Leveling the Playing Field between Inherited Income and Income from Work through an Inheritance Tax

In a new book titled *Tackling the Tax Code: Efficient and Equitable Ways to Raise Revenue*, The Hamilton Project offers a range of detailed proposals by leading economists and other experts for better tax policies that can raise revenue in a progressive and growth-friendly manner. In one chapter, Lily Batchelder of the New York University School of Law proposes to raise revenue by reforming the way inherited income is taxed.

Specifically, Batchelder's proposal would:

- **Shift the focus of taxation from estates to inheritances,** which has efficiency and equity benefits.
- **End stepped-up basis,** which absolves estates of capital gains taxes and allows large capital gains to go untaxed.
- **Tax inherited income (beyond a minimum lifetime exemption) through income and payroll taxes,** as opposed to the current ineffective system of wealth transfer taxes.

Issue Overview

- **Inherited income is currently taxed at less than one-seventh the average tax rate on income from work.** Inherited income is treated much more favorably by the tax system than is income earned from labor.
- **The United States has high economic inequality and low intergenerational mobility.** Taxation of intergenerational transfers could do much more to improve these outcomes.
- **By taxing inherited income through income and payroll taxes, this proposal would raise between $337 billion and $1.4 trillion over the next ten years,** depending on the specific lifetime exemption level chosen.

The Challenge

Inherited income is currently taxed at less than one-seventh the average tax rate on income from work; this low effective rate on inherited income perpetuates high levels of economic inequality and impedes intergenerational mobility.

The current system also provides an intense incentive to delay realization of capital gains, particularly through stepped-up basis at death (i.e., the elimination of tax liability for unrealized capital gains). This distorts capital markets and limits the effectiveness of the overall tax code. Furthermore, estate tax planning is unnecessarily complex under current rules: one example is that bequests are taxed more heavily than gifts during one's lifetime.

The Path Forward

To raise revenue, mitigate economic inequality, and strengthen intergenerational mobility, Lily Batchelder proposes reforms to the taxation of inherited income. The proposal:

- **Taxes inherited income through income and payroll taxes.** Currently, inheritances face an effective tax rate of 2 percent, which is one-seventh the average tax rate on income from work. This reform reduces discrepancies between the treatment of inherited income and income from work.
- **Sets a lifetime exemption for inheritances,** such that only cumulative inheritances above that threshold would be taxed. The author considers multiple options for the lifetime exemption: $2.5 million, $1 million, and $500,000.
- **Leaves the existing rules governing what transfers are taxable largely unchanged.** Transfers to spouses and charities, as well as gifts for education, medical expenses, and support expenses for minors, would still be tax exempt.
- **Accommodates family owned and operated businesses as well as primary residences through a special provision.** To address concerns about an heir owing more in taxes than they inherit in liquid assets (e.g., inheriting a family farm), the heir would be able to defer (with interest) the tax owed to the extent it exceeds the liquid assets they inherit.
- **Applies constructive realization for income tax purposes to large accrued gains on gifts and bequests**, repealing carryover and stepped-up basis for large accrued gains. In other words, these gains would be taxed as if they had been realized.
- **Limits tax avoidance with several reforms to the rules governing the timing and valuation of transfers through trusts and other devices.** The proposal would also substantially simplify and narrow the reach of the generation-skipping transfer tax, limiting it to generation-skipping transfers through dynastic trusts, which are increasingly used to provide for an unlimited number of future generations.

By reforming the way that inheritances are taxed, the United States can better fulfill its commitment to being a land of equal opportunity. The author's proposal would place inherited income on a more level playing field with earned income, while leaving unaffected those who do not receive extraordinarily large inheritances.

About the Author

Lily Batchelder is the Robert C. Kopple Family Professor of Taxation at the New York University School of Law.