Taxation of Wealth Transfers

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Background

- Bequest taxes yield little revenue, have limited public support
- Wealth inequality has grown, and passes through generations
- Inheritance taxes surprisingly unpopular, given disparities
  - In UK, middle class swept into base via housing prices
  - Wealthy avoid tax by inter vivos transfers, private businesses, trusts, movement offshore
  - Rates high, base tenuous: a 'voluntary tax on the wealthy'
- Sources of wealth accumulation also face less taxation
  - Corporate tax
  - Capital gains/capital income tax
  - High-income personal tax
- Design of inheritance taxes — where they exist — differs widely across countries
- No accepted theory of wealth transfer taxation, unlike with income and consumption taxation

Features of Wealth Transfers

- Transfers of wealth take many forms
  - Transfers to persons (bequests) vs transfers to organizations (charitable, political donations)
  - Financial vs in-kind transfers vs volunteer time
  - Lifetime transfers vs transfers on death
  - Voluntary vs unintentional/accidental vs strategic transfers
- Taxes can apply to
  - Wealth transfers (inheritance/bequest tax)
  - Wealth itself (periodic wealth tax, property tax)
  - Gains in the value of wealth (capital gains tax)
  - Sales of wealth (financial transactions taxes)
- Taxes on wealth and wealth transfers can be direct or indirect
- Focus on direct taxation of voluntary transfers to persons
  Similar issues arise with charitable donations (Diamond)

Major Transformation in Tax Policy Thinking

- Pre 1970s view: Taxation should be based on ability to pay, or command over resources
  - Comprehensive income tax à la Shantz-Haig-Simons-Hicks
  - Rate structure based on equal sacrifice
- Kaldor extended command-over-resources approach to exercise of command over resources through consumption
  - Meade Report in this tradition, but argument for wealth transfer taxation not well articulated
- Current thinking dominated by welfarist/utilitarian approach inspired by optimal tax revolution
  - Well-developed theories of earnings, capital income, consumption taxation based on individual preferences
- Limited work on optimal taxation of firm, except for design of business tax as tax on rents (cash-flow, ACE, RRT, etc.)
- General problems with welfarist approach
  - Indices of utility hard to measure and compare across persons
  - Differences in preferences hard to deal with
  - Consequentialist basis of welfarism objected to

Strict Welfarist Approach to Inheritance Taxation

Kaplow, Cremer-Pestieau, Kopczuk, Farhi-Werning, Piketty-Saez

- For donor, bequest like any other consumption item, so should not be treated preferentially
  - With weak separability, Atkinson-Stiglitz applies so no differential treatment of bequests vis-à-vis other goods
  - In principle, VAT should apply to bequests!
- Bequest gives benefit to donor as well as donee: Double benefit an externality that calls for subsidy
- Tax donee benefit like any other source of income
- In principle, tax should be donee-based, unless linear
- Things more complicated if subsidy on bequest is combined with taxation of either bequest or inheritance
- Case for separate taxation of inheritances if different efficiency considerations apply

Problems with Welfarism and Double-Counting

- If benefits of both donors and donees counted, other forms of interdependent utility should also count
- In families, benefit to donees shared by family members should count as well
- Some donations are given for reasons of social norm/duty/ethics, so reduce donor utility
- Similarly for accidental bequests
- If government transfers are on behalf of altruistic rich taxpayers, should also be double counted
- Saving for ones future self should be double counted: Benefit from saving for future self & then from future consumption
- Similar problems arise with charitable donations, valuation of public goods

Note that if bequests passed on from generation to generation, multiple taxation of bequests

Alternative I: Restricted Welfarism

Do not double count: Hammond, Mirrlees, among others

- Treat voluntary donation as transfer of income from donor to donee
- Give deduction for donations, and tax donee receipts (analogue with donations to charity)
- Alternatively, in case of linear inheritance tax, simply ignore bequests as in some countries
  Otherwise, tax system is complicated if nonlinear tax applies, including difficulty of crediting for bequests on death!
- Leads to differential taxation of those who donate and those who do not
- Externality still applies, so bequests not only deductible but also subsidized
- Accidental bequests should be credited as well

Alternative II: Equality of Opportunity

Mirrlees Review: Command-over-resources approach

- Do not penalize or reward behavioral differences (Principle of Responsibility)
- Tax windfall gains (Principle of Compensation)
- Big bequests include rents: adds justification for taxing large bequests
- Donors' taxation not affected by making bequests; donees fully taxed on receipts (cumulative or averaged)
- No need to subsidize bequests
- Still an issue with no VAT paid on bequest, maybe
- Entails multiple taxation of bequests that are passed from one generation to the next

Normative Upshot

A main problem with designing tax on wealth transfers is coming to agreement on normative basis

Existing bequest/inheritance tax systems most closely approximate equality-of-opportunity approach

Inheritance tax related to taxation of rents and super-normal returns in personal and corporate tax system

Inheritance tax takes on added importance if rents under-taxed under personal/corporate tax system

Countries that have no inheritance tax implicitly opt for restricted welfarism approach

Design Issues: Taxpayer and Base I

Donor- vs donee-based tax

- Normative arguments support donee-based tax on cumulative receipts of residents: Residence-based inheritance tax
- Donors could be affected via
  1. Externality or
  2. Weak welfarism credit
  3. In principle, VAT charge
- Tax on donees captures inheritances from abroad
- Donee tax encourages splitting estates: though, could favour splitting estates in donor-based tax as well
- Donee system applies in Ireland and in civil law systems with forced heirship rules; donor system in many other countries (UK, USA)

Design Issues: Taxpayer and Base II

Transfers at death vs inter vivos

- Transfers at death more likely unintentional, so higher rate
  - Minimal incentive effects on saving
  - Unintended bequests reflect either precautionary or wealth-holding motives
- But, incentive to make inter vivos transfers to reduce tax
- Administrative problems with monitoring inter vivos transfers
- Some countries exempt inter vivos transfers $\geq x$ years before death: invites planning to avoid

Design Issues: Rate Structure

Schedular rate structure vs harmonization with personal tax

- Lumpiness a problem for income tax without averaging
- Exemption for spouse complicates things
- Case for a different rate structure
  - Different incentive effects: saving for bequests versus lifetime smoothing
  - Case for bigger exemption level for inheritances
  - Steeper rate structure to get at wealth generated by rents/luck
- Fixed tax rate on inheritances above exemption level can lead to punitive marginal effects (UK)
  - Case for piecewise linear rates and brackets
- Tax administration must deal with cumulative inheritances
  - Complicated if rates change over time

Design Issues: Special Treatment I

Transfers to spouses/civil partners

- Makes sense to exempt
  - No new opportunities created
  - No point in double-taxing
  - Consistent with tax treatment of pensions
- However, income tax systems often do not allow inter-spousal asset transfers to reduce capital income tax
- Transfers to heirs vs.non-heirs: No case for specal treatment

Trusts

- Blur definition of owner of assets
- Inheritance taxes usually see through them to effective owner (e.g., who receives interest)
- Sometimes trusts taxed every X years at low rate on capital value (as if it changed hands)

Design Issues: Special Treatment II

Housing

- Main source of wealth for middle classes
- Hard to avoid by inter vivos transfers or movement offshore (cannot donate and retain residency)
- Subject to other taxes, valuation and liquidity problems
- UK allows smoothing of tax payments over time with interest
- Ireland allows deferral of tax if there are any joint occupants

Other Special Cases

- Family farm, family business
  - Favored for political/social reasons, but prone to abuse: sale of property after inheritance
  - Could require that property be held for minimum period
- In-kind transfers (private education, health, goods and services, etc.): hard to monitor

Design Issues: Technicalities I

Incentive to reduce tax by skipping generations

- Not a problem on normative grounds

Relation to capital gains tax

- In principle, capital gains tax and inheritance tax independent
- Deemed realization on transfer of wealth (over and above inheritance tax)? or
- Simply carry forward base value until realized?
- Some countries rebase assets when transfer made without any capital gains tax paid: seems improper
- Indexing an issue

Design Issues: Technicalities II

Residency and emigration

- Possibility to escape tax by renouncing residency, so many countries require minimum period abroad before liability is eliminated
- Treatment of domestic assets bequeathed to non-resident donees
  - Under residence principle, not taxed
  - Definition of non-resident may be an issue
- Treatment of assets held abroad by residents:
  - In principle should be taxed, although possibility to evade tax by relocating assets abroad
  - Or, having bequest go to an offshore company
- Transfer from non-resident to resident liable for tax