A Better Way to Tax Unearned Income

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INTRODUCTION

The belief that success should come from your personal initiative and hard work, rather than the good fortune of your birth, is central to our nation's identity as the "land of opportunity."

Rags to riches stories are deeply rooted in American history and folklore, with several of our founding fathers, such as Alexander Hamilton and Benjamin Franklin, rising from impoverished backgrounds to build a nation. Conversely, the American ethos has steadfastly rejected the "artificial aristocracy founded on wealth and birth," as Thomas Jefferson writes, in favor of one built upon "virtue and talents."[1] Success in America is supposed to be built upon merit and hard work rather than who your parents are.

Despite this national ethos, America has fallen behind many of our international peers in creating opportunities for social mobility. In the World Economic Forum's measure for social mobility, the United States performs worse than the Nordic countries, France, and even the United Kingdom, with their long history of hereditary aristocracy.[2] Declining levels of intergenerational mobility have come in tandem with rising levels of wealth inequality. U.S. wealth is densely concentrated among relatively few

households, with the top 10% of households today owning roughly 67% of the nation's wealth, compared to the 2.5% for the bottom 50% of households.[3] Even among households that are exclusively above age 50, which removes cases where people are high-income but low-wealth (such as a recent law school graduate), the wealthiest 10% of households own 70% of wealth in that age range, while the bottom 50% of households only have 3%.[4]

This combination of low social mobility and high wealth inequality produces a self-perpetuating hierarchy of economic privilege, making it difficult to get ahead on hard work alone. As much as 60% of all wealth in the United States is inherited rather than earned.[5] Moreover, this inheritance income is skewed toward those who already enjoy comfortable lives: In 2021, the top 10% of earners received 55% of total inherited wealth, while the bottom 40% received less than 10%.[6] It's perfectly natural that people who have enjoyed economic success would want to pass some of their wealth on to their children. But the privilege cannot be limitless. Entrenched aristocracies built upon generations of inherited wealth create a substantially uneven playing field and pose a threat to our democracy, as concentrated wealth, in turn, leads to concentrated economic opportunities and political power.

The best tool for reconciling this tension between individual liberty and America's promise of equal opportunity for all is the U.S. tax system. But as the next section of this paper explains, the current estate tax is undermined by large exemptions and loopholes that make it easy to avoid for even the wealthiest families. It has also become deeply unpopular with the general public after years of anti-tax Republicans arguing that, because taxes are already levied on the income a person earns during their lifetime, taxing the assets a person leaves behind is an unfair "death tax" that amounts to double taxation.[7] But these critiques misrepresent who actually pays the estate tax. Someone who is already dead suffers no inconvenience from the estate tax or any other tax policy; the tax is instead borne entirely by heirs who never paid any tax on the income they receive from an inheritance.

The following sections of this paper offer federal policymakers a technical framework for reforming the taxation of intergenerational wealth transfers to progressively raise revenue and undercut the misleading political attacks levied against the current system. To start, we propose to replace the estate tax — which taxes a decedent's estate — with a new system that would only tax inheritance as it is received by an heir. This approach would both limit Republican "death tax" arguments by making it more clear that the tax is paid by wealthy heirs and create a fairer system for heirs by only taxing the inheritance they actually receive as income. We also propose reforms to the gift and generation-skipping transfer taxes — two taxes intended to complement the estate tax — to work better alongside our proposed inheritance tax.

Next, we offer a series of reforms to close the largest loopholes in the current wealth transfer tax system. One of the biggest is the stepped-up basis, which permits previously unrealized capital gains to completely escape taxation after an asset has been passed down. In addition, our proposal takes aim at the myriad of loopholes that arise from the IRS's favorable treatment

of non-liquid assets, including tax deductions and discounts commonly abused by wealthy families. However, we also pair these reforms with expanded protections to ensure that no heir has to sell the family farm, home, or small business they inherit just to pay an onerous tax bill. Lastly, we make major reforms to the taxation of trusts, streamlining complicated tax rules and closing the many loopholes that arise from this complexity while preserving the use of trusts for valid reasons unrelated to tax avoidance.

Left out of our proposal are changes to address other vehicles that are sometimes used to avoid estate tax, such as leaving estates to questionable nonprofit “family foundations” or using life insurance to pass along wealth tax-free. Since closing these loopholes would require a much broader rethink of the taxation of nonprofits and life insurance overall, and our proposal makes them no worse than under current law, we have chosen to leave them unchanged. Despite these omissions, our proposal would be a substantial improvement over the status quo, raising several hundred billion dollars over ten years from the wealthiest households while creating a better and fairer tax regime. Furthermore, every dollar raised by taxing unearned inheritance is one that does not need to be raised by increasing taxes on the earned incomes of working and middle-class Americans, making it a strong option for policymakers to consider in the context of future tax reform or deficit reduction efforts.

WHY OUR ESTATE TAX IS BROKEN

Contrary to Republican attacks that claim the estate tax is a threat to many Americans’ “way of life,” taxing large estates is an idea almost as old as the nation itself.[8] The first estate tax was temporarily enacted in 1797 during the Washington administration to fund the United States Navy as it clashed with European powers. During the Civil War, the Lincoln administration again turned to an estate tax to raise revenue, imposing a “succession tax” on bequests of real estate to descendants, as well as enacting the nation’s first gift tax. This too was ultimately repealed when the need for revenue dissipated after the war.[9] The advent of the modern estate tax came in the progressive era during the early 20th century, when the Wilson administration included it in a tax package to pay for World War I. Since then, the estate tax has undergone several revisions.

Yet despite this history and contemporary polls consistently showing high levels of public support for taxing wealthy Americans, Republican attacks have successfully eroded public support for the estate tax even though it mainly targets the nation’s richest households.[10] In 2017, the most recent year in which significant polling was done on the issue, surveys found that 75% felt that the wealthiest families should face higher taxes, but that 54% were in favor of completely repealing the estate tax, compared to just 39% against.[11, 12] These dynamics have allowed Republicans to weaken the estate tax regime in multiple tax reform bills over the past few decades, while Democrats have not made it a centerpiece of their tax plans.[13, 14]

As a result, the share of estates that face any estate tax has fallen from 6.5% in 1972 to merely 0.14% today.[15, 16] The main reason so few estates are subject to any estate tax is that heirs are allowed to claim an excessively generous Unified

Tax Credit (UTC) credit against it. The UTC effectively eliminates any tax on up to $13.99 million of inherited wealth, a figure referred to as the applicable exclusion amount. Spouses can also combine their exclusions, meaning that couples effectively get a $27.98 million exclusion on their estates.[17] For context, $27.98 million is 145 times the typical American household's net worth and 347 times their annual household income.[18, 19]

This giveaway stems from the Republicans' 2017 Tax Cuts and Jobs Act (TCJA), which also indexed the applicable exclusion amount to inflation. For the few extremely wealthy estates that exceed the tax exclusion, a 40% tax is levied on everything above it. This provision of TCJA is set to expire in 2025, at which point the exclusion will revert to approximately $7 million for singles and $14 million for couples.[20] Even then, this exemption would be an extreme international outlier: Among OECD countries, the next-highest tax exemption for bequeathed wealth historically was just $1.1 million.[21]

America's wealthiest plutocrats also deploy an array of complicated estate planning strategies to protect their assets from the taxman. Consider the example of Phil Knight, the billionaire founder of Nike. His son's position on the Nike board gave shareholders and the public a window into the litany of trusts, family holding companies, and other avoidance strategies Knight used to pass substantial wealth to his heirs tax-free.[22] The Knight family is hardly alone in taking advantage of our porous system. Each year, assets worth billions of dollars are passed from generation to generation tax-free. Thanks to its myriad of loopholes and shrinking tax base, estate tax receipts have fallen in real terms by 43% since 2001, with the total number of taxable estates dropping by a whopping 92% in the same time period.[23]

A PROGRESSIVE INHERITANCE TAX WOULD FIX THIS BROKEN SYSTEM

Progressive Policy Institute proposes to fix this mess by replacing the hopelessly compromised estate tax with a progressive inheritance tax. Rather than tax the estate of someone who dies, it would only levy tax on what heirs receive as income from their inheritance. This tax treatment is more intuitive and easier to administer, which is why five times as many OECD countries tax inheritances versus taxing estates.[24]

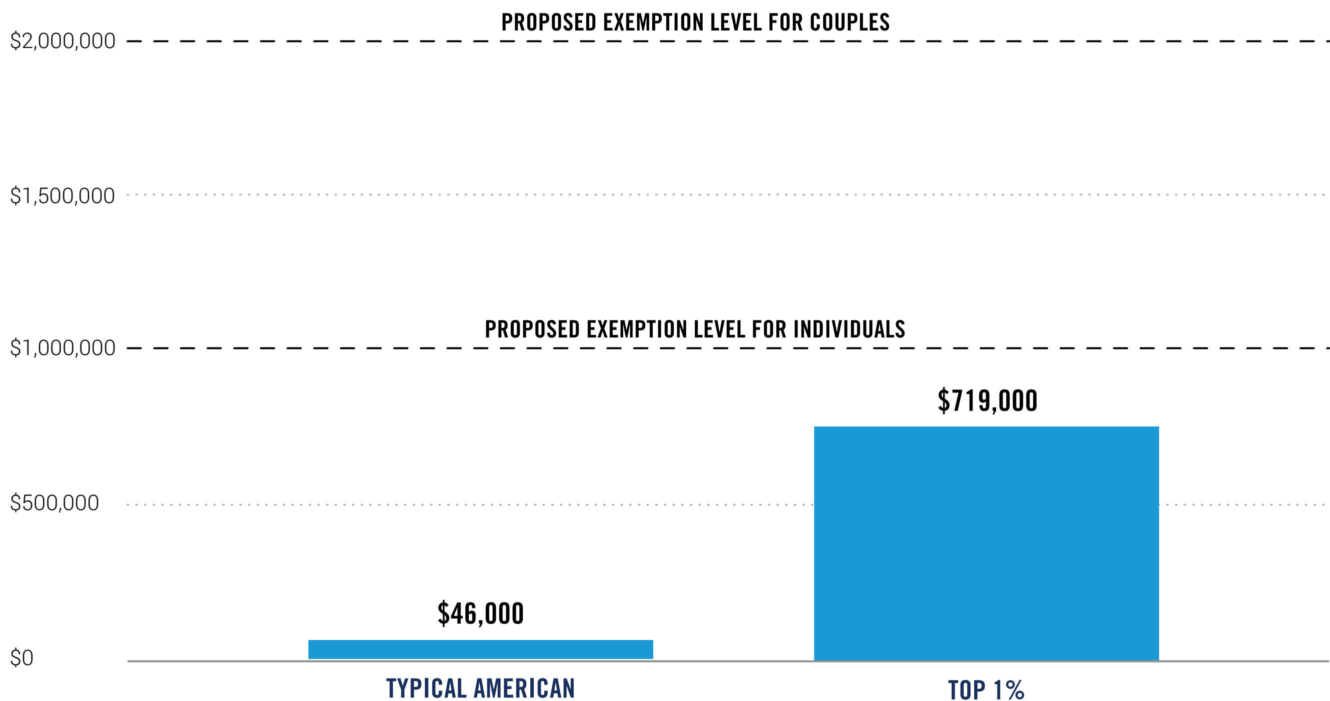
Just as under current law, transfers to a surviving spouse or charity would remain tax-free, as would estate spending on debts, funeral expenses, and legal and administrative fees. The switch from taxing estates to taxing individual heirs when they receive a bequest makes it clearer that taxing inheritance is not an additional tax on the decedent's earnings, but a completely separate tax on the heir's unearned income. While this may take some sting out of Republican attacks, it would primarily serve to make the system fairer by only taxing what actually accrues to heirs as income.

To replace the applicable exclusion amount, our proposal would create a $1 million lifetime exemption that is assigned per person, rather than per estate. Like under current law, this exemption would be adjusted annually for inflation, and include the option for spouses to assign it to their partner if they choose. For example, if someone received a $1.5 million bequest and exhausted their own exemption,

their spouse could assign half of their exemption to cover the remainder of the inheritance without facing any tax. People who receive multiple gifts and bequests throughout their lifetime would be permitted to use the remaining percentage of their exemptions from previous transfers applied to the current exclusion amount. For example, if an individual claimed 50% of the initial $1 million exemption amount, then received a future bequest when the exemption rose to $1.2 million, they would be able to claim an exemption up to 50% of the new exemption limit, which would be $600,000.

Setting the lifetime exemption at $1 million allows for an inheritance tax to capture more revenue from the wealthiest households, expanding the tax base beyond the pitiful 0.14% of estates that currently pay estate tax. But it is also high enough to avoid taxing ordinary Americans who do not receive large inheritances. According to the Federal Reserve, lifetime inheritance for the average American was a mere $46,000 — well below our proposed exemption level. Even for those in households in the top 1% of wealth, the average lifetime inheritance was still $719,000, and thus comfortably below our exemption **(Fig. 1)**.[25]

FIGURE 1: AVERAGE LIFETIME INHERITANCE BY HOUSEHOLD WEALTH



Note: "Typical American" represents the average inheritance received across the wealth distribution, while the "Top 1%" represents the average inheritance for just those in the top 1% of the wealth distribution.

Source: Survey of Consumer Finances[26]

Our proposed inheritance tax would also progressively overhaul the rates that heirs face on their unearned inheritance income. After exhausting their lifetime exemption, heirs would count gifts or bequests received as part of their taxable income. PPI proposes applying an additional surtax for inheritance income on top of ordinary income tax rates for three reasons:

- The top ordinary income tax rate is less than the current estate tax rate, meaning that the largest inheritances would actually receive a tax cut if no surtax were imposed.
- Most other forms of income are also subject to additional taxes on top of ordinary income tax rates, such as the payroll tax or net investment income tax, and we believe that income someone earns through their own hard work or strategic investment should not be taxed at a lower rate than the windfall income they receive due to the luck of their birth.
- Taxing something results in less of it, and while policymakers should be concerned about the impact on our economy of discouraging work or productive investment, there are far fewer negative behavioral responses that would be taken in response to higher tax rates on inheritance. In other words, every inheritance tax dollar raised does not need to be raised from taxing more productive economic activities.

When PPI first proposed adopting a progressive inheritance tax as part of our comprehensive budget plan, we called for a 15% surtax rate.[27] However, we realize that political constraints may require Congress to choose different parameters than the authors of this report would. The table on the next page of this report shows roughly how much additional revenue policymakers could raise under different scenarios relative to current law, which assumes TCJA's ludicrously generous exemption threshold increase is not extended past its scheduled expiration at the end of 2025 **(Fig. 2)**. Notably, even those permutations depicted in the table as losing revenue relative to current law would likely raise revenue relative to full extension of TCJA.

In reforming the rate structure, our proposal also goes to great lengths to avoid taxing heirs who are middle-income at the same rate that it taxes extremely wealthy heirs. Heirs would be allowed to spread their inheritance over the year it is received plus the four previous tax years. In other words, the inheritance would be subject to tax as if it was received in parts over that five-year period rather than as a lump sum. If they took advantage of this provision, heirs with annual incomes that already place them in the highest tax bracket would still be subject to the top rate on inherited income, but lower-earners who receive large inheritances would benefit from a greater share of the inheritance being taxed in lower brackets.

FIGURE 2. TEN-YEAR REVENUE EFFECTS OF SWITCHING TO PPI'S PROPOSED INHERITANCE TAX UNDER DIFFERENT SURTAX RATE AND EXEMPTION COMBINATIONS

		SURTAX RATE				
		NONE	5%	10%	15%	20%
INDIVIDUAL EXEMPTION	NONE	$1.495 T	$1.950 T	$2.405 T	$2.855 T	$3.310 T
	$500,000	$510 B	$675 B	$845 B	$1.015 T	$1.180 T
	$1,000,000	$220 B	$320 B	$425 B	$530 B	$630 B
	$1,500,000	$85 B	$160 B	$230 B	$305 B	$375 B
	$2,000,000	$10 B	$65 B	$125 B	$185 B	$245 B
	$2,500,000	-$50 B	$0 B	$45 B	$95 B	$145 B
	$3,000,000	-$95 B	-$55 B	-$10 B	$30 B	$70 B
	$3,500,000	-$125 B	-$90 B	-$55 B	-$20 B	$15 B
	$4,000,000	-$145 B	-$115 B	-$85 B	-$55 B	-$25 B

Note: Revenue changes are measured relative to CBO's current-law baseline for the FY2026-2035 budget window and rounded to the nearest $5 billion. Estimates are based on the Gale, Hall, and Sabelhaus wealth transfer model using 2021 data. Scores assume ordinary income tax rates from the Tax Cuts and Jobs Act are extended and include the estimated effects of all provisions described in this report, but not interactions with other provisions of the tax code that may modestly reduce revenue. The surtax is assumed to apply to taxable income in all brackets.

Sources: Brookings,[28] Congressional Budget Office,[29, 30, 31] and PPI calculations

To see how this works in practice, consider two single heirs who each inherit $1.5 million dollars, but have annual incomes of $50,000 and $1 million, respectively. Under a system with PPI's proposed parameters, if they chose not to amortize, these heirs would owe tax on the $500,000 that remains after they exhaust their exemption. While the middle-income heir would pay slightly less owing to his lower income, he would still face an effective tax rate of roughly 46.2%, compared to 52% for the high-income heir (not including the 0% rate they face on the first $1 million covered by the exemption). However, if they both choose to amortize, they could treat the remaining $500,000 inheritance as if it was spread out in $100,000 increments over 5 years. This would bring down the effective tax rate faced by the middle-income heir to roughly 38%, while the high-income heir would still face an effective tax rate of 52%.

In order to prevent any gaming from this provision, our proposal requires heirs to disregard net operating loss when using amortization. If left unaddressed, people such as pass-through business owners, who file their businesses' losses on their individual income tax returns, could artificially concentrate business losses in preceding years to deflate their taxable income if they expected an inheritance in the near future.

Beyond replacing the current estate tax, PPI proposes several additional reforms that complement an inheritance tax system, which are detailed in the following sections of this report.

REFORMING GST AND GIFT TAXES TO COMPLEMENT AN INHERITANCE TAX

In addition to the estate tax, there are a number of smaller federal taxes that add complexity to the existing regime for taxing inherited income. One example is the gift tax. Under current law, individuals are able to give up to $19,000 every year tax-free. Any gifted amount above this begins to count towards the UTC's applicable exclusion amount. This amount would double to $38,000 if the gift giver is married and her spouse gives half of the gift(s).[32] The $19,000 threshold is per year and per person, so a wealthy couple could give each of three relatives $38,000 a year for 20 years without affecting the family's estate tax liability, or using any of the estate's exclusion amount. All gifts for educational or medical expenses, as well as support expenses for a minor child, are also tax-exempt.[33]

While gifts given after the giver has exhausted their applicable exclusion amount are nominally taxed at the same 40% rate that other bequests face under the estate tax, they functionally face a lower tax rate because the rate is applied to a tax-exclusive base instead of a tax-inclusive one.[34] In other words, taxpayers pay gift tax liabilities equal to 40% of the gift rather than 40% of the gift and gift tax paid. For example, an individual who has exhausted their applicable exclusion amount estimates that they will have $500 million in their estate at death. If they were to wait until death to transfer any money, they would pay 40% of that amount, or $200 million, while transferring $300 million to heirs. However, the same individual could structure that $500 million as a gift. This would allow

them to transfer $357 million dollars as a gift, then use the remaining $143 million to pay gift taxes (since 143 is 40% of 357). This allows for a much lower “effective” tax rate of 28.6% on unearned wealth transfers.

The federal government also imposes an additional generation-skipping transfer (GST) tax on bequests left to people who are more than one generation (or 37.5 years) younger than the donor. The GST tax rate is equal to 40% times the percent of the total post-tax estate in excess of the applicable exclusion amount being transferred to an heir subject to the tax. This second layer of taxation is designed to account for the fact that bequests passed to a grandchild through their parents would be taxed twice, while bequests passed from grandparent to grandchild would only be taxed once. The GST tax only imposes one additional layer of taxation, so bequests left to great-grandchildren are still taxed at the same level as bequests to grandchildren. This creates a loophole in the existing system where wealthy decedents can leave wealth for their great-grandchildren, without paying the additional layer of taxation that would have arisen if they chose to do so for their grandchildren.

While these additional taxes are designed to plug holes in the estate tax system, they also create confusing layers of taxation that can be difficult for people to track or understand. This complexity increases the difficulty of navigating the tax system honestly, with differing layers of exemptions, exclusions, and rates.[35] It also invites opportunities for gaming and working around the system that might not be available under a more consolidated regime.

Our proposal repeals the existing GST and gift taxes to create a more streamlined system. In their place, we would implement a single $15,000 annual cap per recipient. Gifts in excess of this annual amount would count against their lifetime inheritance tax exemption. To prevent Americans from being burdened with logging smaller items such as their annual Christmas or birthday gifts, gifts of less than $2,000 wouldn’t count towards this $15,000 at all. For example, a young adult receives a $700 Playstation for their birthday. Later that year, they are given two concert tickets worth $800 for Christmas. Since these gifts each fall below the $2,000 threshold, the recipient wouldn’t even be required to report them for tax purposes. Gifts used to pay for educational or medical expenses would also not count against the annual exemption.

CLOSING CAPITAL GAINS TAX LOOPHOLES

Our proposal also closes a major loophole that allows wealthy families to avoid ever paying capital gains taxes. Normally, people who sell an asset at a higher price than they purchased it have to pay capital gains tax on the difference when the gain is “realized” through sale. But if the asset was inherited rather than purchased by the person who sells it, they only pay taxes on the increase in value from when they inherited the asset, not when the decedent bought it.[36] This is known as the “stepped-up basis” loophole, and it creates a powerful incentive for wealthy people to hoard assets until their death. Capital gains accrued to estates worth less than the applicable exclusion amount are never subject to any form of taxation, while gains subject to the estate tax face only one layer of taxation instead of the two they would face if realized during the donor’s lifetime.

If policymakers want to be extremely aggressive, one available option is to treat death as a realization event. This change would levy capital gains tax on an estate's appreciated assets before they are subject to any estate or inheritance tax. Doing so would eliminate the incentive for wealthy parents to hoard assets with large unrealized gains by ensuring that they cannot pass those on to their children tax-free. It would also raise the most revenue of the available options for reform.[37] While the policy merits of this approach are sound, it would likely come with greater political costs. Taxing capital gains at death would likely intensify the misleading "death tax" and "double taxation" claims currently levied against the estate tax, neutralizing any potential political improvements from moving to an inheritance tax.

Instead, we propose to close the loophole by requiring heirs to carry over the basis on inherited assets. A carryover basis system requires anyone who sells an inherited asset to pay capital gains tax on the difference between the sale price and the price at which it was acquired by the original owner. In instances where records of the original purchase price have been lost, the basis for the taxable gain would be reverse-engineered using a benchmark growth rate calculated by the IRS that estimates how much an asset is likely to have appreciated since its original purchase date.

Our proposal harmonizes the switch to a carryover basis with the new inheritance tax regime. Any inheritance tax paid on just an asset's unrealized gains (but not the taxes paid on the remainder of the asset) could be added onto the asset's basis at the time they choose to sell it. This approach prevents any double taxation that would result from applying inheritance tax to the share of a capital gain used to pay capital gains tax.

We would also allow the tax exemption for capital gains on primary residences, which is currently $250,000 for singles and $500,000 for couples, to be added to the residence's basis at the time of the owner's death. If an heir first lives in an inherited home but later chooses to sell it, they can also rely upon their own exclusion to further lower their tax liabilities. This generous treatment creates a capital gains exclusion of up to $1 million on a primary residence bequeathed to a married couple by a married couple, which is separate from the $2 million inheritance tax exemption that these heirs are already entitled to on their entire inheritance under our proposal. As a result, it shields most family homes that are passed down through multiple generations from accumulating a snowballing capital gains liability that would otherwise pressure the family to sell it.

FAIR TREATMENT OF FAMILY FARMS, SMALL BUSINESSES, AND OTHER ILLIQUID ASSETS

An additional source of loopholes is the favorable treatment that certain assets receive from the IRS for estate or gift tax purposes. Oftentimes this can be for a legitimate reason, such as lowering the tax base for a business or farm that takes in less income than what the property itself is worth. The IRS uses a "special use formula" to value property used in a farm or business based on its current-use value rather than the market value of the underlying assets. Under these rules, a farm that might only be worth $2,000,000 when used as farmland

could reduce their tax bill, even if the land the farm sits on would be valued at $12 million if redeveloped.[38] Under current law, a qualified farm or business can reduce its property value up to an annually adjusted limit, currently sitting at $1.31 million, before estate tax liabilities are calculated.[39] In addition, the IRS offers some flexibility for those who inherit primarily non-liquid assets, and may not be able to pay their liabilities in full right away. When farms or businesses make up at least 35 percent of a gross estate, the tax may be paid in installments over 14 years at reduced interest rates, with only interest due during the first five years (whereas other estates must typically file and pay taxes within 15 months of the donor's death).[40]

Our proposal goes to great lengths to protect farmers and businesses from facing substantially higher inheritance tax liabilities by dramatically expanding the "special use" rules that benefit family farms and businesses. This rule permits these assets to be valued based on the use value of their assets rather than their market value, with heirs able to deduct the lower of a capped amount or the use valuation. To make up for an inheritance tax exemption that is smaller than the current estate tax exemption, PPI proposes to increase the current $1.31 million cap on the valuation deduction to $20.4 million, which is greater than or equal to the value of 98% of farms in the United States.[41, 42] The proposal would also retain rules to prevent tax avoidance schemes that open temporary "small businesses" to reduce an heir's tax liability, before quickly cashing them out once the tax has been paid. To qualify for the special use discount, these rules would require the asset to be used for that purpose for the next 10 years after an heir receives it.[43] If an heir chooses to sell before the ten years are up, then they would owe the original inheritance liability with interest for each year since they received it.

Favorable treatment of non-liquid assets can also be abused to merely avoid taxation. Currently, estates may value assets differently for tax purposes than they do in other instances where they benefit from a higher valuation, such as when using it as collateral for a loan or purchasing insurance coverage. Additionally, heirs may claim various "discounts," or reductions in the market valuation of their assets, before estate tax is calculated. These discounts can lead to gaming and prioritization of certain assets that might yield lower estate tax liabilities.[44] One is the "lack-of-marketability" discount, which reduces an asset's valuation for estate tax purposes if it is not easily sold or valued on the market. Another is the "lack-of-control" discount, which is granted to assets where the owner does not have full control over an asset, or only controls part of the whole. Lastly, heirs can claim the "minority" discount, which reflects the fact that their partial ownership of an asset makes it worth less than market value because it is merely a part of a whole.[45] While there can be some valid scenarios for these discounts' existence, they are commonly used by estate planners to lower estate tax liabilities by intentionally placing wealth into artificial enterprises that are harder to sell.

Consider this example: A wealthy individual opens an LLC and dumps $100 million in assets into it, dividing its share amongst himself and his three heirs. Each heir can then take advantage

of a minority discount by arguing that since no single person controls the entire company, the parts they own are worth less separately. To claim the lack of marketability discount, they can argue that their private stake in an LLC is difficult to sell for true market value. However, these distinctions are typically just artificial facades. There is nothing to stop the heirs from getting together later on and selling these assets for their true market value, after having claimed estate tax discounts for their separation.

PPI's proposal would make substantial reforms to the treatment of non-liquid assets, preserving protections for small businesses and family farms while cracking down on clear tax avoidance schemes. Our plan does not give a blanket preference to all non-liquid assets as currently exists, nor does it wholly exempt certain asset types in a way that would open up new tax avoidance strategies. Instead, it offers the option for taxpayers to amortize their tax liabilities over a period of up to thirty years (so long as they paid an annual market-rate interest payment determined by the IRS). This would allow for heirs who inherit large non-liquid assets to cover their annual tax liabilities without being forced to sell those assets. To prevent heirs from using a lower valuation for tax purposes and a higher one elsewhere, they would be required to use the same valuations for assets being left to heirs that they use for insurance, banking, or other financial reporting purposes. To prevent wealthy families from artificially dividing their assets to use the "minority" or "marketability" discounts, our proposal disallows their use for family-controlled entities.

CLOSING LOOPHOLES IN THE TRUST TAX SYSTEM

Our proposal also makes key changes to the tax system to reform the way trusts are taxed and close loopholes. At the same time, it preserves protections for legitimate uses of trusts, such as providing for a minor or disabled child.

Typically, trusts are estate planning arrangements that hold a grantor's property or assets for a beneficiary or beneficiaries. They are generally either "irrevocable," meaning that the grantor can't make unilateral changes to it after establishment, or "revocable," meaning that they retain primary control.[46] Both irrevocable and revocable trusts can also be "grantor trusts," meaning that the grantor retains control of the trust for income tax purposes. In an irrevocable grantor trust, the source of many of the largest loopholes, the initial contribution is subject to gift tax while the trust itself is treated as a non-entity for income tax purposes, with the grantor required to report any trust income on their personal tax returns. This differs from non-grantor trusts, which are subject to a unique rate structure that mirrors normal income tax brackets, but with far lower income thresholds. For example, these trusts pay a top tax rate of 37%, but it begins at merely $15,201 of income.[47]

In our proposal, taxation of gifts and bequests made in irrevocable trusts would now occur entirely at the trust level, removing existing grantor-trust rules. Generally, when these trusts receive a contribution, they would immediately pay taxes on it according to the trust tax brackets that exist under current law, plus the appropriate surtax for unearned

income. When the original contribution is actually distributed to a beneficiary, it would not be taxed again. However, any income from that contribution, such as the interest it earns while being held in the trust, would be taxed like ordinary income when it is distributed to the beneficiary. This mirrors the treatment of irrevocable non-grantor trusts under current law. Since revocable trusts remain part of a grantor's estate, they would mostly continue to be treated as they are under current law, but would now be taxed at the inheritance rate when distributed to an heir.

Beneficiaries could choose to assign their exemptions to a trust to reduce the trust's tax liabilities. For example, a beneficiary could assign their $1 million inheritance exemption to a trust so that the first $1 million in a trust's income faces no tax liabilities. They can also choose to assign the tax rates they would have to pay on any inheritance, so long as they had not received any inheritance distributions from the trust yet. Doing so would tax the trust at a rate more comparable to what the beneficiary would have faced if the money had been given directly as inheritance instead of through a trust. This provision would preserve the progressivity of the new system by permitting middle-income heirs to lower their tax rates relative to wealthy ones.

Our proposal also tackles "dynasty trusts," which are extremely long-term trusts that are designed to protect and pass on wealth through several generations with minimal tax liabilities. They are typically created by wealthy families such as the Rockefellers or Vanderbilts, who have used them to preserve substantial wealth for their families for more than a century.[48] To prevent dynasty trusts from existing in perpetuity without facing inheritance tax, trusts would face a tax corresponding to their trust balance every generation using the appropriate rates. The passage of a generation would be determined using existing GST tax rules, which state that a generation is considered to have passed when there is no longer any beneficiary of the trust from a member of the previous generation. Existing trusts would be subject to transition rules, being treated as if they were created on the day before the law is enacted. While they would not face any retroactive taxation on their initial contributions, they would still face future taxes for the passage of a generation and any additional trust income.

While much of the trust system is a way for people to avoid paying estate taxes on their wealth, it can also have legitimate uses, such as setting aside money for a disabled child or trying to create small nest eggs for minor children. Our proposal would allow for parents and guardians to create a special trust form to protect minors and disabled children without facing any tax liabilities. To ensure that this is not just used as another loophole to avoid inheritance taxation for extremely wealthy families, it would come with a specific set of guardrails. Initial gifts would be limited to $1 million or less, and the trust could only have one beneficiary. This keeps the trust focused on the intended beneficiary with a limited benefit, rather than snowballing into multiple potential heirs at limitless amounts of untaxed wealth.

The beneficiary (or someone acting on their behalf), could demand distribution of the original

contribution at any age between 18 and 25. If the beneficiary does not take the distribution, then they are deemed to have received the inheritance at age 25. Setting an end date for the trust prevents it from being used in perpetuity to shelter inherited income. Lastly, the original contribution would be taxed at the inheritance rate while income would be taxed at the recipient's ordinary income rate. Legal guardians would also be empowered to assign an heir's exemptions or request distributions from this trust.

Our reforms to the broader taxation of trusts also has implications for the trust system's most egregious loopholes. On its own, replacing grantor trust rules with our overall system would sufficiently close certain loopholes, such as the "the intentionally defective grantor trust" that effectively allows grantors to pass along the value of the income taxes they pay on the trust to their heirs as a tax-free gift.[49] However, others would still require some specific reforms to eliminate completely. The largest of these is the "grantor-retained annuity trust" (GRAT). GRATs are structured to provide an annuity to the donor for a set number of years, then typically transfer any remaining assets at the end of the period to the donor's heirs tax-free. When contributing to a GRAT, the donor typically owes tax on the value of the contribution minus the value of the annuity. The value of the annuity is equal to the present value of the annuity payments, using a discount rate equal to 120% of the 10-year treasury rate.[50]

Often, the GRAT is structured such that the value of the annuity is equal to the value of the GRAT assets, causing the value of the gift to be zero. This is referred to as a zeroed-out GRAT. In a zeroed-out GRAT, the failure of the GRAT's assets to generate a return equal or higher than the rate at which the annuity payments are discounted will cause all the GRAT assets to return to the grantor. This underperformance scenario has no adverse tax consequences. It is just a "nothing" for tax purposes. However, if the assets are able to generate a return higher than that discount rate, which they typically do, then all the gain above that rate can pass to the beneficiary without incurring any gift or estate tax liabilities. Thus, a zeroed-out GRAT is a "heads I win, tails we tie" proposition for the GRAT donor.[51] Because there is no limit to the number of GRATs a taxpayer may establish, or how long the annuity repayment must be structured, persistent taxpayers can eventually transfer huge tax-free amounts to their descendants through GRATS, even if only a fraction of those GRATs succeed.

Our proposal takes a straightforward path to cracking down on the abusive use of GRATs. Once a contributor's annuity has been paid back to them in full, the trust would be treated as having received a taxable gift equal to the remaining value of the GRAT assets. This change, alongside the removal of grantor trust rules, would remove their ability to pass on wealth tax-free.

OTHER RELATED TAX ISSUES

Although our proposal makes substantial improvements over the status quo by closing most of the worst loopholes in our current tax code's taxation of inheritance, a few would require an overhaul of other tax provisions that are outside the scope of this paper. For

example, one of the biggest ways estates currently avoid taxation is by leaving assets to family foundations or tax-exempt nonprofit organizations. While these organizations are supposed to use their resources to fulfill a charitable mission, they can often be used to shield funds under the direction of the donor's descendants.[52]

Another example is the tax treatment of life insurance. Life insurance trusts are commonly used as a loophole to pass on wealth, given that benefits are not typically considered taxable income.[53] Wealthy estates will set up trusts with massive life insurance plans, naming their heirs as the beneficiaries. These plans are structured with massive premiums equal to or more than the benefit value, plus some interest. When the insured decedent passes away, the benefit can be passed on tax-free to the beneficiary.

However, closing these respective loopholes would require a broader overhaul of the tax treatments for life insurance and nonprofits that go well beyond changes to the taxation of estates and inheritances. Since these changes would surely impact far more than just those seeking to use it as a tax loophole, and these loopholes are no worse under our proposed inheritance tax than they are under the current system, our plan leaves them unaddressed for now.

CONCLUSION

Adopting a progressive inheritance tax, as proposed by PPI in this report, would end the perverse practice of taxing income someone earns through their own hard work or entrepreneurial investments at a higher rate than the windfall they receive simply for being born to wealthy parents. At the same time, our reforms would close the most egregious loopholes wealthy families use by simplifying the complex system that has created them. Together, these comprehensive changes would make the system substantially fairer by preventing the passage of massive wealth from generation to generation without ever being subject to taxation. Moreover, it would raise hundreds of billions of dollars in new revenue, every dollar of which no longer needs to be raised from taxing the earned incomes of hard-working Americans.

Our proposal also adapts to the political challenges that have weakened the estate tax over time. Whereas in the past, Republicans have targeted the estate tax as a "death tax" or "double taxation," an inheritance tax makes this characterization harder. By more explicitly focusing on the heir as the sole target of taxation, our reforms help to shore up the political durability of the tax system's most progressive feature.

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