

Wealth and Wealth Transfer Taxation

Robin Boadway
Queen's University, Canada

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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 (rebasings)
 - 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 required 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