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Tax Reform: Estate and Gift Tax

The estate and gift tax is a unified tax, so that assets transferred as gifts during a person's lifetime are combined with those transferred at death (bequests) and subject to a single rate schedule. The tax is imposed on the decedent's estate, and the rate structure applies to total bequests and gifts given; heirs are not subject to tax.

Rates and Basic Exemptions

The exemption for 2017 is $5.49 million, and it is indexed for inflation. Although the rates of the tax are graduated, the exemption is applied in the form of a credit and offsets taxes applied at the lower rates. Thus the taxable estate is subject to a flat 40% rate.

Individuals are allowed to exempt annual gifts made in 2017 of $14,000 per recipient, which are not counted as part of the lifetime exemption. The annual gift tax exemption is indexed for inflation in $1,000 increments. A generation-skipping tax is also imposed, to address estate tax avoidance through gifts and bequests to a later generation.

Other Exemptions and Deductions

Transfers between spouses are exempt. Estates are allowed to take deductions for charitable contributions and administrative expenses; to take a deduction for taxes paid on estates and inheritances imposed by states; and to exempt up to $5.49 million in remaining assets from the tax.

A spouse can inherit any unused exemption. Thus, if a husband dies and leaves an estate of $3 million, the remainder of his $5.49 million exemption can be used by his wife, whose exemption would be increased by the $2.49 million difference.

Special Provisions for Small Businesses, Farms, and Landowners

A series of provisions benefit small businesses, including farms or landowners. These include the ability of family businesses to pay any estate tax due in installments with only interest payments during part of the installment period, special use valuations, and conservation easements. Minority discounts, although granted by courts rather than specifically in the law, may also benefit small businesses. Minority discounts are allowed when assets are left to a family partnership in which no individual has a controlling share and are thus deemed to be worth less than the current market value for that reason.

Although the estate tax return is due within nine months of death, small businesses are allowed to defer payment (except for interest) for the next five years, and pay the remaining installment payments over 10 years. Because the last interest payment and the first installment coincide, the overall delay in full payment is 14 years. The benefit is allowed only for the business portion of assets and only if 35% of the estate is in a farm or closely held business.

Small businesses are also allowed to value their assets at use as a farm or business. This provision is particularly beneficial to farms and allows a reduction in the estate value of up to $1,120,000 in 2017. It means, for example, that the value of the farm will be what it could be sold for if restricted to farm use rather than, for example, to be subdivided for development. Heirs are required to continue use of the assets as a farm or business for 10 years.

Farmers and other landowners may also benefit from conservation easements, a perpetual restriction on the use of the land. In addition to the reduction in value due to the easement itself, an exclusion of up to 40% of the restricted value of the land, capped at $500,000, is allowed.

Step-up in Basis for Appreciated Assets

Heirs take as their basis (the amount to be deducted from the sales price) for purposes of future capital gains the value of the asset at the date of the decedent's death. This treatment is referred to as step-up in basis and means that no capital gains tax is paid on the appreciation of assets during the decedent's lifetime. For example, if a decedent purchased stock for $100,000 and the value of the stock at the time of death were $200,000, if the heir sells the property for $250,000 a gain of $50,000 is recognized and the $100,000 of gain that accrued during the decedent's lifetime is never taxed. The step-up rules do not apply to gifts, in which carryover basis is applied. In that case, the original basis of $100,000 would be carried over and the gain would be $150,000.

Differences in the Treatment of Bequests and Gifts

Aside from the different exemption levels and basis step-up in some estate tax rules, there are other differences between the taxation of gifts and bequests. The gift tax is tax exclusive (i.e., the tax is imposed on the gift net of the tax), whereas the estate tax is tax inclusive (i.e., the tax is applied to the estate inclusive of the tax). To illustrate, consider a 50% tax rate. Assuming the exemption is already used, to provide a gift with an after-tax value of $1 million the gift giver would have to transfer $1.5 million: the tax rate of 50% is applied to the gift of $1 million for a $0.5 million tax. To provide a net amount of $1 million for a bequest, $2 million is required: a tax of $1 million (50% of $2 million) and a net to the heir of $1 million. Another way of stating this is that the gift tax rate, if stated as a tax inclusive rate like the estate tax, would be 33%. Thus for a 40% estate tax rate, the gift tax rate equivalent is 28.6% (0.4/(1+0.4)).

Estate and Gift Tax Revenue and Coverage

According to Congressional Budget Office (CBO) baseline budget projections, the estate and gift taxes are estimated to raise $281 billion between 2018-2027. Over the time period receipts are projected to slowly increase due largely to growth in wealth exceeding inflation.

As a result of the estate tax exemption level, relatively few decedents will have estates that face the estate tax. Overall, less than 0.5% of all estates are required to file an estate tax return with less than 0.2% having to pay the estate tax.

As shown in **Table 1**, an estimated 11,300 estate tax returns will be filed in 2017. According to the Urban-Brookings Tax Policy Center, 88% of estate tax revenue will come from the estates of decedents who were in the top 10% of the income distribution. While business owners and farmers are more likely than the general population to pay the estate tax, coverage is limited among small business owners and farmers whose estates are most likely to have limited liquid assets.

Table 1. Estimated Estate Tax Coverage, 2017

		Businesses and Farms	
	All Estates	**All**	**Small**
Number of Returns	11,300	1,300	300
Number of Taxable Returns	5,460	600	80
Estate Taxes Paid (millions)	$19,950	$2,350	$30

Source: Urban-Brookings Tax Policy Center, "Microsimulation Model," version 0217-1, Recent Proposals.

Recent Reform Proposals

H.R. 1 and the Senate Finance Committee's chairman's mark to the "Tax Cuts and Jobs Act" would each double the estate tax exemption immediately and retain step-up basis. H.R. 1, however, would repeal the estate tax for years after 2025.

The House "Better Way" tax reform blueprint proposed to eliminate the estate tax. The blueprint does not specify whether the gift tax or step-up basis would be eliminated or retained.

This In Focus is part of a series of short CRS products on tax reform. For more information, visit the "Taxes, Budget, & the Economy" Issue Area Page at www.crs.gov.

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