Wealth and Wealth Transfer
Taxation

Robin Boadway
Queen’s University, Canada

Prepared for the International Symposium on
Tax Reform in Globalization Era: World Trend and Japan's Choice, February 22-23, 2008, IRPP, Hitotsubashi University, Tokyo
Introduction

• Inheritance tax subject to much criticism
  – Unfair
  – Little revenue raise
  – Double taxation
• No consistent approach in G7 countries
• No accepted guiding principles
• Alternatives:
  – Reform inheritance tax
  – Replace with accessions tax
  – Replace with capital gains tax at death
Overview of UK System

• Inheritance tax on estates at death
  – Flat rate of 40% above a threshold
  – Transfers to spouses and charities exempt
  – Relief for farms and private businesses
  – Lifetime gifts exempt if donor survives 7 years and gives up all benefit in the gifted asset
  – Gifts to trusts taxed at 20% above threshold
UK System, Cont’d

• Capital gains:
  – Taxed at 18% above exemption
  – Deemed realization on lifetime gifts
  – No deemed realization on death (rebasing)
  – Holdover relief on gifts of business assets
  – Exemption for private residence and spouses

• Stamp duty on houses and UK stock sales

• Property tax on occupants
Criticisms of Inheritance Tax

- Raises little revenue
- Double taxation of wealth
- No effect on wealth distribution
- Lifetime gift exemption favours rich
- Flat rate of 40% too high
- Threshold too low
- Exemptions unfair (incl. human capital)
- Trust taxation irrational
- Not harmonized with capital gains tax
Meade Recommendations

• Wealth and wealth transfers should be taxed
  – Wealth confers its own benefits
  – Wealth transfers more than a transfer of base

• PAWAT combines both
  – Progressive Annual Wealth and Transfer Tax
  – Base: cumulative net transfers received
  – Progressive tax falling with age

• Simple alternative: LAWAT
  – Linear Annual Wealth and Transfer Tax
Optimal Tax Benchmark

• Simple OLG models with public debt
• Bequest tax depends on bequest motive:
  – Altruism
  – Utility of bequest
  – Unintentional (precautionary saving)
  – Strategic bequest
• Depends on whether donor utility “counts”
• Results generally agnostic
Principles for Wealth Taxation

- Few accepted normative principles
- Difficult value judgments
- Optimal tax literature gives little guidance
- Implementation problems significant
- Political support limited
- Three criteria for evaluating tax systems
  - Welfarist
  - Non-welfarist
  - Paternalistic
Welfarist Criterion

- The standard utility-based approach
- Tax base a measure of well-being
- Rate structure aims at equality in utilities
- General problems:
  - measurability
  - information and reliance on self-reporting
  - commitment
  - enforcement and administrative costs
  - incentives and societal consensus
Special Problems

• Should all sources of utility count?
  – Altruism, envy, relative income/wealth
  – Double counting depending on motive
  – Utility of holding wealth
  – Extreme case: *Strict welfarism*

• Different preferences
  – Preferences for leisure, goods, saving, etc.
  – Altruism and preferences for bequests
  – Choice of family
Equality of Opportunity

• Principle of Compensation
  – Compensate for things beyond control
  – Tax inheritances progressively
• Principle of Responsibility
  – No penalty for free choices (e.g. bequests)
• Social & economic rights, basic needs
• Benefits conferred by wealth
  – Status, power
  – Human wealth
Paternalism

• Three problems from behavioural economics
  – Bounded rationality
  – Choices based on ethical or social norms
  – Time-inconsistent preferences (self-control, procrastination, myopia: under-saving)

• Corrective role of government contentious

• Reduces case for taxation of wealth
Taxation of Wealth Transfers

Three Approaches

• Strict Welfarism
  – Welfare (utility) of donees counts
  – Tax donees, no relief for donors

• Restricted Welfarism
  – Utility of donor does not count
  – Tax donees, tax credit for donor

• Equality of Opportunity
  – Tax donees, no relief for donors
Caveats & Concerns with Strict Welfarist Approach

• Standing of benefit to donor
  – Double benefit even with no transfer
  – What about ethical motives for giving?
  – Saving as transfer between ‘selves’

• Involuntary (unintentional) transfers
  – No benefit to donor (except wealth held)
  – Tax non-distortionary

• Strategic (requited) transfers
  – No double counting here
Caveats & Concerns, Cont’d

• Transfers to heirs
  – Parental care also produces double benefit
  – Multiple benefits if many family members
  – Human capital transfers important

• Externalities
  – Donations to charities and non-profits
  – Third party beneficiaries not taxed
  – Crowding out of public provision efficient
Alternative Approaches

• Restricted welfarism
  – Consistent treatment of altruism, envy, etc.
  – Case for no tax on voluntary wealth transfers
  – Still tax unintended and requited transfers

• Equality of opportunity
  – Deals with differences in preferences
  – Same tax treatment as Strict Welfarism
  – Case for expenditure tax as personal base
  – Case for wealth transfers to low-wealth persons
Design Issues

Consequences of the Tax Mix

• Strict welfarism or equality of opportunity:
  – Could integrate transfers with direct taxes:
    • Tax donees on inheritances
    • No relief for donors
  – Donors should pay VAT on transfers

• Restricted welfarism
  – Tax donees, give relief to donors
  – No need to apply VAT on transfers
  – Second best: Ignore transfers for tax purposes
Specific Design Issues

- Threshold, rate structure, lumpiness
- Taxpaying entity (resident versus non-resident)
- Transfers to charities and non-profits
- Transfers to spouse
- Family house, farm or business
- Measurement and avoidance
- Transfers at death versus lifetime
- Treatment of capital gains on transfers
- Integration with personal tax?
- Incentives
Taxation of Wealth

• Substitute for capital income tax
  – Housing, offshore assets
  – Supplement to dual tax

• Wealth as a source of utility
  – Status, power, security, envy
  – Standing of such utility and double counting

• Non-Welfarist arguments
  – Equality of opportunity
  – Ability to participate in society
Design Issues

- Wealth for lifecycle smoothing
- Inherited versus accumulated wealth
- Pension wealth
- Human wealth
- Compliance problems
- Restriction to real property?
- Threshold and rates
- Deduction of liabilities leads to avoidance
- Tax on capital income a simple substitute
Policy Options

• Rule out separate wealth tax
  – Better achieved by taxing capital income
  – Redistribution better served by wealth transfer tax
• Reform the existing inheritance tax system
• Move to donee-based (accessions) tax
• Abolish inheritance tax, and tax capital gains on transfers
Reform Inheritance Tax

• Tax donor transfers
• Higher threshold, progressive rates
• Include lifetime gifts to 15 yrs before death
• Restrict or abolish farm and business relief
• Maintain heritage property relief
• Continue to include housing
• Include foreign domiciliaries without relief
Move to Accessions Tax

- Theory suggests a donee-based tax
- Encourages wider wealth distribution
- Reduces incentives for lifetime gifts
- Should be separate from personal tax
- Based on cumulative lifetime receipts
- Same issues of threshold, rate structure, exemptions, etc. as in current tax
- More complex than donor-based system
Abolish Inheritance Tax

- Equivalent to restricted welfarist approach
- Tax gains on transfers at market value
- Deemed realization and inheritance tax *not* substitutes
- Reduces tax planning
- Deemed realization on emigration and rebasing on immigration
- Treatment of housing? (now exempt)
- Treatment of farms and private businesses?
Dual Income Tax

• Complicates treatment of wealth and wealth transfers
• Dual income tax taxes capital income proportionately at low rates
• This reduces the advantages of replacing inheritance tax with taxation of capital gains on transfers, and enhances the case for a donee-based wealth transfer tax