration of extreme wealth in the hands of a few powerful families. Those against the estate tax, on the other hand, are concerned that the tax discourages business activity and capital accumulation and penalizes successful individuals. Given these conflicting views, different political and economic environments have led to numerous revisions of the law, which was originally enacted in 1797.

When looking at the historical and current "estate tax" system, it is important to consider several distinct types of transfer taxes:

1. **Estate tax:** tax on the transfer of property at death.
2. **Gift tax:** tax on the transfer of property during life.
3. **Inheritance tax:** tax on the receipt of property from a decedent by a particular beneficiary.
4. **Generation-skipping transfer tax (GST):** tax on the transfer of property (during life or at death) between a transferor and a beneficiary who is more than one generation removed from that transferor.

Historical Context – The 18th and 19th Century

The earliest estate and inheritance taxes were principally enacted to provide a source of funding to cover war-related expenses. As the timeline on Page 5 reveals, revenue generated from 18th and 19th century estate tax systems helped cover expenses related to events such as the Civil War and the Spanish-American War. Once those crises or wars were resolved and there was no longer a need for extra revenue, the estate tax would then be repealed.

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Modern Estate Taxes – The 20th Century and Today

ESTATE TAXES AND AN INDUSTRIALIZING AMERICA

During the latter part of the 19th century and into the 20th century, America experienced a systemic change to its economy as the country shifted from an agrarian economy to an industrialized one. During this period, the existing taxation regimes tended to disproportionately favor industrialists. This, coupled with unprecedented business development and new corporate ownership laws, resulted in the accumulation and concentration of substantial wealth in the hands of a few powerful individuals. To combat these growing inequalities, the 16th Amendment was ratified, which enacted the federal income tax.

Shortly thereafter, the first modern estate tax was enacted in 1916 through the Revenue Act of 1916 in response to World War I. The estate tax at that time carried a $50,000 exemption and saw rates ranging from 1% to 10%.

INTRODUCTION OF THE GIFT TAX AND ENACTMENT OF THE MARITAL DEDUCTION

During this time, individuals could circumvent paying the estate tax by transferring assets away during life. In 1924, Congress closed this loophole by enacting a gift tax. The gift tax was later made permanent by legislation in 1932. Also during the 1930's, an optional valuation date election was introduced, allowing a decedent's estate to be valued for estate tax purposes one year after his or her death.

In 1948, key estate tax legislation was enacted that introduced the marital deduction for the first time. In its earliest form, the martial deduction allowed spouses to transfer one-half of their adjusted gross estate to their spouse; today, it allows spouses to transfer 100% of property to one another without incurring an immediate tax liability.

ESTATE TAX REFORM – 1976 TO 1999

After the 1930s and 1940s, there was a period of stability in the estate tax system. The next major overhaul of the system did not occur until 1976 when the Tax Reform Act (TRA) of 1976 was passed. Before the TRA, gifts made during life enjoyed lower tax rates, effectively making it more costly to transfer property upon death. The TRA collapsed the estate and gift tax systems into one—imposing a single graduated rate of tax on lifetime and testamentary transfers and combining the gift and estate tax exclusions into one "unified credit." Along with decreasing the top tax rates, TRA also created the generation-skipping transfer tax (GST).

Key changes to the estate tax came next in 1981 with the passage of The Economic Recovery Tax Act (ERTA). ERTA expanded the marital deduction by allowing a deduction on transfers where the surviving spouse's interest was not "terminable" (i.e, interest in property could expire due to the passage of time, or due to the occurrence of some future event or failure of an event to occur) so long as the property was "qualified terminable interest property" (QTIP). The Act also increased the unified credit.

In 1997, the Taxpayer Relief Act was passed. This act brought an incremental increase in the unified credit, created a family business deduction, and introduced inflation indexing for thresholds and limits such as the annual gift tax exclusion.

ESTATE TAX OVERHAUL – EGTRRA AND 2010 REPEAL

The most notable changes to the estate tax system in modern times came under the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001. EGTRRA provided for gradual increases in the estate tax exemption amount from $1MM in 2002 to its maximum exemption of $3.5MM in 2009. On January 1, 2010, EGTRRA repealed the estate tax for one year.

In December 2010, Congress passed the 2010 Tax Act, which retroactively reinstated the estate and GST tax for 2010. However, for decedents dying in 2010, their executors had the choice between: (1) applying the federal estate tax reinstated by the 2010 Tax Act and receiving a step-up of the basis of estate assets to the value on the date of death, or (2) electing no estate tax but taking a "modified carryover basis."

Generally speaking, assets receive a step-up in basis to their current fair market value upon the death of a decedent. However, under the modified carryover basis rules available only upon election by the estates of individuals who passed away in 2010, a recipient of property owned by the decedent received a basis equal to the lower of the decedent's adjusted basis or the fair market value at the date of the decedent's death. Under the "modified carryover basis" rules, each estate could allocate up to $1.3MM in basis step-up for assets held in the estate, with an additional $3MM basis increase allowed for assets transferring to a surviving spouse or QTIP trust.

UNCERTAINTY, THE "FISCAL CLIFF," AND ATRA

Under EGTRRA, after the one year of repeal, the estate tax was scheduled to return to its pre-2001 form. Legislation passed as part of the 2010 Tax Act temporarily addressed gift, estate and GST taxes by implementing an estate tax with a maximum rate of 35% and an increased exemption of $5MM. Notably, this legislation was only applicable for two years and was set to expire on December 31, 2012. Absent new legislation, on January 1, 2013, the transfer tax laws of 2001 were scheduled to be reintroduced once again. Under the 2001 laws, there would have been a reduction in the lifetime exemption from $5MM to $1MM and an increase in the estate tax rates from 35% to 55%. The prospect of returning to 2001 laws caused great uncertainty and concern for planners and their clients.

This so-called "fiscal cliff" was avoided by the passing of the American Taxpayer Relief Act (ATRA) of 2012. ATRA made laws governing estate, gift and GST taxes "permanent," including a $5MM exemption indexed for inflation and top rates of 40%. ATRA also made permanent portability, which, upon election, enables a surviving spouse to add the deceased spouse's unused federal estate tax exemption to his or her own.

The Future of the Estate Tax Under the Trump Administration

During his campaign, Donald Trump proposed a repeal of the estate tax, gift tax, and GST tax and a denial of basis step up for estates exceeding $5MM ($10MM for a married couple).

Trump's election victory and the fact that the House of Representatives and the Senate are both controlled by the Republicans has many advisors wondering, "How likely is it that the estate tax will be repealed?" Ultimately, only time will tell. However, his path to a complete repeal may not be as easy as one thinks.

Most important Senate decisions require a supermajority of 60 votes to avoid a filibuster. Getting 60 or more votes on a bill that would repeal the estate tax would likely require extensive negotiation with Democratic Senators, who generally would be against repealing a tax that only affects the extremely wealthy. If, however, tax reform is passed through a process known as "Reconciliation," only fifty-one (51) Senate votes would be required, but such tax reform could not last longer than 10 years if such reform would be deemed to substantially increase the federal deficit beyond ten years (known as the "Byrd Rule").

Interestingly, it was the Reconciliation process that enabled President Bush to get EGTRRA enacted in 2001 when he was unable to receive a supermajority in the Senate, and the Byrd Rule that required EGTRRA to sunset after 10 years. Although Bush, like Trump, campaigned for a repeal of the estate tax, he was unable to pass legislation that resulted in such repeal, despite having a Republican majority in both the House and Senate his first term. Instead, EGTRRA provided for nine years of increasing exemptions and only one year of repeal before the provisions had to sunset.

COST OF ESTATE TAX REFORM

The estate tax is expected to generate about $275 billion between 2017 and 2026. While this represents a small percentage of revenue for that time period, it is likely that estate tax reform will be part of a larger tax reform measure. In that case, significant spending cuts likely would need to be made in order to support the substantial revenue lost such tax reforms.[1]

If Trump makes the estate tax repeal a priority, it is likely that he will need to compromise significantly in order to have legislation passed, even under Reconciliation. Whether a complete repeal is possible is anyone's guess, but history has told us that repealing the estate tax (especially on a "permanent" basis) is easier said than done.

Conclusion

The estate tax has evolved quite considerably over the last 200 years. Throughout its history, the estate tax has been used by politicians to meet current agendas – from military buildup in earlier years to a social/redistribution tax in the 20th century – and trends to reduce or repeal the tax historically have not held.

Regardless of how the political landscape changes in the future, clients should keep in mind that estate planning is much more than estate tax planning. Even during periods where the estate tax is reduced or repealed, clients should work with their advisors to ensure that their wealth and legacy goals are met.

Timeline of key historical changes to the estate tax

YEAR	LEGISLATION
1797	Stamp Act of 1797 enacted a small, graduated transfer tax in order to pay for a naval buildup in response to heightened tensions with France
1802	Stamp tax repealed
1862-64	A series of Acts created a federal inheritance tax to help finance the Civil War. Rates ranged from 0.75% to 5% and estates had a $1,000 exemption
1870	Inheritance tax repealed
1898	War Revenue Act established tax to offset the cost of the Spanish-American War. Rates ranged from 0.75% to 15%
1902	Estate tax repealed
1916	The modern estate tax was enacted as part of The Revenue Act of 1916 in response to the costs of World War I. Rates ranged from 1% to 10% and estates had an exemption of $50,000
1924	Federal gift tax enacted to prevent avoidance of the estate tax. (The gift tax was repealed in 1926 and then reinstated and made permanent in 1932.)
1930s	Various changes made to the estate tax system, including introduction of an optional valuation date election
1940s	Various legislation enacted, including first version of the marital deduction
1976	The Tax Reform Act (TRA) of 1976 overhauled the system by combining separate estate and gift tax exemptions into one, unified estate and gift tax credit. There was also a decrease in the top tax rates from 70% to 50%. GST introduced by TRA
1981	The Economic Recovery Tax Act (ERTA) of 1981 expanded the marital deduction, increased unified credit amount, and saw a decrease in the top rates from 70% to 50%
1997	The Taxpayer Relief Act of 1997 introduced an incremental increase of the unified credit, introduced inflation indexing
2001	Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided extensive changes in the system, most notably, the repeal of the estate tax. Law provided for increases in the exemption until 2009 (up to $3.5MM) and then a repeal of the tax for decedents dying in 2010. EGTRRA was set to expire in 2011
2010	Estate tax repealed. For decedents dying in 2010, executors had the choice of (1) applying the federal estate tax and receiving an unlimited step-up on assets or (2) electing no estate tax but taking a "modified carryover basis"
2011-12	After EGTRRA sunset, estate tax scheduled to return to a 55% rate and a $1MM exemption. Act set the rate at 35% and increased the exemption to $5MM, but was only in force for two years
2013+	American Taxpayer Relief Act (ATRA) made laws governing estate, gift and GST taxes permanent, including a $5MM exemption indexed for inflation, top rates of 40%, and portability

1. Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2016 to 2026," August 23, 2016, https://www.cbo.gov/publication/51908; see also: http://www.cbpp.org/research/federal-tax/ten-facts-you-should-know-about-the-federal-estate-tax

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