Transferring Business Interests During Lifetime: How to Have Your Cake and Eat it Too

Wisconsin State Bar

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1. Estate and gift tax by the numbers
    a. *Understanding Federal Estate and Gift Taxes*, Congressional Budget Office June 2021 (https://www.cbo.gov/publication/57272)
    b. Historic filings and revenue
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2. Potential non-tax consequences of not planning
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      (1) Creditor protection

      (2) Divorce protection

      (3) Spendthrift protection

      (4) Minimize parties involved

         (a) Same trustee/directing party on all trusts

   ii. Selection of trustee/directing party is key

      (1) Beneficiary can be his/her own trustee

e. S corporation considerations

   i. Not all trusts can hold S corporation stock

      (1) Grantor trust that is wholly-owned by one US person (or former grantor trust within 2 years of the cessation of such status as a result of the grantor's death) (IRC §§ 1361(c)(2)(A)(i) and (ii))

      (2) Electing small business trust (ESBT) (IRC § 1361(c)(2)(A)(v))

      (3) Qualified subchapter S trust (QSST) (IRC § 1361(d))

      (4) Testamentary trust for 2 years after the date on which it was funded (IRC § 1361(c)(2)(A)((iii))

      (5) Voting trust (IRC § 1361(c)(2)(A)(iv))

   ii. Understand how trust will be treated after grantor trust status is terminated and ensure that any required elections are timely made

f. Impact of recapitalization on valuation

g. Shareholder agreement considerations

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iii. Permitted transfers

iv. Death

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i. Income tax implications

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iii. Cash flow projections

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(1) Tax distributions

(2) Distribution of non-business assets

v. Loss of basis step-up for gifted property

(1) Compare to estate tax triggered by retaining assets

vi. Valuations

b. Sale to intentionally defective grantor trust

i. Grantor transfers assets to trust

(1) Gift vs sale considerations

(2) Seed gift: 10% or more of the value of the assets that will be sold to the trust

(3) Grantor receives promissory note for assets sold to trust; value is frozen

ii. Key to success is outperformance of AFR (October mid-term AFR: 0.91%)

(1) Growth beyond AFR passes to beneficiaries free of estate tax

iii. Income tax consequences

(1) Trust is ignored for income tax purposes

(a) No gain recognized on sale

(b) Interest payments have no income tax consequences to grantor or trust

(2) Grantor is responsible for payment of trust's income tax liability

(a) Grantor can use note payments to pay income tax liability

(b) Tax reimbursement (see Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (7/6/2004))

iv. Anticipated trust cash flow must support note payments

(1) Structure of note is a function of cash flow

(2) Note to IDGT can be prepaid at any time

v. Gift tax consequences

(1) Gifts treated as taxable gifts that use exemption

(2) Sales not treated as gifts as long as assets are sold for fair market value

(a) Report sales on gift tax returns

(3) Payment of income tax by grantor is not a gift

vi. Estate tax consequences of death before note is repaid

(1) Not clear whether trust assets are subject to estate tax

(2) Unpaid note balance subject to estate tax

vii. Single grantor vs joint grantors

viii. Grantor should not be trustee

ix. Typically structured as dynasty trusts

x. Grantor trust powers

(1) Anyone in a nonfiduciary capacity has the ability to reacquire the trust corpus by substituting other property of an equivalent value (IRC § 675(4)(C))

(2) Grantor or nonadverse party has the power to borrow from the trust without adequate interest or security (IRC § 675(2))

(3) Nonadverse party has the power to add charitable beneficiaries (IRC § 674(a))

(4) Distributions to spouse without consent of adverse party (IRC § 677(a)(1))

xi. Turning off grantor trust status

(1) Trust should continue as grantor trust until note is paid in full; may continue longer

(2) Loss of ability to substitute assets

(3) Toggling

c. Rental income

d. Salary and health insurance

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f. Consulting fees

g. Board service fees

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5. Keep things simple

a. Annual exclusion gifts

b. Valuation discounts

i. Marketability

ii. Lack of control

iii. Trends in valuation discounts

iv. Tax affecting S corporation earnings

6. Synchronizing corporate documents

a. Shareholder agreements

b. Operating agreements

c. Buy-sell agreements

d. Redemption agreements

e. Life insurance agreements

f. Key provisions

i. Permitted transferees

ii. Redemption rights

iii. Manager selection and removal

iv. Limitations on manager authority

v. Rights of first refusal

vi. Valuation

vii. Treatment of marital property interest

g. Sample provisions

i. Permitted Transfers/Transferees

(1) Permitted Transfers. Each Shareholder may freely Transfer any or all of his or her Stock to: (i) the Company, (ii) any other Shareholder, (iii) a Shareholder's lineal descendants (including adopted children, provided the child was placed for adoption as a minor) or (iv) one or more trusts exclusively for the benefit of a Shareholder or a Shareholder's lineal descendants (each, a "Permitted Transferee").

(2) "Permitted Transferee" of a Shareholder means: (i) an issue of an Existing Shareholder; (ii) a custodian or guardian of such Shareholder; or (iii) a trust for the exclusive benefit of an Existing Shareholder, her or his spouse and/or issue of an Existing Shareholder (excluding in any case contingent beneficiaries having an actuarial interest in the value of the trust assets at the time of the trust's creation of 10% or less). For purposes of this definition, the word "issue" means lineal descendants forever and shall include legally adopted persons; provided, however, a legally adopted person shall be considered an issue only if the adopted person is a minor at the time of adoption or is the child of the adoptive parent's spouse.

ii. Redemption rights at death

Death. Following the death of a Shareholder, the Company will have the option to purchase from such deceased Shareholder's personal representative or special administrator or the trustee of a trust established by the deceased Shareholder which holds such Shareholder's Stock ("Personal Representative") all of such deceased Shareholder's Stock. The Company's option may be exercised by delivering notice to the Personal Representative notifying him, her or it of the Company's exercise of such option. Such notice shall be delivered to the Personal Representative not later than ninety (90) days following the death of the Shareholder (or such later period as agreed by the parties), and if the Company exercises its option, the Personal Representative

shall sell to the Company all of the deceased Shareholder's Stock. The provisions of this Section 4 shall have no application to Stock transferred to a Permitted Transferee as a result of a Shareholder's death.

iii. Manager selection and removal

(1) Management of the Company. The business and affairs of the Company will be managed by one or more Managers elected in accordance with the terms of this Agreement. The initial Manager of the Company is _____. There shall be no more than three Managers serving at any time. Except as otherwise expressly provided in this Agreement and notwithstanding any provision of the Act, the Managers will have the sole authority to manage the Company and are authorized to make any and all contracts and decisions, enter into transactions and make and obtain any commitments on behalf of the Company necessary or convenient to carry out the business and affairs of the Company. Without limiting the foregoing, the Managers may appoint, employ or otherwise contract with other persons or entities for the transaction of business of the Company or the performance of services for or on behalf of the Company as they may deem necessary or appropriate, and may delegate to any officer of the Company or to any other Person such authority to act on behalf of the Company as they may deem appropriate.

(2) Term of Service; Resignation; Removal; Vacancies. Managers will serve until they resign, die, become incapacitated or are removed. Managers may be removed with or without cause by a vote of Members holding more than 50% of the issued and outstanding Voting Units. A Manager may resign at any time by giving notice to the remaining Managers or, if there are none, to the Members. If there is no then serving Manager, one or more Managers shall be appointed by a vote of Members holding more than 50% of the issued and outstanding Voting Units.

iv. Limitations on Managerial Powers. Notwithstanding section 6:

(1) The Managers may not take any of the following actions unless approved by the Members holding more than 50% of the issued and outstanding Voting Units:

(a) issue or redeem any Units, options, warrants or other instruments exercisable or convertible into Units;

(b) approve a merger, consolidation or conversion of the Company with or into any other Entity, regardless of whether the Company is the survivor;

(c) approve an Asset Disposition;

(d) authorize the borrowing or lending of funds from or to any Member or director or any affiliate of any Member or director;

(e) amend the Company's Articles of Organization, this Agreement or any other management agreement among the Members (provided, however, that the Managers will amend Exhibit A to this Agreement from time to time as necessary to reflect changes in the ownership of Units); or

(f) permit any Member or other Person to do any act on behalf of the Company which would contravene this Agreement.

(2) The Managers may not take any action to approve the dissolution of the Company except as provided in section 9.

v. Rights of first refusal

(1) Right of First Refusal in the Company. Except for any Transfer to a Permitted Transferee, if a Shareholder receives a written bona fide offer to sell, transfer or otherwise dispose of all or any part of such Shareholder's Stock from a third party and the Shareholder desires to accept such offer, such Shareholder (the "Selling Shareholder") will immediately deliver a notice (the "Sale Notice") containing a copy of such written third-party offer to the President of the Company and the other Shareholders (such other Shareholders collectively referred to as the "Non-Selling Shareholders") and will offer to sell the Stock subject to such written third-party offer (the "Offered Stock") to the Company. Within 30 days after receipt of such written offer, the Company may, by notice in writing to the Selling Shareholder, elect to purchase any or all of the Offered Stock at either the price offered to the Selling Shareholder by the proposed third-party purchaser (the "Third-Party Price") or the Appraised Value and on either the terms and conditions offered by such proposed third-party purchaser (the "Third-Party Terms") or the terms in Section 7, in the Company's discretion.

(2) Right of Second Refusal in the Non-Selling Shareholders. If the Company does not elect to purchase all of the Offered Stock, the balance of the Offered Stock will be offered for sale and will be subject to an option on the part of the Non-Selling Shareholders to purchase the remaining Offered Stock at either the Third-Party Price or the Appraised Value and on either the Third-Party Terms or the terms in Section 7, in the electing Shareholders' discretion. The Non-Selling Shareholders may exercise such option by written notice within 30 days after the date the Company's option period described above expires. If more than one of the Non-Selling Shareholders elects to purchase Offered Stock, each Non-Selling Shareholder so electing will be entitled to purchase that portion of the Offered Stock which the Stock then owned by such Non-Selling Shareholder bears to the Stock then owned by all of the Non-Selling Shareholders so electing.

vi. Valuation methodology

For any sale of Stock, the purchase price per share of Stock (the "Purchase Price") will be the price mutually agreed upon by the Transferring Shareholder and the purchaser. If the Transferring Shareholder and the purchaser cannot mutually

agree on the Purchase Price, the Purchase Price will be the "Fair Market Value" per share of the Company as determined by an "Independent Appraiser," determined as of the end of the calendar month immediately preceding the month in which the event giving rise to such sale occurred (the "Appraised Value"). The "Fair Market Value" means that pro rata share allocable to a share of Stock of the cash or cash equivalent price at which a willing buyer would buy and a willing seller would sell all of the outstanding shares of Stock in the Company, neither being under any compulsion to buy or to sell and both having a reasonable knowledge of relevant facts. The "Independent Appraiser" means a regionally or nationally recognized investment banking or appraisal firm that is qualified in the valuation of business transactions and securities of the general type being analyzed and does not have a material direct or indirect interest in the Company or any Shareholder. The Company will appoint an Independent Appraiser for a proposed Transfer.

In performing such appraisal, the Independent Appraiser will consider all information, facts and data relating to the Company, its business, assets, competitive position, past and anticipated future earnings, and other information (as well as similar information concerning companies deemed by the appraiser to be comparable to the Company), as it deems relevant; provided that the Independent Appraiser will take into account any discount, if applicable, due to the lack of marketability of the Stock and any discount from fair market value for size, blockage or minority interest. Life or disability policies owned by the Company will be considered in the appraisal only to the extent that the cash values of such policies exceed any policy loans with respect to such policies and the proceeds of any such policies received by the Company in connection with the event giving rise to the appraisal will not be considered in the appraisal. If an appraisal has been conducted to determine the Purchase Price per share of Stock within the 180 days prior to the event giving rise to the sale, then such appraisal will be used to determine the Purchase Price unless the Company and Transferring Shareholder (or such Shareholder's Personal Representative, as the case may be) mutually agree to the contrary. The determination by the Independent Appraiser will be final, binding and nonappealable. The costs of any such appraisal will be shared evenly by the Company and the Transferring Shareholder (or such Shareholder's Personal Representative, as the case may be).

vii. Treatment of marital property rights

(1) Marital Interest; Option. For purposes of this Agreement, all references to Stock owned or held by a Shareholder will include all interest in such Stock now owned or hereafter acquired by such Shareholder's spouse as marital property, community property or otherwise. The creation of such an interest in Stock in such Shareholder's spouse by operation of the marital or community property laws during such Shareholder's lifetime will not be deemed to be a Transfer of such Stock or any portion thereof or interest therein so long as the Stock in which such interest is created continues to be registered on the transfer records of the Company solely in the name of such Shareholder and: (i) such Shareholder

maintains all rights to manage, control and transfer such Stock and (ii) such Shareholder's spouse executes and delivers to the Company a spousal consent and acknowledgment in substantially the form attached as Exhibit B (the "Spousal Consent and Acknowledgment"). If either of such conditions ceases to be satisfied at any time, then such Shareholder will offer his or her Stock to the Company. The Company may, from time to time, require a Shareholder's spouse, or former spouse, as the case may be, to provide written confirmation that he or she does not have any right to manage, control and/or transfer any portion of the Stock. The Company's option to purchase the Stock pursuant to this section 5(a) will continue until the conditions mentioned above are again satisfied. The Shareholder's obligations under this Agreement will include an obligation on the part of his or her spouse to sell or to offer to sell or transfer any interest of the spouse in Stock in the same manner and on the same terms and conditions as set forth in this Agreement.

Marriage; Option. Each Shareholder agrees that during the term of this Agreement, if he or she plans to marry or remarry and his or her prospective spouse (the "Prospective Spouse") fails to execute and deliver the Spousal Consent and Acknowledgment to the Company within 60 days of the marriage, such Shareholder will offer his or her Stock to the Company. The Company's option to purchase the Stock pursuant to this section 5(b) will continue until exercised or until the execution by the Prospective Spouse of the Spousal Consent and Acknowledgment.

Termination of Marital Relationship. Within 10 days of the termination of a Shareholder's marriage for any reason other than such Shareholder's death, such Shareholder will provide the Company with written notice of such event. If such Shareholder does not succeed to his or her spouse's interest in the Stock registered in such Shareholder's name (the "Spousal Interest"), then he or she will have an option to purchase all of the Spousal Interest and, upon exercise of such option, his spouse or his spouse's representative, as the case may be, will be obligated to sell the Spousal Interest to such Shareholder. Such option may be exercised in writing within 60 days after the applicable Option Event. "Option Event" means: (i) in the event of the death of a Shareholder's spouse, the first to occur of: [a] the filing by the spouse's representative of a statement to close the estate pursuant to the relevant State's estates closing statute; [b] the entry of the final judgment in a probate proceeding involving the spouse's estate; or [c] any other similar order, judgment or other final determination of the Spousal Interest; or (ii) in the event of the dissolution of such Shareholder's marriage, the expiration of the time period allowed for appeal after the entry of any final order, judgment or decree determining the Spousal Interest. If the Shareholder fails to purchase all of the Spousal Interest within the applicable 60-day period, the Company will have a continuing option to purchase any remaining Spousal Interest.

7. Proposed changes to current law

    a. Reduced gift/estate tax exemption

    b. Changes to treatment of grantor trusts and transactions with grantor trusts

8. Plan for flexibility

    i. Spousal lifetime access trust (SLAT)

        (1) Reciprocal trust doctrine

        (2) Will be treated as a grantor trust unless distributions to spouse must be agreed to by an adverse party

            (a) Sample: Notwithstanding anything herein to the contrary, if I relinquish those powers described in Article 8 during my lifetime such that this trust is no longer taxed as a "grantor trust" under Code sections 671-679, then any distributions to my wife after the relinquishment of such powers shall be approved in writing by another beneficiary, provided that such beneficiary is an "adverse party" as defined by Code section 672(a), such that the trust is not inadvertently taxed as a grantor trust.

        (3) Consider impact of divorce or death

    ii. Trust protectors

        (1) Sample powers

            (a) Appointment and removal of trustees

            (b) Appointment and removal of directing parties

            (c) Modification of the duty to inform and report

            (d) Trust modifications to achieve legal or tax objectives

            (e) Modification of administrative provisions or principal place of administration, tax situs, or governing law

            (f) Granting or modification of powers of appointment

            (g) Trust termination

    iii. Removal and replacement powers

    iv. Substitution power (grantor trusts)

    v. Powers of appointment (limited and general)

Congressional Budget Office
Nonpartisan Analysis for the U.S. Congress

Understanding Federal Estate and Gift Taxes

JUNE | 2021

Estate and gift taxes are a linked set of federal taxes that apply to transfers of wealth. In 2021, estates face a 40 percent tax rate on their value above $11.7 million, although various deductions reduce the value subject to the tax. The same threshold and tax rate apply to gift taxes.

In 2020, revenues from federal estate and gift taxes totaled $17.6 billion (equal to 0.1 percent of gross domestic product, or GDP). In recent years, changes to estate and gift tax laws have reduced the revenues raised by the taxes and the number of taxpayers who incur that liability.

In this report, the Congressional Budget Office describes estate and gift taxes, the people who pay them, the types of assets that make up taxable estates, and the model the agency uses to project estate and gift tax revenues in its baseline. Here are the report's main findings:

- **Relatively few people pay estate and gift taxes.** Of the 2.7 million people who died in 2016 (the most recent year for which complete data were available when this analysis was done), only about 5,500 had estates that were taxable. That is about 0.2 percent of all estates in that year. In 2018, about 2,000 taxpayers paid the gift tax. The estate tax also affects people who do not directly owe the tax, including heirs and people who engage in estate planning to avoid or lessen the tax.
- **The estate tax may act as a tax on saving** by making it more expensive for people to leave money to their heirs. The empirical evidence on the effect of the estate tax on saving is inconclusive, though.
- **The composition of taxable estates has remained stable** over the past decade even as the exemption amount has risen substantially. Financial and real estate assets have accounted for more than 80 percent of the value of taxable estates.
- **Wealth is concentrated in a small number of the largest estates.** Estates valued at $50 million or more accounted for 6 percent of all taxable estates in 2018 and held 42 percent of assets reported by taxable estates in that year.

To project estate and gift tax liability for a representative sample of households under current law, CBO uses information from estate tax returns, the Survey of Consumer Finances, and its own economic and demographic projections.

What Are Estate and Gift Taxes?

Estate and gift taxes are often considered together because they are subject to the same rate and share the lifetime exemption amount. However, one main difference is that the estate tax applies to transfers of the decedent's property at death, whereas the gift tax applies to transfers made during his or her life.[1] Over the past 40 years, estate and gift taxes have been changed many times; they are scheduled to change again in 2026 under current law.

Estate Tax

When people die, their assets become the property of their estate. Everything a decedent owned or had a financial interest in at the time of death—from stocks and buildings, for example, to jewelry and artwork—is

1. A related provision, the generation-skipping transfer tax, applies to certain transfers made directly to a recipient more than one generation younger than the donor. That provision is intended to limit the amount of estate and gift taxes that can be avoided. It is not examined in this report.

Notes: Numbers in the text and table may not add up to totals because of rounding. In this report, revenues are reported on a fiscal year basis. (Federal fiscal years run from October 1 to September 30 and are designated by the calendar year in which they end.) All other years referred to in this report are calendar years.

considered part of his or her estate. If the value of the decedent's *gross* estate exceeds $11.7 million in 2021, then the executor of the estate must file a federal estate tax return, even if no amount is owed. (The decedent and the estate are separate taxable entities.) The amount owed is based on the value of the *taxable* estate. In 2021, any value above the exemption amount of $11.7 million is taxed at a rate of 40 percent.[2]

The value of the *gross* estate is computed by adding all the decedent's assets and property, the decedent's share of jointly owned assets, gifts and gift taxes paid within three years of death, and (in certain cases) life insurance proceeds. The value of the estate's assets is usually determined as the fair-market value on the owner's date of death, although other provisions apply to assets used in a farm or a closely held business (which typically has very few shareholders).[3] The value of the *taxable* estate is determined by deducting from that total amount any transfers to the surviving spouse, contributions to charitable organizations, debts, funeral costs, state estate tax liability, and other costs associated with administering the estate.

Married decedents can transfer any unused exemption amount to their surviving spouse, which effectively doubles the exemption for married couples to $23.4 million.[4] To account for inflation, the exemption amount is indexed to changes in the chained consumer price index (CPI).

An estate tax return is due within nine months of the owner's death. Estates can apply for an automatic six-month extension, though, so estate tax returns for deaths in a particular year may be filed in that year or in one of the two following calendar years. Payment of estate tax liability is generally due nine months after the owner's death. Under certain conditions, however, executors can apply for an extension. For example, estates of farms and closely held businesses can defer their tax liability and pay the amount due over 10 years.

Gift Tax

The gift tax applies to transfers of property when the full value is not received in return.[5] Gifts below the annual exclusion amount—$15,000 per recipient from each donor in 2021, or $30,000 per recipient from married couples—are not taxable.[6] Donors who make gifts that exceed that amount are required to file a gift tax return and pay any resulting gift tax liability by April 15 of the following year.

By law, the gift tax has the same tax rate structure and exemption amount as the estate tax.[7] A donor may give as many gifts as he or she chooses to each year; the donor pays taxes on those gifts only when the cumulative amount of annual gifts (above the annual per-recipient exclusion amount) during his or her lifetime exceeds the lifetime estate and gift exemption. For example, if a donor gives a recipient a gift with a value exceeding $15,000, the donor's lifetime estate and gift exemption is reduced by the gift's value in excess of $15,000.

Scheduled Changes to Estate and Gift Taxes

The 2017 tax act (Public Law 115-97) doubled the exemption amount for the estate tax through the end of 2025. CBO projects that the exemption amount will drop to $6.4 million in 2026 under current law.[8] People who make gifts before 2026, and estates that transfer the unused exemption to the surviving spouse before 2026,

2. In 2021, the estate tax rate begins at 18 percent on the first $10,000 in taxable transfers and reaches 40 percent on taxable transfers over $1 million. (Taxable transfers comprise taxable gifts and transfers at death.) Because a credit effectively exempts $11.7 million in taxable transfers, the tax rates below 40 percent are not applicable.

3. Executors can choose an alternate valuation date that is six months after the owner's death (or the date on which assets are sold or otherwise transferred if that occurs within six months of the death) if it would result in a lower valuation of the estate. In addition, executors can value assets used in a farm or a closely held business at their value as they are currently used (or productive value) rather than their fair-market value, or they can discount the value of those assets owing to the heirs' lack of control as minority owners and the assets' lack of marketability.

4. If a married decedent leaves his or her property to the surviving spouse using the spousal deduction, the decedent's estate is not subject to the estate tax; however, once the surviving spouse dies, the estate potentially becomes subject to the estate tax if its value exceeds the exemption amount.

5. In the tax code, gifts are distinguished from donations, which are given for charitable purposes and may be deductible from income taxes.

6. Other nontaxable gifts include transfers to charitable organizations, transfers to spouses, and payments made directly to educational institutions or medical providers on someone's behalf. Exclusion amounts for the gift tax are indexed to changes in the chained CPI.

7. In practice, the gift tax is lower than the estate tax. That is because the gift tax is calculated on the basis of the amount received, whereas the estate tax is calculated on the basis of the value of the entire estate, including the assets used to pay the estate tax.

8. Current law provides for a $5 million exemption with an adjustment for inflation. According to CBO's projections of the chained CPI, the exemption will be $6.4 million in 2026.

will be able to keep the tax benefit of the higher exemption amount.

Who Pays Estate and Gift Taxes?

Relatively few people pay estate and gift taxes. Among the 2.7 million decedents in 2016, about 13,000 estates were required to file a return—and of those, 5,500 estates owed taxes. CBO projects that the number of taxable estates will drop to 2,800 among 2021 decedents because of the higher exemption allowed by the 2017 tax act. In terms of gift taxes, about 236,000 gift tax returns were filed in 2018, but only 2,000 of those owed the tax. People who do not pay estate taxes may still be affected by them; that group includes heirs and people who engage in estate planning (the process of managing and allocating assets while a person is still alive) to avoid or lessen the tax.

People Who Pay Estate and Gift Taxes

Widowed decedents and people age 80 or older accounted for the majority of taxable returns filed and estate taxes paid among decedents in 2016.[9] Most estates that filed an estate tax return in that year belonged to widowed decedents who were 80 or older.

- About 64 percent of taxable returns were filed by the estates of widowed decedents, and those returns accounted for 54 percent of estate tax revenues.
- About 78 percent of taxable returns were filed by the estates of decedents age 80 or older, and those returns accounted for 80 percent of estate tax revenues.

In addition, most taxable returns were filed by relatively small estates, even though most estate tax revenues came from the largest estates.

- In 2016, estates with a gross value of $10 million or less accounted for 57 percent of taxable returns but only 11 percent of estate tax revenues.
- Estates with a gross value of $50 million or more filed 5 percent of taxable returns but accounted for 46 percent of estate tax revenues.

In 2018, 22 percent of taxable gifts were at least $1 million, and they accounted for 86 percent of gift tax revenues. Typically, filers must apply their estate tax exemption to the gift tax, which reduces their gift tax liability. The estate tax exemption available when those filers die, however, will be reduced by the amounts previously applied to the gift tax while they were alive.

Other Affected People

The estate tax affects people who do not pay it directly, such as heirs. Some people engage in estate planning to avoid paying the tax (or to reduce the amount that they owe), which may result in ownership arrangements for their assets that they would otherwise not choose. For example, people might transfer assets through a trust to their heirs earlier than they had intended so as to remove those assets from their estate.[10] Although the decedent's estate is responsible for paying estate taxes, the tax reduces the amount that heirs may receive.[11]

Heirs tend to have relatively high income. Families that received an inheritance in 2019—about 3 percent of all families according to the 2019 Survey of Consumer Finances—typically had a higher median income than other families ($92,000 compared with $58,000).[12] About half of the heirs were between the ages of 55 and 75, and most received inheritances from their parents. Those inheritances did not necessarily come from a taxable estate. The median inheritance was $50,000, and the average inheritance was $186,000 (because of a relatively small number of large inheritances).

Do Estate and Gift Taxes Affect Saving?

Because the estate tax is imposed on the transfer of assets, it in effect taxes people's savings. The amount of estate tax that people pay varies—even among people with similar resources—depending on what they choose to do with their money. For instance, the tax on an estate left by someone who saves more will be higher than the

9. See Internal Revenue Service, Statistics of Income Tax Statistics, "Estate Tax Data Tables, Selected Years of Death" (accessed January 8, 2021), https://go.usa.gov/xHjC2.

10. A trust is a legal arrangement in which assets are held or used by a person or entity for the benefit of another person. There are many types of trusts, and they are generally governed by state laws. One such type is an irrevocable trust, which is commonly used because it places assets outside of the grantor's estate and therefore not subject to the estate tax; however, once the trust is established, the grantor loses control of the assets and cannot change the terms of the trust.

11. An alternative to the estate tax is an inheritance tax under which heirs are responsible for paying taxes on the assets transferred to them. For more discussion, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems*, JCX-22-08 (March 10, 2008), www.jct.gov/publications/2008/jcx-22-08 (PDF, 102 KB).

12. Median family income is the income dividing families into two equal groups. For example, half of all families that received an inheritance had an income that was below $92,000, while half had income above it.

tax on an estate left by someone who spends more. As a result, the estate tax could encourage people to save and invest less by making it more expensive for them to leave money to their heirs. Overall, however, the empirical evidence on the effect of the estate tax on saving is inconclusive.[13]

The lack of consensus about the overall effect of the estate tax on saving stems from several factors. The smaller inheritances left to heirs because of the estate tax might induce people, or their heirs, to save more. Alternatively, estate taxes would have little effect on the saving behavior of people who do not intend to leave an inheritance. Another consideration is the way capital gains taxes apply to the value of inherited assets (see Box 1). Because of the step up in basis—upon inheritance, the cost basis of an asset is increased to its fair-market value—any appreciation in value while the decedent held the asset is not subject to capital gains taxes, which could motivate people to save more.

What Assets Make Up Taxable Estates?

Assets of taxable estates can be classified in one of five categories: financial, real estate, business, retirement, and other (which includes works of art and depletable and intangible assets).[14] As reported on estate tax returns, those asset groupings are similar to the ones used in CBO's estate tax model. Understanding their distribution helps CBO project estate and gift tax receipts more precisely and accurately.

Taxable Estates Over Time

In 2018, taxable estates reported $106 billion in gross assets.[15] Financial assets, which include stocks, bonds, and cash, made up the majority of those gross assets, totaling $64.6 billion.[16] The next-largest category was real estate assets, which totaled $20.9 billion in 2018. The remaining asset types—business, retirement, and other—contributed smaller amounts: $11.7 billion, $4.7 billion, and $4.2 billion, respectively.

Except in 2011, the overall composition of assets was relatively stable between 2009 and 2018 (see Figure 1).[17] Financial assets declined slightly over the period as a share of the total, from 63 percent of all assets in 2009 to 61 percent in 2018, although the dollar amount of those assets remained constant at about $64 billion in both years. As a percentage of total assets, the shares of business assets and other assets grew: Business assets increased from 8 percent of all assets in 2009 to 11 percent in 2018, and other assets rose from 3 percent of all assets in 2009 to 4 percent in 2018. In contrast, allocations of real estate and retirement assets decreased: Real estate assets declined from 21 percent of all assets in 2009 to 20 percent in 2018, and retirement assets fell from 5 percent to 4 percent over that period.[18]

Taxable Estates by Size

In 2018, the largest taxable estates—those with gross assets of $50 million or more—held 42 percent of the gross assets among all taxable estates, despite accounting for 6 percent of those estates (see Table 1 on page 7). The largest estates held 43 percent (or $27.9 billion) of reported financial assets, 56 percent (or $6.6 billion) of business assets, and 67 percent (or $2.8 billion) of the assets categorized as other. The largest estates also held the greatest proportion of real estate assets (32 percent, or $6.6 billion). The rest of those assets were distributed relatively evenly among smaller taxable estates.

13. For a recent summary of the behavioral effects of estate and gift taxes, see David Joulfaian, "What Do We Know About the Behavioral Effects of the Estate Tax?" *Boston College Law Review*, vol. 57, no. 3 (May 2016), pp. 843–858, https://tinyurl.com/2bnnbafd. For more discussion of the behavioral effects of estate taxes on people's work, saving, and charitable contributions, see Congressional Budget Office, *Federal Estate and Gift Taxes* (December 2009), www.cbo.gov/publication/41851; and Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System*, JCX-52-15 (March 2015), www.jct.gov/publications/2015/jcx-52-15 (PDF, 263 KB).

14. Depletable assets are those whose use is subject to exhaustion, such as oil and gas wells or other natural deposits. Intangible assets include licenses, patents, and registered trademarks.

15. Most returns filed in 2018 were for deaths that occurred in 2017, when the filing threshold was $5.49 million in gross assets. Because of filing extensions, however, some returns were filed in 2018 for deaths that occurred before 2017, when filing thresholds were lower. A small number of estate tax returns were filed for deaths that occurred in 2016.

16. Assets were placed into one of five categories based on the type of property that was reported on the estate tax return.

17. The filing threshold rose from $2 million for people who died in 2008 to $5.49 million for people who died in 2017. In 2011, the amount of assets reported was unusually low, owing to the repeal of the estate tax for people who died in 2010. (Estates had the option of paying the estate tax in effect in 2011 instead.)

18. Retirement assets include annuities, assets held in defined contribution plans (such as individual retirement accounts), and the taxable portion of survivors' benefits from defined benefit plans (such as employer-provided pensions).

Box 1.

How Inherited Assets Are Valued for Capital Gains Taxes

People who sell assets are generally subject to tax on any resulting capital gains. Those gains are typically calculated as the asset's sale price minus its adjusted basis, or the cost of acquiring the asset. In 2021, capital gains on assets held for more than one year are subject to a maximum individual income tax of 20 percent, plus a 3.8 percent net investment income tax for taxpayers with higher income.

Assets that are held until an owner's death avoid those taxes because their basis is "stepped up" to the fair-market value at the time of the owner's death. When an heir sells an inherited asset, the heir's capital gains taxes are based only on the change in the asset's value from the stepped-up basis.[1] (For gifted assets, the recipient's basis for the asset is the same as the donor's—also called carryover basis.) Stepped-up basis creates an incentive for owners to hold on to their assets instead of shifting them into other uses. That lock-in effect could reduce productivity if those assets could have instead been shifted into more productive uses. Owners who hold on to their assets may incur the estate tax even if they avoid capital gains taxes, however, because those assets are included in the decedent's gross estate.[2]

Researchers have estimated that unrealized capital gains account for 34 percent to 44 percent of the value of all taxable estates, though the estimates vary by asset type and estate size.[3] Unrealized gains account for most of the value of closely held stocks and intangible assets.[4] In addition, unrealized gains as a share of taxable estates are highest among the largest estates (defined here as those with assets of $20 million or more).

Lawmakers have proposed changing the tax treatment of assets transferred at death. Among those proposals are ones that would replace stepped-up basis with carryover basis or treat transfers at death as a sale so that appreciated assets would be subject to capital gains taxes.[5] Those proposals would reduce the lock-in effect for decedents but could still affect when assets were sold. If carryover basis was adopted for inherited assets, heirs could be more reluctant to sell appreciated assets than they are now. Also, if accrued capital gains were taxed at death, then estates might need to liquidate assets to pay the tax liability due. In addition, those proposals would act as a wealth tax, so their implementation could increase the progressivity of the tax system and reduce wealth inequality.[6] To administer the proposals, policymakers would need to consider what basis to use to value a decedent's assets if the original basis could not be determined.

1. The estate tax was repealed for people who died in 2010. Assets transferred at death in that year were valued using a modified carryover basis, but estates could instead choose to pay the estate tax under the law in effect in 2011 and thus use stepped-up basis.

2. There is evidence that the estate tax encourages people to realize capital gains. For more discussion, see Athiphat Muthitacharoen, *The Impact of the Estate Tax on Capital Gains Realizations: Evidence From the Taxpayer Relief Act of 1997*, Working Paper 2010-08 (Congressional Budget Office, November 2010), www.cbo.gov/publication/21941.

3. See Robert Gordon, David Joulfaian, and James Poterba, "Revenue and Incentive Effects of Basis Step-Up at Death: Lessons From the 2010 'Voluntary' Estate Tax Regime," *American Economic Review: Papers & Proceedings 2016*, vol. 106, no. 5 (May 2016), pp. 662–667, http://dx.doi.org/10.1257/aer.p20161037; Robert B. Avery, Daniel J. Grodzicki, and Kevin B. Moore, "Death and Taxes: An Evaluation of the Impact of Prospective Policies for Taxing Wealth at the Time of Death," *National Tax Journal*, vol. 68, no. 3 (September 2015), pp. 601–632, http://dx.doi.org/10.17310/ntj.2015.3.05; and Department of the Treasury, Office of Tax Analysis, *Tax Expenditure for Exclusion of Capital Gains at Death* (August 2014), https://go.usa.gov/xHW4f (PDF, 1.4 MB).

4. Closely held stocks are stocks of a company that are held predominantly by a small number of people and therefore not actively traded. Intangible assets are assets such as licenses, patents, or registered trademarks.

5. See Congressional Budget Office, "Change the Tax Treatment of Capital Gains From Sales of Inherited Assets," in *Options for Reducing the Deficit: 2019 to 2028* (December 2018), pp. 219–220, www.cbo.gov/publication/54667; and Harry L. Gutman, "Taxing Gains at Death," *Tax Notes Federal* (January 11, 2021), https://tinyurl.com/a2tp6vrn.

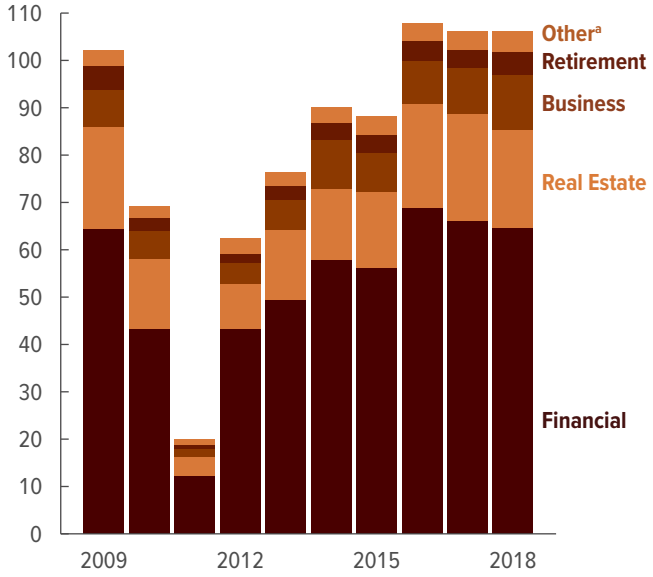
6. See Natasha Sarin, Lawrence H. Summers, and Joe Kupferberg, "Tax Reform for Progressivity: A Pragmatic Approach," in Emily Moss, Ryan Nunn, and Jay Shambaugh, eds., *Tackling the Tax Code: Efficient and Equitable Ways to Raise Revenue* (Brookings Institution, 2020), pp. 317–352.

Retirement assets followed a different pattern in 2018. The smallest taxable estates, those with gross assets of less than $10 million, held the largest proportion of retirement assets, accounting for 38 percent of the $4.7 billion in reported retirement assets. Estates with gross assets of $10 million to less than $20 million held 25 percent (or $1.2 billion) of retirement assets, and the remaining retirement assets were held by taxable estates with $20 million or more in gross assets.

Figure 1.

Assets of Taxable Estates, by Category and Year of Filing

Billions of Dollars



Data source: Internal Revenue Service's Statistics of Income. See www.cbo.gov/publication/57129#data.

Amounts are in nominal dollars.

Most returns are filed in the year following the owner's death; however, because of filing extensions, some returns are filed for deaths that occurred two years earlier.

a. "Other" includes works of art, depletable assets (such as oil and gas holdings), and intangible assets (such as intellectual property products).

What Are Projected Revenues From Estate and Gift Taxes?

Estate and gift tax revenues in 2020 totaled $17.6 billion, which was 0.5 percent of total receipts and 0.1 percent of GDP. Since 1980, combined estate and gift tax revenues have varied from close to zero as a share of GDP (or $7 billion) in 2011 to 0.3 percent of GDP (or $28 billion) in 1999.

As part of its baseline budget projections, CBO projects estate and gift receipts for each fiscal year in its 10-year budget period. CBO projects that, under current law, estate and gift tax revenues would total $21.6 billion in 2021 and rise to $49.5 billion in 2031. Estate tax revenues are projected to increase sharply after 2025, when the exemption amount is scheduled to drop (see Figure 2).[19] Over the 2021–2031 period, combined estate and gift tax revenues are projected to total $372 billion. In CBO's projections, estate and gift receipts equal less than 0.2 percent of GDP in each year of that period.

To project estate and gift tax revenues, CBO uses a model that estimates the tax liability for a representative sample of U.S. households. The model projects the distribution of wealth across the population over the 10-year period, reflecting changes in the economy and demographic shifts, including changes in mortality.

How CBO Models Estate and Gift Tax Revenues

CBO uses two sources of data to estimate a complete distribution of household wealth. The first source is estate tax returns, which provide information about household wealth for decedents whose wealth is greater than the exemption amount. The second source is the Survey of Consumer Finances, which provides information about other decedents.[20] Both sources are necessary to create a comprehensive measure of wealth for all decedents in a given year—those that are required to file an estate tax return as well as those with estates whose gross value falls below the filing threshold.

The model uses a sample of estate tax returns to estimate the wealth of people who died in a particular year, also known as the decedent sample. Because estates have an extended period to file a return, several years of tax data are combined to capture data representing the wealth of all people who died in a year. The model then estimates the wealth of the entire living population using the estate multiplier method, which divides the sample weights designed to approximate the population of estate tax filers by each person's probability of death.[21]

19. For revenue projections by category, see the supplemental data published with Congressional Budget Office, *The Budget and Economic Outlook: 2021 to 2031* (February 2021), www.cbo.gov/publication/56970.

20. The exemption amount has risen over time. In 2018, the most recent year for which tax data are available, the exemption was $11.18 million. CBO also used data from earlier years to create the distribution—for example, estate tax returns from 2001 decedents were used to fill in the sample between $1 million and $5 million.

21. For more discussion of the estate multiplier method, see Aaron Barnes, *Personal Wealth, 2013*, Statistics of Income Bulletin (Internal Revenue Service, Winter 2019), https://go.usa.gov/xHD9A (PDF, 563 KB).

Table 1.

Asset Allocation Among Taxable Estates, by Estate Size, 2018

Percent

	Estate Size, From Smallest to Largest Value (Millions of dollars)				
	Less Than 10	10 to Less Than 20	20 to Less Than 50	50 or More	Total
Asset Category					
Financial	18	18	21	43	100
Real estate	22	22	24	32	100
Business	14	14	15	56	100
Retirement	38	25	20	17	100
Other[a]	8	9	16	67	100
All	**19**	**18**	**20**	**42**	**100**
Memorandum:					
Number of Taxable Estate Tax Returns	3,037	1,413	722	313	5,485

Data source: Internal Revenue Service's Statistics of Income. See www.cbo.gov/publication/57129#data.

Most returns filed in 2018 were for deaths that occurred in 2017, when the filing threshold was $5.49 million in gross estate assets. Because of filing extensions, however, some returns were filed in 2018 for deaths that occurred before, when filing thresholds were lower.

a. "Other" includes works of art, depletable assets (such as oil and gas holdings), and intangible assets (such as intellectual property products).

Once CBO has estimated a distribution of wealth, the agency groups assets and liabilities into categories, including stocks, real estate, business, bonds, mutual funds, cash, life insurance, and retirement accounts. The growth of each asset group is adjusted to match the most recent balance sheet data from the Federal Reserve's "Financial Accounts of the United States." Household wealth based on those groupings is then projected—consistent with CBO's macroeconomic, financial, and demographic projections—over the 10-year period.

In each year of the projection period, estate tax liability is estimated on the basis of estate tax law, projected wealth, and mortality probabilities. Deductions from the value of a decedent's gross estate are imputed using reported deductions as a share of wealth calculated from estate tax returns. For each estate, the model estimates its potential tax liability and assigns it a mortality risk based on the age and sex of the owner. (For married couples, the mortality risk of the estate is the probability that both spouses will die in the same year.) Mortality risks are adjusted to reflect differential mortality for individuals who purchase annuities from life insurance companies.[22]

For gift taxes, CBO projects revenues on the basis of projected wealth, economic conditions, and historical relationships between those variables and actual revenue collections. In addition, gift tax receipts are adjusted for anticipated changes in the exemption amount and tax rates.

Sources of Uncertainty in CBO's Revenue Projections

CBO's projections of estate and gift tax revenues are meant to reflect the middle of the distribution of possible outcomes. Actual year-to-year changes in receipts may be more volatile, reflecting the inherent uncertainty about people's motivations and behavior. In the past three years, for example, revenues projected early in the previous year were higher than actual revenues by 1 percent (2020), 15 percent (2019), and 3 percent (2018).[23] Particular sources of uncertainty include the following:

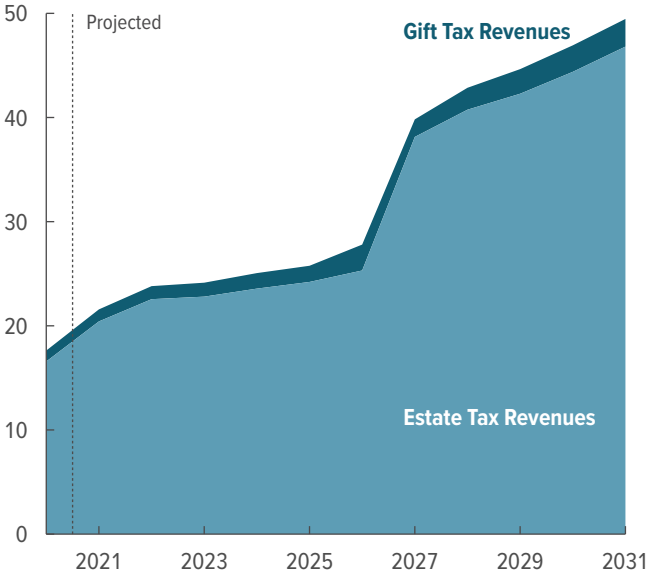
- **The degree of estate tax planning.** Tax planning can affect the size and composition of an estate's assets. People may have varying ideas about future tax legislation and about how the law will be applied to their estate. Those factors can affect the degree to which they engage in estate tax planning and other behaviors to minimize their tax liability. For example, some people may set up trusts so that their assets can be transferred to a beneficiary without incurring estate and gift taxes while allowing the donor to receive income from those assets. Other people may decide to sell an asset and realize a capital gain if they anticipate that tax rates on capital gains will rise in the future (or, conversely, they may delay realizations if they believe that rates are likely to be lower in the future).

22. Those calculations are based on estimates from Olivia S. Mitchell and others, "New Evidence on the Money's Worth of Individual Annuities," *American Economic Review*, vol. 89, no. 5 (December 1999), pp. 1299–1318, https://tinyurl.com/2addujyd. For information about wealth's effect on death, also see Jeffrey R. Brown, "Differential Mortality and the Value of Individual Account Retirement Annuities," in Martin Feldstein and Jeffrey B. Liebman, eds., *The Distributional Aspects of Social Security and Social Security Reform* (University of Chicago Press, January 2002), www.nber.org/chapters/c9756.

23. See Congressional Budget Office, *The Accuracy of CBO's Budget Projections for Fiscal Year 2020* (December 2020), www.cbo.gov/publication/56885, *The Accuracy of CBO's Baseline Estimates for Fiscal Year 2019* (December 2019), www.cbo.gov/publication/55927, and *The Accuracy of CBO's Baseline Estimates for Fiscal Year 2018* (December 2018), www.cbo.gov/publication/54872.

Figure 2.

Projected Revenues From Estate and Gift Taxes



Data source: Congressional Budget Office, using the agency's February 2021 baseline. See www.cbo.gov/publication/57129#data.

Amounts are in nominal dollars.

- **The timing of gift giving.** Whether and when people decide to give gifts is challenging to predict and may depend on their motivations for giving. Those motivations can vary—from providing financial support to reducing income tax liability through qualified charitable giving—which can also affect how responsive people are to changes in tax law.[24] In CBO's judgment, under current law some people will accelerate their giving of gifts in response to the lowering of the estate tax exemption at the end of 2025. Although CBO attempts to adjust for that shift, its extent is uncertain.

- **The estates subject to taxation.** Because of the relatively large exemption amount, few estates pay the estate tax, and predicting their tax liability is difficult. The model projects revenues from large estates using information from estate tax returns as well as the mortality rates of the decedents who own those estates. Because relatively few estates file an estate tax return, though, the estates observed in the data may not be representative of the top end of the wealth distribution. In addition, wealthy people have lower mortality rates than the overall population; although CBO adjusts for that on the basis of the research literature, those estimates are uncertain.

This report, which is part of the Congressional Budget Office's continuing effort to make its work transparent, explains how CBO prepares revenue projections for estate and gift taxes. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

Shannon Mok and James Williamson prepared the report, with guidance from John McClelland and Joseph Rosenberg. Tess Prendergast assisted with data collection and analysis. Ann Futrell, Nadia Karamcheva, Jeffrey Schafer, Jennifer Shand, and Ellen Steele provided helpful comments on the draft. Madeleine Fox fact-checked the report.

Mark Doms and Robert Sunshine reviewed the report. Christine Bogusz was the editor, and R. L. Rebach was the graphics editor. This report is available on CBO's website (www.cbo.gov/publication/57129).

CBO continually seeks feedback to make its work as useful as possible. Please send any comments to communications@cbo.gov.

Phillip L. Swagel
Director

24. Researchers have found that gift giving between a parent and child while the parent is still alive can depend on the parent's lifetime income and the child's income; gifts to a child increase as a parent's income rises but decrease as the child's income rises. See, for example, Joseph G. Altonji, Fumio Hayashi, and Laurence J. Kotlikoff, "Parental Altruism and Inter Vivos Transfers: Theory and Evidence," *Journal of Political Economy*, vol. 105, no. 6 (December 1997), pp. 1121–1166, https://doi.org/10.1086/516388.