If Estate Tax Is Repealed,  
Repeal of Gift Tax Would Not Be Far Behind  

by Iris J. Lav

The Senate Finance Committee Chairman’s mark is rumored to repeal the Estate Tax by 2007; it is rumored to repeal the Estate Tax only, retaining the Gift Tax. Retaining the Gift Tax seems to respond to concerns that Estate Tax repeal would result in large revenue losses from widespread income tax evasion, above and beyond the loss of Estate Tax revenue. In the long run, however, it is unlikely that a Gift Tax can be maintained in the absence of an Estate Tax. To the extent that pressure mounts and the Gift Tax also ultimately is repealed, the large revenue losses this approach appears to avoid would in fact occur. Setting up the conditions for the ultimate repeal of the Gift Tax simply becomes one more way, like the mounting Alternative Minimum Tax liabilities, that this tax bill fails to account for all of its future costs.

- Earlier this year, the JCT issued a report showing that repeal of the Estate and Gift Taxes would result in massive income tax avoidance and evasion and attendant large revenue loses. Thus immediate repeal of the Estate and Gift Taxes would cost $662 billion over 10 years, an amount that far exceeds the anticipated Estate and Gift Tax revenue over that period. According to the JCT, an additional 80 cents of income tax revenue would be lost for every dollar of estate and gift tax foregone when repeal was fully in effect.

- Apparently taking this problem into account, the Senate Finance Chairman’s mark is rumored to repeal only the Estate Tax and not the Gift Tax. As described below, retaining the Gift Tax effectively blocks many of the income tax evasion schemes that could be used if both the Estate and Gift Taxes were repealed.

- In the long run, however, it is doubtful that the Gift Tax is sustainable in the absence of an Estate Tax. If a clamor develops to repeal the Gift Tax as well — on the grounds that it discriminates against people who want or need to give funds to their heirs during their own lifetime — then the income tax avoidance and evasion the JCT found would indeed occur.

- To the extent to which repeal of the Estate Tax in this bill sets up the conditions that lead to repeal of the Gift Tax in future legislation, the revenue estimate for repeal of the Estate Tax is misleading. The actual revenue loss ultimately could be as much as 80 percent greater than shown.
A Gift Tax Alone May be Unsustainable

Under current law, the Estate and Gift Taxes are coordinated; the unified exemption is applicable to gifts made during a person’s lifetime, and taxes paid on gifts during a person’s lifetime reduce the amount of Estate Tax that ultimately has to be paid. Thus there is little or no difference in tax consequences, for example, whether a person chooses to give a majority share in a business to his son or daughter during his lifetime or as a bequest after he dies.

If the Estate Tax is repealed but the Gift Tax is retained, people would be taxed on large gifts (amounts exceeding $10,000 per year) given during their lifetime but not on bequests after death. This situation is likely to engender complaints that the policy makes no sense; some significant number of wealthy people will want to give gifts to their children during their lifetime and will view the Gift Tax as discriminatory with respect to the desire to give these gifts. For example, people with a family business may have a reason to transfer control to children before death. People with disabled children may want to transfer assets to assure themselves that the child will be taken care of during their declining years. As a result, there are likely to be strong calls for repeal of the Gift Tax as well, once the Estate Tax is fully repealed.

A Gift Tax alone will not raise much revenue; it brings in little money under current law. It does, however, prevent income tax avoidance and evasion. In the absence of a Gift Tax, for example, people can give assets to their children (or to anyone who has little other income) who pay income tax at low rates. The child can receive the income from the assets, pay income tax at, say, the 15 percent rate (or capital gains tax at the 10 percent rate) and then return the income to the parent. The asset also could be returned at any time. These types of manipulations are not possible under current law, because the transfer of assets and income would trigger Gift Tax liability. So long as the Gift Tax is retained, these manipulations still would not be possible. But if the anomaly of a Gift Tax without an Estate Tax leads to repeal of the Gift Tax, then massive income tax avoidance and evasion would occur.

Retaining the Gift Tax now when it is likely to be repealed in the future would be one of many ways in which the tax cut legislation is likely to have far more cost than is apparent in the official revenue estimate. Another example is the Alternative Minimum Tax. The number of taxpayers subject to the alternative minimum tax projected to grow from 1.5 million in 2001 to 20.7 million by 2011 under current law. Once the proposed tax cuts are enacted, that number will rise substantially; it is likely that between one-quarter and one-third of all taxpayers would be subject to the AMT. This situation is not sustainable and will have to be rectified sometime in the next decade, but none of the current tax bills include sufficient funding to seriously address this problem. It is left as an unfunded liability for the future. The future repeal of the Gift Tax is likely to become a similar unfunded liability.