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The Tax Environment Facing the Wealthy

by

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LEADING IN THOUGHT AND ACTION

The Tax Environment Facing the Wealthy

1. Introduction

This paper analyses the effect of income and transfer (gift and estate) taxes on the sources and uses of wealth, in order to estimate the real tax burden on working and saving and the relative prices of certain forms of consumption. The principal question addressed in this paper is: If laborers only faced a tax on wages (i.e., returns to capital were exempt and transfer taxes were abolished), what tax rate would leave them indifferent compared with the current tax system?

To address this question, I develop a model that attempts to capture the individual income and transfer tax incentives facing wealthy individuals. The model is used to estimate the marginal tax rates arising in the absence of tax planning. It also provides comparisons of different forms of consumption, including inter vivos gifts versus bequests for spouses, children and charities.

I find that the wage tax rate that would leave laborers indifferent depends critically on two factors. The first factor is: Can the laborer transform wages into a return of capital for tax purposes? Marginal tax rates on labor income fall if the wages are paid in a form that qualifies for capital treatment, e.g., employer equity. The second factor is: How will the laborer dispose of the wealth generated by his labor? Wealth dispositions are taxed differently, causing the marginal tax rate on labor income to vary with the intended disposition. For example, charitable contributions are deductible. Thus, labor income that is contributed to charities faces a zero marginal tax rate. Conversely, labor income that is bequeathed to children is reduced by a wage tax, the returns to investment of the remaining wages are subject to capital taxes, and the bequest faces estate tax rates ranging up to 55 percent. Under the most tax-disadvantaged conditions analyzed in this

paper, laborers, who bequeath the wealth from their labor to their children, are indifferent between a single wage tax of 91 percent and the current tax system.

Not surprisingly, taxpayers, facing such potentially exorbitant marginal tax rates, create a demand for tax plans that supports a vast tax avoidance industry composed of attorneys, accountants, bankers, insurers, and appraisers. To assess the potential effect of tax planning on marginal tax rates, I outline several income and transfer tax plans currently employed by wealthy individuals.

Income tax plans generally attempt to skirt the realization principle, enabling consumption and diversification without income taxation. The realization principle triggers taxation when the legal ownership of the property changes. For example, the payment of dividends generates income taxation to the recipient (and sometimes to the payor) because dividends shift the ownership of the distributed assets from the corporation to the shareholders. Taxation arises even though, shareholder wealth does not change on the dividend payment date (except for taxes) because the dividend decreases the value of the company by the same amount that it increases the shareholder's cash. In other words, dividends are taxed even though shareholder value is unchanged.

Income tax avoidance opportunities arise because income recognition is determined by legal, rather than economic, changes in ownership. By designing income tax plans that permit economic changes, such as reinvestment, without changing the legal form of ownership, planners can lower the wealthy individuals' marginal tax rates without deleterious effects on their lifestyles. For example, wealthy individuals might borrow against appreciated property rather than sell the property and trigger income taxation.

Transfer tax plans generally exploit inherent difficulties in determining valuations, enabling justification of below-market values. Transfer taxes are levied on the fair market values of gifts annually and on the fair market value of decedents' net assets. Gifts and bequests to spouses and charities are exempt from transfer taxes. Every donor also can exempt from the transfer tax \$10,000 per donee annually.¹ In addition, a \$192,800 credit allows each individual to transfer his first \$600,000 of gifts and bequests tax-free.² The \$600,000 includes neither \$10,000 annual exclusions nor spousal or charitable transfers. Transfer taxes, whether arising from lifetime gifts or at death, are assessed on the cumulative transfer tax base. For example, suppose an individual dies with a \$2 million estate, has no spousal or charitable bequests, and has made taxable gifts of \$1 million during his life (excluding \$10,000 annual exclusions). The transfer tax is computed on a \$3 million base (a tax of \$1,025,800 using 1997 rates) and reduced by the current tax on a \$1 million base (\$248,300) leaving the estate with a tax of \$777,500, which is reduced by the credit of \$192,800, to produce an estate tax liability of \$584,700.³

Gift and estate tax plans that successfully undervalue assets enable more property to be transferred tax-free under the annual exclusions and the lifetime credit and reduce the taxes due on amounts exceeding these de minimus provisions. For example, a wealthy couple, who intends to leave their home to their children after their deaths, could give their children a future interest in their home today through a trust. The transfer would be valued at the present value of the future interest in the home, which is substantially less than its value after the death of the couple. As a

¹ Additional tax-free transfers are possible to cover medical and educational needs.

² The Taxpayer Relief Act of 1997 (TRA 97) increases the exempt gifts and bequests to \$625,000 in 1998 and continues increasing the exemption total until it reaches \$1 million in 2006. It adds a new estate tax exclusion for certain closely-held businesses that can enable up to \$1.3 million in total exempt gifts and bequests effective 1998.

³ For purposes of determining the estate tax, the credit for previous gift taxes paid is the gift tax that would have been paid if the current transfer tax rates had applied when the gifts were made, not the actual gift taxes paid.

result, by gifting the less valuable future interest rather than bequeathing a complete interest, the transfer taxes are reduced without affecting the eventual owners of the house.

The income and transfer tax plans detailed in this study include a diverse set of transactions (e.g., shorting-against-the-box and like-kind exchanges), products (e.g., derivatives and life insurance) and organizational structures (e.g., family partnerships and investment companies). Customized to individuals' specific tax needs, the plans are capable of lowering the actual marginal tax rates faced by wealthy individuals enough that marginal tax rates approaching zero are not implausible.

The remainder of the paper is as follows: The next section derives a model for evaluating the effects of income and transfer taxes and estimates various marginal tax rates in the absence of tax planning. Section 3 describes current income tax plans. Section 4 details current transfer tax plans. Section 5 revisits the marginal tax rate estimates in light of the tax plans. Section 6 provides concluding remarks, including policy recommendations.

2. Model

2.1 Derivation

Individuals can accumulate wealth from four sources: (1) wages, which generally are taxed at ordinary rates upon receipt; (2) returns to capital, whose tax character (capital versus ordinary) and tax timing (present versus future) are sufficiently determined by the legal form of the earnings process (i.e., realization principle) that taxpayers have some discretion over their tax treatment; (3) gifts, which are tax-exempt to the donee but carry the donor's tax basis; and (4) bequests, which are tax-exempt to the heir and have tax basis equal to fair market value. During her life an individual can consume personally, give her wealth to her spouse, charities, or other individuals or

enterprises (hereafter called “children”), pay income taxes, or purchase tax avoidance plans. At death, the remaining wealth is bequeathed to her spouse, children, or charities or forfeited in transfer taxes.

The model assumes the individual is work-averse, but values her own consumption and the wealth of her spouse, children, and charities at her death, as described in the following utility function:⁴

$$\text{Max } U(L, C, S, K, D),$$

subject to a budget constraint:

$$w(1-L)(1-t_p) + G = C + S_0 + K_0(1+e_0) + D_0(1-t_p) + A(1-t_p) + \\ (S_n + K_n + D_n) / [(1 + R_p)^n (1-t_p) + t_p b_p]$$

where: w = wage rate,

L = leisure (time endowment=1),

t = income tax rate,
= $\tau_y Y^A y$,

G = gifts and bequests received,

C = individual's consumption,

S = spouse's consumption,

= $S_0 [(1 + R_s)^n (1-t_s) + t_s b_s] + S_n$,

K = children's consumption

= $K_0 [(1 + R_k)^n (1-t_k) + t_k b_k] + K_n (1-e_n)$,

e = transfer tax rate,

= $\tau_e Y^e A^e$,

D = charity's consumption

= $D_0 (1 + R_d)^n + D_n$,

A = tax avoidance expenditures,

= $\alpha (A_y + A_e)$,

⁴ For simplicity and because conclusions are not qualitatively affected, the model ignores the transfer tax credit and annual \$10,000 exclusions. The relative importance of both provisions decreases in wealth. The credit excludes de minimus bequests to children, and the exclusions permit tax-free de minimus annual transfers to children. However, exclusion of these provisions from the model should not be interpreted as their being irrelevant for planning purposes. In fact, exploitation of both of these de minimus provisions are the initial components of transfer tax avoidance and may comprise the entire transfer tax avoidance strategy for smaller estates. Also for simplicity, the model assumes that the individual will predecease his spouse and children. The model's implications hold if this assumption is lifted; however, the introduction of uncertainty about life expectancy adds a probabilistic nature to the analysis.

R = the savings rate of return before considering income and transfer taxes,
 n = years remaining in individual's life,
 b = tax basis as a percentage of fair market value,
 τ_i = statutory tax rate i ,

subscripts p , s , k , and d refer to the individual, spouse, children and charities, respectively; subscripts 0 and n refers to inter vivos gifts and bequests, respectively; subscripts y and e refer to income taxes and transfer taxes, respectively; L , C , S_i , K_i , D_i , and A , where $i=0, n$, are non-negative, $\gamma > 0$ and $\alpha > 1$.

The budget constraint equates the individual's initial sources of wealth (labor income and gifts and bequests received) with the uses of wealth (her and her donees' consumption plus tax avoidance fees), adjusted for the individual's returns to capital from investing the retained wealth. The individual can transfer wealth to her spouse, children and charities during her lifetime and at her death. The donor is assumed to be indifferent to the timing of the consumption of those she cares about and seeks only to maximize the present value of the transfers. Obviously, the donor can consume only during her life.

The form of the model's savings vehicles, used for both donor and donees $[(1+R)^n (1-t)+tb]$, presents tax-favored business returns. The model adopts these tax-favored savings vehicles to ensure that the taxes analyzed in the paper are focused on individual income and transfer tax planning, not business tax planning (unless it affects the taxes of interest). Therefore, any value from tax planning, identified in this paper, can be linked specifically to personal income and transfer taxes.

Specifically, the savings vehicles assume business returns grow tax-exempt. This assumption likely understates the tax burden facing wealthy individuals. If savings are invested in C corporations, and corporate taxes arise or taxable dividends are distributed, the returns to the investor are overstated and the wealthy's total tax burden is understated. Similarly, if savings are

invested in “flow-through” business entities, such as partnerships, limited liability corporations, or S corporations, and investors recognize annual taxes from their pro rata share of the enterprise’s profits, the returns to the investor are overstated and the tax burden is understated. On the other hand, the savings vehicles provide accurate accumulations for investors in businesses where taxable income is not generated and all appreciation is realized at the end of the investment period. For example, if a start-up company pays no taxes or dividends, and yet appreciates in value, its investors can sell their stock in the company and realize all of the gains to the investment as modeled with the savings vehicles used in this paper. To assess the sensitivity of this restriction, this assumption is relaxed, enabling consideration of less tax-favored business returns later in the paper.

The wealthy are assumed to purchase tax avoidance until the tax savings associated with tax plans equals the costs of tax avoidance, including planners’ fees, implicit taxes, opportunity costs, and tax-motivated restructuring that would be suboptimal without taxes (Scholes and Wolfson [1992]) plus the increase in expected costs associated with an audit as a result of engaging in tax avoidance activities (as captured by α in the model).⁵ However, to assess the importance of individual income and transfer tax planning, I initially analyze the model assuming no tax plans are purchased ($A=0$). Two questions are addressed under this assumption. First, should wealthy individuals accelerate transfers to donees through inter vivos gifts or defer transfers until death? A general tax preference for accelerating transfers is noted. The second question is: What is the marginal tax rate facing labor income? The findings show taxpayers can

⁵ Anecdotal evidence suggests that the opportunity costs taxpayers assign to tax planning vary greatly. Some taxpayers enjoy tax avoidance while others have little tolerance for any planning. This heterogeneity enables tax planners who have developed a keen understanding of their clients’ “tax taste functions” to compete against competitors with dominant tax plans but less client-specific knowledge. The importance of this client-specific

face marginal tax rates on wages from zero to over 90 percent, depending on whether wages are treated for tax purposes as returns to labor or capital and the desired disposition of the wealth arising from the labor. The wide range of marginal tax rate estimates implies variation in the demand for tax avoidance and the nearly insatiable need for tax planning by certain taxpayers.

2.2 *Transfers to Spouses*

Analysis of the model indicates inter vivos spousal gifts dominate bequests when the spouse can earn at a higher after-tax rate of return than the donor $[(1+R_s)^n (1-t_s) + t_s b_s > (1+R_p)^n (1-t_p) + t_p b_p]$. Transfer taxes are irrelevant to this decision because spousal transfers are subject to neither gift nor estate taxes. Thus, individuals wishing to maximize their spouses' wealth should direct their avoidance energies to income taxes. Because the decedent's tax bases are adjusted to fair market value at death, appreciated (depreciated) properties bequeathed to the spouse face a lower (higher) tax when sold by the spouse than if the properties had been transferred to the spouse during the transferor's life. Thus, the spouse's wealth is maximized if the donor transfers depreciated properties during life and bequeaths appreciated properties.

2.3 *Transfers to Children*

Inter vivos gifts to children dominate bequests when the children's after-income tax earnings on the gift exceeds the parent's after-income tax earnings, on the gift and the avoided gift tax, less estate taxes $[(1 + R_k)^n (1-t_k) + t_k b_k > (1 + e_0) [(1 + R_p)^n (1-t_p) + t_p b_p] (1-e_n)]$. Assuming time-invariant transfer tax rates ($e_0=e_n$) and identical after-tax returns for child and

information also may explain the willingness of tax planners to underprice initial products in a new client relationship in exchange for a better understanding of the client's specific tax interests.

parent ($R_k=R_p$, $t_k=t_p$, $b_k=b_p$), bequests produce only $1-e^2$ percent (70 percent, using the current maximum transfer tax rate) of the wealth that lifetime gifts do, evaluated at the parent's death or.

The preference for inter vivos gifts is counterintuitive because gifts accelerate the transfer taxes that could have been deferred until death. However, the tax-favored status of lifetime gifts arises because the transfer tax base excludes gift taxes, but not estate taxes.⁶ In other words, the estate tax is tax-inclusive (i.e., the base includes the tax) and the gift tax is tax-exclusive (i.e., the base excludes the tax). Thus, if the estate tax rate is e , then the gift tax rate is $e/(e+1)$.

Consequently, at the current maximum transfer tax rate of 55 percent, the estate tax rate is 55 percent, but the effective gift tax rate is only 35 percent ($0.55/1.55$).

This analysis assumes that the after-tax earnings rates of parents and children are equal. This assumption may be inappropriate for at least two reasons. First, step-up in tax basis to fair market value at death enables parents to earn at before-tax rates. If $t_p=0$, $R_k=R_p$, and $e_0=e_n$, the tax disadvantage of bequests (stated as a percentage of the wealth created by gifts) shrinks to $(1-e^2) / [(1-t_k) + (t_k b_k)/(1+R)^n]$. If the tax basis of the transferred property is zero ($b_k=0$) or $(1+R)^{n \rightarrow \infty}$, the parent is indifferent between gifts and bequests when $e^2 = t_k$. Applying current maximum statutory tax rates (55 percent transfer and 20 percent capital gains--reduced from 28 percent by the recent Taxpayer Relief Act of 1997 (TRA 97)), bequests' yields approach 87 percent of lifetime gifts, retaining some bias towards acceleration.

A second reason that parents' returns could exceed their children's returns is differences in financial experience, maturity, or savvy. If $t_k=t_p$, $b_k=b_p=0$, and $e_0=e_n$, $1-e^2 = [(1+R_k)^n] /$

⁶ To maintain the transfer tax base as death approaches, gift taxes arising during the last three years of life are included in the estate tax base.

$[(1 + R_p)^n]$. Using the current maximum transfer tax rate, the parent is indifferent between inter vivos gifts and bequests if his before-tax accumulations are 143 percent of his children. Such accumulation differences are not implausible. Indifference occurs after ten (twenty) years if the parent earns 10 percent annually before-tax and the child earns 6 (8) percent.

As an aside, if a couple wishes to defer transfer of wealth to their child until they both die, the child may receive a smaller bequest than if a partial transfer is made at the death of the first parent. The couple's combined estate taxes increase because the surviving spouse cannot use her late husband's credits at her death. In other words, the transfer tax credit cannot be bequeathed, i.e., each individual can use only one credit.

2.4 *Transfers to Charities*

The optimal timing of philanthropy is relatively straightforward. The model shows inter vivos donations dominate bequests if the charity's tax-exempt earnings, augmented by the individual's income tax deduction for inter vivos charitable contributions, exceed the individual's after-tax earnings rate, $[(1 + R_d)^n / (1 - t_p) > (1 + R_p)^n (1 - t_p) + t_p b_p]$. Relative to charitable gifts, charitable bequests are tax-disadvantaged because they forfeit income tax deductions and forego the charity's opportunity to earn at the before-tax rate of return.

Although acceleration usually dominates deferral in charitable settings, two factors can shift the balance toward bequests. First, the step-up in tax basis at death enables the donor to earn at the before-tax rate of return on assets held at death, reducing the tax advantages of inter vivos gifts. Second, to the extent charities restrict their investment opportunity set (e.g., to avoid political costs), their donors' before-tax returns may exceed the charities' returns.

On a final note, depreciated properties should be neither gifted nor bequeathed to charities. Instead, they should be sold before death, generating a tax deduction for the donor, and the proceeds donated because charities cannot avail themselves of deductions imbedded in tax bases and the step-up in tax basis at death prevents usage of the tax basis in excess of fair market value for any party.

2.5 *Children vs. Charities*

Among transferees, charities are the most tax-advantaged recipients and children are the most tax-disadvantaged. Comparing inter vivos gifts, the charity's accumulations exceeds the child's accumulations (at the death of the donor) if the charity's before-tax yields, augmented by the donor's income tax deduction, exceed the child's after-tax returns, diminished by the gift tax: $(1 + R_d)^n / (1 - t_p) > [(1 + R_k)^n (1 - t_k) + t_k b_k] / (1 + e_0)$. Applying current maximum statutory rates ($t_p = t_k = 39.6$ percent and $e_0 = 55$ percent) and letting $R_d = R_k$ and $b_k = 0$, gifts to children accumulate only 24 percent of the amount that gifts to charities accumulate. Similarly, charitable bequests are estate tax-exempt while children's bequests are taxed. Thus, at the current maximum statutory estate tax rate of 55 percent, children's bequests are 45 percent of charitable bequests, after payment of estate taxes. As a result of the differential taxation, we can infer from observing transfers to children by taxpayers in the highest tax brackets that the utility those donors derive from enhancing their children's wealth far exceeds the utility they derive from philanthropic activities.

2.6 *Implied Tax Burden on Labor-Sourced Dispositions*

This section attempts to estimate the tax burden assessed on wealth derived from wages and transferred in the most tax disadvantaged manner, children's bequests. Assume a laborer invests his after-income tax wages in a savings account that provides his children with $(1-t_p)$ $[(1+R_p)^n (1-t_p) + t_p b_p] (1-e_n)$ dollars for every dollar of wages. As discussed above, this savings account permits tax-free accumulation until immediately before death, when all returns from capital are subjected to income taxation.

Let t^* equal the tax rate on labor that would produce the same bequest if no other income or transfer taxes were levied: $(1-t_p) [(1+R_p)^n (1-t_p) + t_p b_p] (1-e_n) = (1-t^*) (1+R_p)^n$. As $(1+R_p)^n \rightarrow \infty$, $t^* \rightarrow [1 - (1-t_p)^2 (1-e_n)]$. Using current maximum statutory rates ($t_p=39.6$ percent and $e_n=55$ percent), $t^* \rightarrow 0.84$.⁷ In other words, if 84 percent of wages were extracted in taxes and returns to capital and transfers were tax-exempt, heirs would inherit the same wealth as they would under current law. If the returns to capital are subject to more favorable capital gains taxes ($t_p=20$ percent), $t^* \rightarrow 0.71$ as $(1+R_p)^n \rightarrow \infty$.

If the returns to capital avoid income taxation by being held until death and receiving step-up in tax basis (i.e., $(1+R_p)^n (1-t_p) + t_p b_p = (1+R_p)^n$), then $t^* = [1 - (1-t_p) (1-e_n)]$. Applying current estate and ordinary income tax rates, $t^* = 0.73$. In other words, exempting capital from labor income taxation lowers the tax rate from 0.84 to 0.73. Similarly, if the laborer dies immediately following the performance of services, each dollar of labor income provides $(1-t_p) (1-e_n)$ dollars to the laborer's children or a labor tax rate of 73 percent.

⁷ The income tax rates on wages, used throughout the paper, understates the tax burden on labor because they exclude FICA and in particular the 2.9 percent Medicare charge which, unlike other FICA payments, applies to all labor income levels. Other taxes also are understated because they exclude state and local assessments.

Even higher marginal tax rates on wages are possible if less tax-favored savings vehicles are employed. Recall that the model assumes business returns in the savings vehicles accumulate tax-free. Alternatively, if the investment is made through a “flow-through” entity and all returns to capital are taxed immediately at ordinary rates (e.g., $[1 + R_p (1 - t_p)]^n - t_p (1 - b_p)$), assumptions are needed for R_p and n to estimate t^* . Assuming before-tax returns to capital are 10 percent for twenty years, current tax rates apply, and that tax basis equaled fair market value at the time of the investment (i.e., $b_p = 1$), $t^* = 0.87$.

If the investment is made through a more tax-disadvantaged savings vehicle (C corporations), the total implied tax rate on labor income soars even higher. Suppose no dividends are paid but that all returns are subject annually to corporate taxes, i.e., $[1 + R_p (1 - t_c)]^n (1 - t_p) + t_p b_p$, where t_c is the corporate tax rate. Using current maximum corporate tax rates of 35 percent and the same assumptions as in the preceding paragraph, $t^* = 0.90$. If all returns are distributed annually in taxable dividends (e.g., $[1 + R_p (1 - t_c) (1 - t_p)]^n - t_p (1 - b_p)$), $t^* = 0.91$.

The substitution of inter vivos gifts for bequests lowers the implied labor tax. Analyzing the original model (i.e., tax-exempt business returns) for the effects of the gift tax, $t^* \rightarrow [1 - (1 - t_p)^2 (1 + e_0)]$ or 0.76 as $(1 + R)^{n \rightarrow \infty}$ (assuming parents and children’s after-tax earnings rate are equal). This is 8 percentage points lower than the 0.84 estimate for children’s bequests.

Furthermore, using the same analysis, the implied labor tax on inter vivos philanthropic donations is zero because the charitable contribution creates a tax deduction offsetting the tax on labor and the charity’s returns to capital are tax-exempt. Charitable bequests are less tax-favored because both the returns to labor and capital, which create the wealth that is bequeathed to the charity, are taxed. Only the estate tax is avoided. Thus, for philanthropic bequests, $t^* \rightarrow (1 - t_p)^2$ or 0.64 as $(1 + R)^{n \rightarrow \infty}$. This marginal tax rate is the same rate facing the laborer on wealth, consumed

immediately preceding his death or given or bequeathed to his spouse (assuming identical after-tax earnings by husband and wife).

In summary, the marginal tax rate on wages varies widely depending on the disposition option and the taxation accorded the returns to capital. The marginal tax rate for labor income could range from zero (inter vivos philanthropy) to 91 percent (bequests to children employing tax-disfavored savings vehicles) depending largely on the disposition option.

Finally, each laborer's marginal tax rate is a blend of the rates associated with his preference for each option. For example, an individual, who desires to donate half of his labor earnings to charity during his life and bequeath the remainder to his children using tax disfavored investment options would face a 45.5 percent (the mean of zero and 91 percent) marginal tax rate on each dollar of wages.

3. Income Tax Avoidance Plans

The preceding section shows that, in the absence of tax planning, large percentages of wealth (particularly labor-sourced and children-bequeathed) can flow to the government through income and transfer taxes. Predictably taxpayers facing these arguably confiscatory levels of tax demand tax avoidance and are satiated only when the costs of tax plans exceed the reduction in tax payments.

This section and the following section illustrate tax plans that currently are being employed to meet the demand for lower tax burdens. The half-life of these plans is short. They become obsolete as the law changes and as tax innovators, unaided by patents and copyrights, are forced to recover their investments quickly and develop superior avoidance techniques. Hopefully the pertinence of this discussion in understanding the avoidance industry will outlast the actual

usefulness of the plans. The analysis begins with specific examples of how the source of the wealth (capital versus labor) affects the appropriate income tax plan.

Capitalists usually face lower marginal tax rates and have more control over when their income is taxed than laborers. Thus, capitalists typically implement tax plans that enable them to manage their portfolio while avoiding or timing income tax recognition. Laborers strive to gain the tax-favored status of capitalists by implementing tax plans that convert wages into a form of payment that qualifies for capital tax treatment, including increased discretion over the timing of the tax payment and the possibility of favorable capital gains tax rates. As a result of lowering the maximum individual capital gains tax rate from 28 percent to 20 percent, TRA 97 increases the demand for tax plans that can convert ordinary income into capital gains income. Conversion nearly halves the tax burden for taxpayers in the upper tax bracket from 39.6 percent to 20 percent. Unfortunately for laborers, they face relatively few options to camouflage their wages as returns to capital unless they hold equity in their employers.

3.1 Capital

3.1.1 Reinvestment without taxation

Highly appreciated securities and real estate typically mark the portfolio of individuals who derive their wealth from capital.⁸ A principal tax objective for a wealthy capitalist is to avoid capital gains taxes without interfering with his pattern of consumption or the diversification and redeployment of his capital to its most appropriate investment. A common thread in most

⁸ Appreciation historically has marked the properties of the wealthy because capital appreciation is a means of becoming wealthy, income taxes provide an incentive to sell depreciated properties, and tax bases are not adjusted for inflation. In recent years, the U.S. equity bull market has exacerbated the wealthy's holdings of appreciated financial assets.

capitalist income tax plans is that they enable investors to manage their portfolio and consumption without generating taxable income.

A major tax impediment to portfolio management is that selling or exchanging property typically causes the recognition of taxable income for the excess of the property's fair market value over its tax basis. For some transactions, the statutes provide an exception to the recognition of taxable income at the time of realization (e.g., real estate exchanges). However, realization is an inherently flawed trigger for determining the transfer of ownership (and consequently income tax recognition) because realization generally relies on a shift in legal ownership, rather than economic ownership, to determine whether a sale has occurred. This flaw facilitates tax avoidance and spawns endless tax plans designed to enable reinvestment without taxation.

Perhaps the simplest form of reinvestment without taxation is borrowing against appreciated property. Issuing debt secured by highly appreciated assets does not trigger taxation of the assets. Moreover, the interest expense arising from the leverage is deductible to the extent of investment income. Collateralization is an efficient means of reinvestment without taxation because the legal owner of the property retains all rights to the underlying income streams. This provides the owner with an inexpensive option to redeploy his capital in the original investment (by repaying the loan). Although collateralization can provide some diversification (by creating additional income flows), it alone cannot provide complete divestiture because the owner remains the residual claimant of the securitized property.

To divest fully of the investment and still avoid tax realization, alternate tax plans are needed. One option is statutory exemption from tax realization. For example, the tax law permits divestiture of real estate without taxation if the properties are exchanged for other real estate.

These “like-kind” exchanges are common and permit unlimited diversification and reinvestment within the real estate sector. For example, a developer can exchange an appreciated shopping mall for undeveloped land without incurring gain for the mall’s appreciation, and the land can be used for any business purpose. Recycling real estate through like-kind exchanges enables investors to earn at the before-tax rate of return indefinitely, including step-up in tax basis if the property is held until death. If reinvestment is desired outside the real estate market, then the new real estate holdings (obtained without triggering income taxation on the appreciation) can be collateralized and the cash reinvested in non-real estate properties.

Similarly, the statutes permit appreciated stock of closely-held companies to be sold to employee stock ownership plans (ESOPs) tax-free if the proceeds from the sale are reinvested in domestic corporate securities.⁹ The shareholder’s basis in the closely-held company is allocated to the new securities, deferring taxation until sale of the diversified portfolio.

The statutes do not provide similar deferral for holders of appreciated publicly-traded securities. However, creative tax planners developed transactions and synthetic products that achieved similar ends. “Shorting-against-the-box” (borrowing and selling short shares identical to those held long) merged collateralization with divestiture. For many years shorting-against-the-box enabled investors to convert securities to cash, maintain the appreciation in the security, and postpone taxation. Tax deferral was achieved because the investor did not transfer legal ownership of the long shares even though all risk associated with the shares was eliminated. If the shorted shares were repaid by selling the long shares, gain was recognized when the long shares are sold. If the shorted shares were repaid by buying additional shares or the individual died

⁹ ESOPs are defined contribution retirement plans. Besides the tax advantages to shareholders noted above, they are unique because they must invest primarily in the stock of the sponsoring employer and can borrow to purchase plan assets. (See Shackelford [1991] and Scholes and Wolfson [1992] for more details.)

before repayment was required, the deferral of the gain on the long shares continued. Creative financial maneuvers, such as shorting-against-the-box, were not inexpensive. Tax planners tell me that bankers typically charged individuals 100-150 basic points annually to short-against-the-box.

Shorting-against-the-box required borrowable shares and access to an actively traded capital market. Increasingly specialized financial products are providing the benefits of shorting-against-the-box in markets where such transactions have been infeasible. An example of these products is Salomon Brothers' DECS (debt exchangeable for common stock). With DECS, the holder of the appreciated securities issues notes secured by the appreciated stock. At maturity, the issuer has the option to repay the note with either the securities or cash equal to the face value of the note. If the stock has increased in value since the issue, the holder repays the note with cash, producing the same tax effect over the life of the note as collateralization would have produced, i.e., no taxable event.¹⁰ Alternatively, if the stock has decreased in value since the issue, the holder repays the note with the stock, triggering taxation for the difference between the stock's tax basis and the face value of the note. In this case, the proceeds from the sale are accelerated, the taxation on the sale is deferred, and the stock price decline averted.

In recent years another derivative product, equity swaps, provided tax-free diversification. In an equity swap, the shareholder paid a financial intermediary a fee, plus any dividends received on her stock, and plus (minus) any appreciation (depreciation) in the stock during a fixed period. In exchange, the shareholder received the returns from a diversified portfolio (e.g., Standard & Poors 500 index). Taxation was avoided because the shareholder retained legal ownership of the security, even though the shareholder's returns were unrelated to the security during the contract

¹⁰ TRA 97 reduces the attractiveness of DECS and related products by allowing the deductibility of interest on debt that can be repaid with common stock.

period.¹¹ Bankers Trust, a leading developer of equity swaps, reportedly represented orally that they charged 150 basis points annually to effect an equity swap (*Tax Notes*, October 17, 1994, p. 270).

Finally, controlling shareholders can defer taxation on appreciated stock by selling their company in a form that qualifies as a tax-deferred reorganization. For example, an individual could sell his wholly-owned company and avoid any current taxation if he is willing to accept the buyer's stock. The tax basis in the original company carries over to the buyer's equity. Again the investor has reinvested without taxation.

3.1.2 *Taxpayer Relief Act of 1997*

TRA 97 eliminated the usefulness of the relatively pristine forms of shorting-against-the-box and equity swaps described above by treating such transactions as constructive sales and subjecting their appreciated financial positions to immediate taxation. However, tax planners seem confident that alternatives to shorting and equity swaps will be developed that permit reinvestment without triggering constructive sale treatment. The long-term effect of TRA 97 likely is to slow, not halt, the exploitation of the realization principle through financial engineering.

The legislation is too new to understand fully its effects on reinvestment with taxation. The Treasury is instructed to promulgate regulations that delineate precisely between transactions subject to immediate taxation and those that maintain deferral. In its guidance to the regulators, the Senate Committee Report hints at potential areas for renewed tax avoidance planning. For

¹¹ Bankers Trust markets equity swaps with claims such as, "Is your wealth too concentrated in one stock? Here's how to diversify, reduce risk, and enhance income --- while retaining ownership and avoiding tax liability" *Tax Notes*, (October 17, 1994, p. 267).

example, it states that constructive sale treatment should be limited to transactions that substantially eliminate *both* opportunities for gain and loss. Products that provide asymmetric risk elimination presumably retain tax deferral for the underlying investment.

The TRA 97 changes likely will spur the development of tax avoidance options.

Combinations of puts and calls already are used to mitigate risk, when risk elimination is not desired or prohibitively expensive. Similarly, these products would seem ideally situated to retain sufficient risk of gain or loss for the taxpayer to avoid income taxation, but reduce risk enough to remain attractive to investors. Examples of partial risk retention instruments are “collars,” which are common in many derivative products, such as interest rate swaps. With a collar, the investor eliminates the risk associated with extreme price changes while retaining the risk of smaller changes. Tax planners tell me that the annual cost of these customized products is about 200 basis points.

The future usefulness of established financial tax avoidance products, such as shorting and equity swaps, and relatively recent developments, such as collars, depends critically on how broadly the Treasury attempts to define constructive sale. For example, how dissimilar must a shorted security be from the security held in a long position to avoid a tax-generating short sale? Similarly, what percentage of risk must the investor retain following implementation of a risk reduction product, such as a collar, to effect constructive sale?

Definitive answers to these questions may be years in coming; however, incomplete information is not preventing the current development of creative financial instruments that enable taxpayers to reinvest without facing income taxation. In the absence of regulations, tax advisors tell me that the avoidance industry assumes that if the investor retains the risk of a 10% increase or a 10% decrease in value, a collar will not trigger constructive sale. For example, if a stock is

currently worth \$100, a holder of an appreciated stock can construct a collar by buying a put exercisable at \$90 and buying a call exercisable at \$110. This transaction is not believed to constitute constructive sale; however, it achieves similar effects to shorting-against-the-box, except the investor retaining some risk exposure.

3.1.3 State income taxes

Although the computations in this paper ignore them, state income taxes can comprise up to one-quarter of the income tax burden facing wealthy individuals. A special Delaware state tax exemption provides an incentive for wealthy individuals to manage any financial assets trapped in a C corporation through a Delaware investment company. As long as a Delaware-domiciled investment company maintains minimal activities in Delaware, such as board of directors' meetings, it is not subject to state taxation in any state. Thus, by transferring their intangible properties (tax-free) to a Delaware-domiciled investment company, individuals can avoid all state income taxes on interest, dividend, rents, and royalties.

The downside of any C corporation, including a Delaware investment company, is that it potentially produces two levels of taxation (corporate and individual). However, the corporation can limit double federal taxation by restricting distributions. Special federal tax assessments for excessive retention within the corporation (e.g., accumulated earnings and personal holding company taxes) can be mitigated through: (a) deductible payments to shareholder-employees, such as compensation and fringe benefits, e.g., corporate aircraft; (b) interest expense from collateralized properties, and (c) active management of publicly-traded companies controlled by the Delaware investment company. Moreover, if assets are retained in the corporate form, the investment company shelters the income from higher personal income tax rates.

3.2 *Labor*

3.2.1 *Converting labor income into capital income*

Compared to wealthy capitalists, highly compensated laborers, such as corporate executives and entertainers, face few tax avoidance options. Before the Tax Reform Act of 1986, non-labor (passive) deductions and losses could shelter labor income. Since 1986, such losses have not been permitted to offset labor income, dramatically limiting tax avoidance opportunities for laborers. The effect of this separation has been to increase the long-standing incentive to transform compensation received for services rendered into a payment that is treated for tax purposes as capital income.

One way to transform labor income into capital income is to give employees equity. This enables employers to repackage wages as capital income. An example of repackaged wages is stock options. With incentive stock options, employees are taxed at the favorable capital gains tax rate on the difference between the sales proceeds and the strike price when the stock is sold. With nonqualified stock options, employees are taxed at the ordinary income tax rate on the difference between fair market value and the strike price, when the option is exercised. Later when the stock received from the option is sold, the capital gains tax rate is applied to the difference between sales proceeds and the fair market value at exercise.¹²

Similarly, a partnership can compensate an employee by providing an interest in the partnership's profits. The value of this claim on the partnership's profits is directly related to the value of the partnership. If the partnership is sold, the compensation to the holder of an interest in

¹² The appropriate type of option from a tax perspective depends on both employers and employees' tax positions. Although incentive stock options are tax-favored from the employee's perspective compared with non-qualified stock options, they are tax disadvantaged from the employer's perspective. Incentive stock options never create a corporate tax deduction. Non-qualified stock options provide a corporate tax deduction equal to the employee's ordinary income at the time of exercise. See Matsunaga, Shevlin and Shores (1992) for more analysis.

the partnership's profits is taxed as a capital asset at the favorable capital gains tax rates. As with the stock options, wages are transformed into an capital asset that qualifies for capital gain treatment.

Labor income, which cannot be converted into capital income, can be deferred and then taxed when received. From the employee's perspective, deferred compensation is tax-favored compared with current wages if the employee's marginal tax rate is expected to decrease or be less than the employer's tax rate during the deferral period (Scholes and Wolfson [1992]). Unfortunately for employees, deferred compensation obligations are unsecured, leaving employees as general creditors in bankruptcy. Protection against bankruptcy usually triggers immediate income taxation. Thus, tax and bankruptcy considerations must be jointly evaluated.

Anecdotal evidence suggests deferred compensation is widely used, at least by the largest corporations. Reportedly, Coca-Cola's CEO, Roberto Goizueta, has accumulated more than \$1 billion in deferred compensation, mostly in highly appreciated company stock with forfeiture restrictions, and several other executives defer in excess of one million dollars annually (*New York Times*, October 13, 1996). Besides the potential tax savings, executive deferred compensation is popular because it not governed by ERISA, which limits the amount of qualified plan contributions for high-income taxpayers and imposes substantial administrative costs.

Finally, fringe benefits can transform labor income into tax-exempt earnings. Besides the standard fringes available to many employees, e.g., health care, wealthy laborers may assign value to the use of corporate aircraft, limousines, luxurious offices, exotic travel, admission to selective social gatherings and the like. Not only may recipients avoid income taxes for receiving these perquisites, but also employers may be able to deduct them. Moreover, the wealthy may use them to avoid taxation on capital income as well as labor income because fringes are so tax-favored.

For example, a family-owned business may employ shareholders and compensate them with fringe benefits.

A downside of each plan detailed above is that, although it lowers the employee's tax burden, it increases his capital concentration in the source of his labor income. A fundamental weakness of labor income tax plans is that taxes are avoided at the costs of reduced diversification. Thus, laborers whose compensation derives largely from company-specific skills must balance diversification and tax avoidance. Consequently, employees' marginal tax rates on labor income should be increasing in employers' risk because the need for diversification is increasing in employers' risk and, at some point, diversification dominates income tax avoidance.

3.2.2. *Entrepreneurs*

Entrepreneurs constitute a special group of wealth producers, whose human and financial capitals are typically invested in a nondiversified portfolio, such as a single company. It is easier for them to extract labor income as capital income than corporate executives and other highly compensated laborers, because their equity investment comprises a larger component of their total investment in the enterprise. In particular, by assuming a major equity stake at business formation and limiting cash wages, the entrepreneur's wealth grows within the business and is extracted at favorable capital gains tax rates.

3.3 *Summary*

The income tax plans typically used by the wealthy capitalists are woven around a common thread of exploiting the realization concept. Able to determine the timing, character, and amount of taxable income, the capitalist can transform the income tax into a somewhat voluntary

assessment. The wealthy's distinct advantage in this regard is their ability to forego taxable income under tax-disadvantaged circumstances. This tax management is possible because the wealthy can consume from sources that do not generate taxable income. However, their ability to reinvest without generating capital gains on appreciated property raises important policy questions about the efficacy of employing a tax that can so easily be avoided. On the other hand, the income tax on labor is much more difficult to avoid. Laborers' primary planning technique is devising schemes that transform labor income into capital income, enabling them to mimic the tax-favored condition of capitalists.

4. Transfer Tax Avoidance Plans

4.1 *Undervaluation of the transfer tax base*

While income tax plans exploit realization, transfer tax plans exploit valuation.¹³ Transfer taxes are levied on the fair market value of gifts and estates for donees other than spouses and charities (such as children). Thus, taxpayers with such donative intentions have incentives to undervalue their properties. With up to 55 cents of tax associated with every dollar of valuation, taxpayers and taxing authorities predictably disagree about property values. Understatement is facilitated by the law's reliance on arm's length, fair market values to determine the transfer tax base. This link to prices between unrelated parties leads to many avoidance opportunities, because the appropriate valuations between distrustful independent parties often are economically inappropriate for transfers between related parties, often members of the same family.¹⁴

¹³ For a more complete discussion of transfer tax avoidance, see Zabel, 1995, and Scholes and Wolfson, 1992.

¹⁴ Taxpayer advantages arising from related party transactions pervade the tax system and account for much of its complexity. Examples include transfer pricing between commonly-owned businesses located in different jurisdictions, the capital structure of closely-held businesses, and interest-free loans between related parties.

4.1.1 Discount partnerships

One example of a popular transfer tax plan that exploits valuation is a family partnership. Suppose parents own a portfolio of assets they wish to leave for their children following their deaths. Instead of giving (through bequests or inter vivos gifts) the assets to the children and paying transfer taxes on their fair market value, they contribute them (tax-free) to a partnership. Retaining control of the partnership, they then give their children minority interests in the partnership, which are taxable gifts. However, the gift typically is valued at substantially less than the fair market value of the child's pro rata share of the investments' market prices because the child does not control the partnership.

The discount varies with the restrictions on the interest and the nature of the partnership assets. Allen [1987], states discounts range from 30 percent to 70 percent. Zabel [1995], terms 30 percent, the "quite usual discount," but notes discounts can range up to 60 percent. For example, if the partnership's net assets are \$100, a gift of a 1/10 interest in the partnership may be discounted from \$10 ($100 * 1/10$) to perhaps as little as \$3 using a 70 percent discount. Discounts are permitted because unrelated third parties (the basis for determining fair market values) would not pay as much for partnership assets, over which they had no control, as they would pay for the same assets, if they held a controlling interest. Thus, partnership minority interests avoid transfer taxes because they enable donors to discount valuations as though the agency problems between independent parties depress the price regardless of whether the family partnership is impeded by such agency concerns.

4.1.2 *Equity interests*

Entrepreneurs can exploit valuation by giving capital interests in start-ups or out-of-the-money stock options to their children. The fair market value of the new venture interests or stock options have little value at assignment and are discounted (similarly to the family partnerships) because the children have no control over the enterprise. If the company prospers, significant portions of the owner's wealth are transferred to the children at little tax cost. If the company fails, the owner has only foregone the relatively insignificant gift tax associated with the transfer of the equity interests. If the wealthy individual has many investments, no single option may have much value, but a portfolio of capital interests likely includes a few that will increase substantially. The valuation exploitation with these interests is that the taxpayer likely can substantiate a tiny allocation of value to any single interest.

4.1.3 *Personal residences*

Another common transfer tax avoidance scheme involves personal residences. Suppose a parent wishes her children to own her home after she dies. If she bequeaths the house, her taxable estate will include its fair market value. Alternatively, the parent can place the house in a qualified personal residence trust for the benefit of the children, conditional on her rent-free occupancy for a set period of years. At the end of the period, ownership of the house transfers tax-free from the trust to the children. The value of the taxable gift is the present value of a residual interest in a house, subject to rent-free occupancy by a tenant, whose lease cannot be terminated. The taxable gift of the residual interest is assigned a heavily discounted value because of the unfavorable terms of the lease from an unrelated landlord's perspective. For family members, the residual interest becomes a tax-favored means of reducing the transfer tax without changing the eventual owners.

4.1.4 Life insurance

The value of life insurance can be transferred across generations without transfer taxation if the wealth used to buy the policy and the proceeds received at death are structured to escape transfer taxes. One life insurance option involves placing a policy in an irrevocable trust and removing all ownership rights and control from the insured individual. The insured pays the premiums (often without triggering transfer taxes), and the proceeds from the life insurance policy pass tax-free to the beneficiaries of the trust.

For closely-held businesses, split-dollar life insurance can be a particularly attractive means of transfer tax avoidance. With split-dollar, the company purchases a policy for its executive. At death, the company recovers its payments on the policy, and the remaining benefits are paid to the executive's estate and are subject to transfer taxes. However, if the executive contributes the policy to an irrevocable trust, the benefits pass directly to the beneficiaries, escaping estate taxes. Transfer taxes are avoided because the gift taxes, if any, from placing the policy in the irrevocable trust are less than the estate taxes incurred if the policy is not placed in a trust. This occurs because the gift taxes are assessed on a fraction of the premiums paid by the company, not all premiums paid. The base for transfer (and income) tax purposes is the cost of a one-year term life insurance policy (known as P.S. 58 costs) as determined using IRS tables.

Zabel [1995] describes a transfer tax plan using split-dollar and irrevocable trusts that he evaluated for a client. The company considered purchasing a \$50 million life insurance policy for an executive by paying \$2 million per year for ten years. Using the IRS' tables, the P.S. 58 cost in the first year of the policy would have been \$76,000 and subject to income taxes and gift taxes (reduced by annual exclusions if available.) The valuation exploitation is that annual gift taxes are

assessed on only \$76,000 although at death, the proceeds in excess of the premiums (at least \$30 million), pass transfer tax-free to the beneficiaries of the trust.

4.2 *Income and Transfer Tax Avoidance Philanthropy*

Recall charitable contributions reduce both income and transfer taxes, enabling the wealthy to fulfill philanthropic goals tax-advantageously. Charitable remainder trusts are one of the more popular structures for tax-avoidance philanthropy. They provide fixed or variable returns to non-charitable beneficiaries during the life of the grantor. Then at her death, the trust assets are distributed to charitable organizations.¹⁵

The tax advantages of charitable remainder trusts are three-fold. First, the trusts permit appreciated properties to be sold tax-free. Grantors can contribute appreciated properties to the trusts. Then the trusts sell the properties and the capital gains escape taxation.¹⁶ Second, when the property is contributed to the trust, the grantor receives an income tax deduction based on the fair market value of the property. The amount of the deduction depends on the grantor's life expectancy and the expected distributions from the trust during the life of the grantor. The younger the grantor, the lower the assessed value of the gift. Finally, because the trust's assets are distributed to charities, no transfer tax is assessed at death. The tax savings can be large enough that by reinvesting the combined income and transfer taxes avoided in life insurance, the non-charitable heirs' inheritance may be restored to the level that would have occurred without the

¹⁵ Charitable lead trusts offer similar tax-advantaged philanthropic opportunities. Lead trusts are distinguished from remainder trusts in that lead (remainder) trusts create charitable gifts during the grantor's life (at death) and non-charitable distributions at death (during the grantor's life).

¹⁶ TRA 97 restricts the most aggressive forms of charitable remainder trusts by requiring that at the time of contribution, the remainder interest be at least 10 percent of the net fair market value of property transferred.

charitable remainder trust. Tax planners tell me that the annual fees for charitable remainder trusts are approximately 200 basis points.

The latest development in charitable trusts is a NIM-CRUT (“net income with makeup charitable remainder unitrust”), which provides a further tax benefit by enabling beneficiaries to shift distributions to years when their marginal income tax rates are relatively low. Charitable remainder trusts are required to distribute a minimum amount of assets each year to trust beneficiaries. Charitable remainder unitrusts (CRUT) may distribute the lesser of a statutory percentage of assets (increased from 5 to 10 percent by TRA 97) or net income. A NIM-CRUT invests in non-income producing assets (e.g., deferred annuities) when the beneficiary faces high marginal tax rates and shifts to high-income producing assets (e.g., utility equities) when the beneficiary’s marginal tax rates fall, (e.g., during retirement). The NIM-CRUT makes up for the foregone distributions, which occurred when no taxable income was produced in the high tax bracket, early years, with excess distributions in the high-income, low tax bracket, later years. Recent creative uses of NIM-CRUT include joint use with family partnerships. The purported tax benefits/abuses of NIM-CRUT have not gone unnoticed by the Internal Revenue Service. Recently it has taken strong opposition to the most abusive forms of NIM-CRUT, creating uncertainty about their future viability.

5. Tax Plans and Marginal Tax Rates

5.1 Income Tax Plans

Ignoring tax planning, section 2 estimates marginal tax rates on labor income range up to 91 percent depending on the manner in which the wealth is disposed. Sections 3 and 4 describe numerous income and transfer tax plans, each designed to reduce the wealthy’s tax burdens. This

section reestimates the marginal tax rates on labor income, considering tax avoidance opportunities.

The taxes levied on labor-sourced income can be trichotomized into: (1) the wage taxes levied at the time services are performed, (2) the taxes on returns from investments of after-tax wages, and (3) the transfer taxes at disposition. Suppose the laborer's intends to bequeath any wealth from an additional dollar of labor income, after income and transfer taxes, to his children. If the tax on savings is deferred until immediately prior to death, the bequest can be expressed as: $(1-t_p) [(1+R_p)^n (1-t_p) + t_p b_p] (1-e_n)$.

As discussed in section 3, laborers have few options for tax mitigation unless they can reclassify wages as returns to capital, e.g., through equity interests. For example, professional basketball players cannot hold equity positions in their NBA teams. Consequently, the high wages enjoyed by professional basketball players likely are subject to immediate taxation at the highest statutory tax rate. The only apparent avoidance option is deferred compensation, which can shift their cash flow and tax realization to future years when their marginal tax rates may be lower. The likelihood of achieving tax savings from income shifting for professional athletes and other laborers with particularly short periods of labor productivity is greater than for laborers whose labor income is less concentrated in time. However, substantive tax reduction is probably difficult. All in all, professional athletes and other laborers who cannot obtain equity interests in their employers (e.g., government and not-for-profit employees), have few options for substantially lowering the marginal tax rates on their labor income below the rates estimated in section 2.

Conversely, laborers who can obtain equity interests in their employers may lower the tax burden on wages substantially. Suppose an entrepreneur establishes a wholly-owned company

with zero tax basis and never draws a salary. He withdraws the same amount from the company as he would through a salary except in a manner, such as collateralization, that does not trigger income tax realization.¹⁷ Immediately preceding his death, the company is sold and he pays taxes on the appreciation in the company at the capital gains tax rate. The proceeds are bequeathed to his children and equal $(1+R_p)^n (1-t_p) (1-e_n)$. Setting the bequest equal to $(1-t^*) (1+R_p)^n$ and solving for t^* , using current maximum statutory rates ($t_p=0.20$ and $e_n=0.55$), the implied tax burden on labor, t^* , is 0.64. In other words, the children inherit 36 percent of the value of the business, as measured immediately preceding the sale and death. This 0.64 marginal tax rate estimate compares favorably with the 0.71 estimate for t^* in section 2 when the laborer invests after-income tax wages in the same business. The sole difference between the two estimates is the wage tax avoidance.¹⁸ In other words, the entrepreneur who derives his wealth from his business through capital appreciation or other payments that avoid personal income tax realization eliminates the first tax on labor (the direct wage tax).

If the business is not sold but passes to the children at death with a step-up in basis, then all income taxes are eliminated and only the transfer tax applies. Thus, $t^*=0.55$ and 45 percent of the business can be bequeathed to the children. This compares to a t^* estimate of 0.73 in section 2. Again the difference is attributable to the entrepreneur's ability to avoid wage taxes. Identical income-tax exempt returns are possible from using some of the tax plans, detailed in section 3,

¹⁷ To assure marginal tax rates estimated in this section are comparable to those estimated in section 2, the value of the business (after considering any business tax effects) must decrease by the same amount regardless of whether the payments to the owner are through salary, which is taxable to the owner, or other payments that are not taxable to the owner. Also, this analysis ignores business taxes. To the extent the form of payment (e.g., salary versus collateralization) affects the company's tax payments, the analysis becomes more complex. In general, if the employer's marginal tax rate exceeds the employee's marginal tax rate, the corporate deduction for salary exceeds the laborer's taxable income. If so, salary becomes a more attractive vehicle for extracting cash from the business.

¹⁸ To prove: $(1-t_p) (1-0.64) = 0.29$, which yields the 0.71 tax estimate from section 2.

such as like-kind exchanges for real estate, selling closely-held stock to ESOPs, and disposing of equity through derivative products.

5.2 *Transfer Tax Plans*

The preceding discussion shows that tax planners can mitigate income tax burdens for laborers if wages can be transformed into capital without triggering tax realization. Unless a wealthy individual desires to transfer his wealth to his children, there is no additional demand for tax planning. However, to the extent transfers to children matter, even if the income tax plans successfully eliminate income taxes, the wealthy still risk forfeiting over half of their wealth to the government at death unless transfer taxes can be reduced.

The simplest and most effective transfer tax plan is maximum utilization of each person's annual \$10,000 exclusion per donee. Assuming 10 percent annual returns, a wealthy couple could transfer tax-free \$2.8 million (in future value) to each child with forty years of \$20,000 gifts. Without the gifts, if they live forty years, up to 55 percent (\$1.5 million) could be paid in estate taxes at their deaths. If the couple has ten children and grandchildren and the maximum annual gifts are made, the transfer taxes avoided grow to \$15.2 million. If they also make gifts to their descendants' spouses, the tax savings double to over \$30 million. Consequently, annual gifts may be sufficient for a taxpayer's transfer tax planning.

If more wealth is involved, larger gifts are the optimal tax strategy. As noted in section 2, even though a common transfer tax rate schedule is used for gifts and bequests, because gift taxes are tax-exclusive levies, inter vivos gifts are effectively subject to a maximum 35 percent tax rate, as opposed to the 55 percent tax rate facing bequests. Thus, one-fifth of estates can be salvaged and passed tax-free to children by shifting bequests into inter vivos gifts. The limited data

concerning taxable inter vivos gifts suggest that the wealthy are passing non-trivial amounts to their children through relatively tax-favored gifts. McCaffery [1994] notes that in 1990 \$2 billion of the \$11.5 billion paid in transfer taxes arose from inter vivos gifts, concentrated among the wealthiest taxpayers. He estimates these taxable gifts enabled approximately \$7 billion to avoid the higher estate tax rates.

However, the 35 percent favorable gift tax rate likely overstates the percentage of wealth captured by transfer taxes. Section 4 argues that undervaluing wealth is the principal component of more sophisticated transfer tax plans. For example, property gifted to children through discount partnerships are subject to a transfer tax of $1-e(1-\delta)$, where δ is the discount applied to the partnership minority interest. Using the maximum gift tax rate of 35 percent and a 30 percent discount, the family partnership can reduce the transfer tax rate to 25 percent, permitting 3/4 of the parent's wealth to pass transfer tax-free to her children. Using more aggressive discounts enables even greater reductions in the marginal tax rate. If the discount is 70 percent, the transfer tax rate falls to 11 percent.

The remaining transfer tax plans discussed in section 4 identify tax plans that can largely eliminate the transfer tax for parts of the wealthy's estate. For example, giving equity interests to children permits them to gain a toehold on possible future wealth with little, if any, immediate gift tax. To the extent parents can pass these interests to their children, future appreciation largely escapes transfer taxes. Gifting personal residences through qualified trusts transfers the wealth in houses at a minimal transfer tax cost. Similarly, life insurance trusts enables death benefits to avoid the estate tax.

In summary, annual tax-free gifts, substitution of inter vivos gifts for bequests, and transfer of selective properties through tax-advantaged structures emasculates the transfer tax.

The 55 percent marginal tax rate for bequests to children likely is relegated to wealthy individuals with limited philanthropic goals who invest little in tax planning, perhaps because they die unexpectedly. In other words, the transfer tax largely becomes a voluntary assessment that the wealthy can pay in full to the government or in part to tax planners.

5.3 *Tax Avoidance and Wealth*

To summarize, the estimated marginal tax rates in section 2 justify the wealthy's investment in tax avoidance. This section concludes that current tax plans significantly reduce the actual marginal tax rate faced by wealthy individuals. The estimates in this paper suggest the heaviest personal income tax burdens fall on laborers who cannot avoid the wage tax, and the heaviest transfer tax burdens fall on wealthy whose bequests to their children are subject to the estate tax.

The remainder of this section focuses on how marginal tax rates change as the tax base (income or transfer) increases. The model in section 2 indicates effective tax rates are decreasing, at a diminishing rate, in tax avoidance expenditures. I now posit that the demand for tax avoidance causes the functional form linking taxes to tax base to assume a relation similar to the logistic model. Specifically, taxes are always increasing in income. For low levels of income, the second derivative is positive. For high levels of income, the second derivative is negative. Restated, marginal tax rates are increasing in lower levels of income and decreasing in higher levels of income.

The reason for declining marginal tax rates for taxpayers with the largest tax bases lies in the tax planner's production function. The relation between the tax planner's fees (Fee) and the costs of producing a tax plan can be expressed as:

$$\text{Fee} = f(\text{Profit, Fixed Cost, } r_1X_1, r_2X_2, r_3X_3, \dots, r_kX_k),$$

where Profit is the equilibrium profit on the plan, Fixed Cost is the fixed cost of constructing the plan, r_k is the factor input price associated with the k th variable factor input, and X_k is the k th factor input. Fixed costs likely comprise a major component of planners' costs. Human capital becomes obsolete with every legislative change, judicial ruling, and administrative regulation, requiring continual reinvestment in professional education that cannot be assigned to a specific client's tax plan.

Taxpayers will purchase tax plans if the costs of the plan are less than the taxes it saves. Else the taxpayer will pay the taxes and avoid the costlier avoidance option. To the extent the planners' costs are fixed, individuals with tax bases below a certain level will not purchase tax plans while taxpayers with larger bases will purchase the plan and avoid the taxes. Thus, taxpayers with smaller tax bases (e.g., lower income) will face higher marginal tax rates than taxpayers with larger tax bases (e.g., higher income) because the latter group can amortize the planner's fixed costs across a larger tax base.

At least three of the tax plans described in this paper illustrate this separating equilibrium. These plans are restricted to the wealthiest of taxpayers because the implementation fees are so large that the income or transfer taxes saved must be enormous to justify purchasing the tax plan. For example, in June 1996, Eli Broad became the first individual taxpayer to use a DECS. His plan reportedly saved \$54 million in income taxes on the sale of some of his SunAmerica stock (*New York Times*, December 28, 1996). A generic version of the plan Broad used to avoid taxes on his equity holdings could benefit many taxpayers holding appreciated securities; however, the costs of Broad's plan are prohibitively expensive for smaller equity holdings. Note Broad's net savings were the reduced taxes less the tax planners' fees.

Similarly, establishing and maintaining a Delaware investment company involves substantial legal and tax costs, regardless of the state income tax savings. Thus, Delaware investment companies are limited to the wealthiest taxpayers. Consequently, the marginal tax rates on state income taxes are lower for the highest income taxpayers than for other taxpayers, who cannot afford to purchase state tax exemption. As with Broad's DECS, the costs of state income taxes to the wealthiest sector is not zero, rather it is the tax consultant's fee.

Likewise, family discount partnerships provide a mechanism for understating wealth and avoiding transfer taxes. If the present value of avoided transfer taxes, provided through a discount partnership, exceed the planner's fee, the plan is purchased, the partnership formed, and the marginal tax rate on additional dollar of wealth is reduced. If not, the plan is not purchased and transfer taxes are paid in full.

To summarize, high income (wealth) individuals potentially face lower marginal income (transfer) tax rates than persons of more moderate income (wealth) because larger tax bases enable them to acquire tax plans that are too expensive for taxpayers with smaller bases. These marginal tax rate differences are attributable to fixed costs in planners' fee structures.

6. Closing Remarks

The tax environment for the wealthy is a complex composite of income and transfer tax incentives that vary with the source and use of wealth. Without tax planning, many wealthy individuals face heavy tax burdens. Tax planners have responded with an array of products that successfully mitigate income and transfer tax payments. Thus, wealthy individuals exchange large tax levies for smaller tax avoidance fees.

One area of continuing policy interest to which this paper may provide some insight is the appropriate level for capital gains tax rates. To the extent capitalists avoid the taxes levied on their returns, favorable capital gains tax rates seem redundant. However, if avoidance opportunities are limited to the wealthiest taxpayers, then lower capital gains tax rates may equalize the capital gains tax burdens across different levels of wealth. The recent TRA 97's reduction in the capital gains tax rate (as with any tax reduction) also reduces the demand for tax avoidance for assets subject to capital gains taxes. However, by reducing capital gains tax rates, the new law increases the demand for tax plans that transform ordinary income into an asset subject to the more favorable capital gains tax rate.

Having concluded that tax planning is a successful response by taxpayers to potentially confiscatory tax burdens, the remainder of the paper proposes two modifications to the current tax system that could reduce substantially the demand for tax planning. Such reduction is warranted because the current levels of investments in tax avoidance substantially reduces government revenue, erodes public support of the current taxation systems, and employs too many bright minds. To curtail tax avoidance investments, I recommend the elimination of both transfer taxes and the step-up of tax basis to fair market value at death.¹⁹

Abolishing transfer taxes would eliminate the demand for transfer tax avoidance and redeploy a sizable sector of the tax avoidance industry to more productive tasks without substantial government revenue loss.²⁰ It also would eliminate administrative and compliance costs plus suboptimal structuring of family wealth (in the absence of transfer taxes). If transfer taxes were eliminated, the primary losers, besides transfer tax planners, would be charities that

¹⁹ Bartlett (1997) advances similar policy recommendations.

enjoy financial windfalls from a tax system that encourages philanthropy. An assessment of the efficiency of the current transfer tax system in funding charities would be a useful exercise. The primary winner would be the wealthy who would avoid transfer taxes, planning fees, and tax-induced dispositions to charity.

Eliminating step-up at death would mitigate the increased wealth concentration from abolishing transfer taxes by removing a key weapon from the income tax planners' arsenal. Step-up at death provides the ultimate deferral incentive, exemption, and creates an inefficient lock-in effect for older taxpayers. Its elimination would restore to the income tax base property appreciation that currently escapes taxation at death. By providing carryover basis to heirs, income taxation could be deferred until reinvestment ended. Although continued deferral would provide a windfall to the wealthy, it also would eliminate the necessity for cash-constrained closely-held businesses to acquire extensive life insurance coverage for its major shareholders or risk forced liquidation to pay taxes at death.

The effect of these proposals on the timing of intergenerational transfers is unclear. To the extent current inter vivos gifts are motivated by estate tax avoidance, gifts might decline. On the other hand, without step-up, the elderly would have fewer incentives to retain assets until death.

Finally, eliminating step-up at death only partly addresses the income tax system's fundamental realization flaw. Without step-up, taxpayers could still reinvest without taxation by borrowing against appreciated properties or using related, more complex financial options, such as puts and calls. Abandonment of income as a tax base and movement to alternative tax systems,

²⁰ In 1990 transfer tax collections accounted for \$11.5 billion or 1.12 percent of federal revenue (McCaffery [1994]).

e.g., consumption taxes, probably is the only realistic means of remedying the avoidance opportunities provided by income tax realization. Retaining the income tax system and treating loan proceeds as income and principal repayments as deductions is too farfetched to warrant further consideration. Moreover, taxing debt issues and deducting debt repayments would introduce frictions into the capital markets that might be socially counterproductive, even if they improved the comprehensiveness of the tax system. In summary, any tax system built on income will have inherent avoidance opportunities depending on the triggering device for determining income. To my knowledge, no policy changes could eliminate fully the current income tax avoidance opportunities available from exploitation of the realization principle.

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