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The Estate Tax and Inter Vivos Transfers over Time†

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Although the estate tax is paid by a small fraction of decedents, it continues to be one of the most talked about and controversial taxes. The last decade or so has seen nearly annual changes in the parameters of the "death tax" as it was gradually repealed as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (often referred to as the Bush tax cuts). The tax was eliminated in 2010, returned in 2011, and was recently renegotiated as part of the discussions surrounding the fiscal cliff. Throughout this time period there were substantial changes in both the amount of an estate that could be transferred tax-free—increasing from $1 million in 2001 to $5.25 million in 2013—and in the top marginal rate which fell from 55 to 35 percent over this time (with the aforementioned brief spell at zero). However, despite these changes, one feature of the estate and gift tax remained relatively constant, the annual exemption on giving. Individuals may give a specified amount each year, to each of as many recipients as they choose, without incurring any gift tax or even needing to report the gift to the Internal Revenue Service (IRS). The annual exemption has been in place since 1932 and was set at the now familiar amount of $10,000 per recipient in 1981. Although the amount was indexed for inflation beginning in 1998, it did not increase from $10,000 until 2002 when it was changed to $11,000. It reached $14,000 in 2013.

While this annual exclusion provides a simple and potentially powerful way to reduce the burden of the tax, past research has shown it is rarely fully exploited, even by the wealthiest of households. Poterba (2001) finds that among the oldest and wealthiest respondents in the Survey of Consumer Finances (SCF), gifts of above $10,000 are rare with less than 40 percent of those ages 75 or older and with net worth of above $2.4 million making such a transfer. Poterba qualifies his results by noting that his result is based on a single year and may therefore miss an important fraction of giving if transfers are made in some years and not others. Joulfaian and McGarry (2005) and McGarry (2001) find that gifts from wealthy parents to their children are common but in line with Poterba's results, rarely reach anywhere near the tax-free limits. In fact, calculations in McGarry (2001) indicate that taking advantage of this tax-free giving could reduce the eventual estate tax bill to nearly one-third of the amount expected if households simply followed their current patterns of giving.

These results provide strong evidence that the wealthy are not taking full advantage of perhaps the simplest way to transfer their wealth and reduce or avoid an eventual estate tax burden. However, the conclusions reached thus far are limited in that they are drawn, for the most part, from examinations of giving in a single year. If we are to have a more accurate understanding of the degree to which individuals take advantage of the opportunity to reduce the eventual estate and gift tax bill through inter vivos giving, we need to examine giving over time. This paper provides just such a look—examining giving among the wealthy over a period of as long as 17 years. With this expanded window of observation, it is apparent that not only do few wealthy individuals make large gifts in a single year, but even when looking at a longer period of time the majority of individuals give far less than the amount they are potentially able to give tax-free. Furthermore, among those wealthy who are observed to give a large amount in a particular year, few continue to give as generously in subsequent years. This pattern suggests that even wealthy "givers" are likely motivated by reasons other than tax avoidance.

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I. Background on the Estate and Gift Tax

Since 1977 the United States has had a unified estate and gift tax, meaning that taxes are due on the total amount of transfers made over the decedent's lifetime, regardless of when the transfer was made. (See Jacobson, Raub, and Johnson for a history of the estate tax up until 2011.) However, there is also an estate and gift tax *credit* which effectively eliminates any taxes owed on estates and gifts below a specific amount. In addition, there is an annual exclusion allowing for relatively small gifts to be made in each year exclusive of any tax obligation. The amount of the tax credit and that of the annual exclusion have changed numerous times over the past two decades. In 1992 (the start of observations for this paper) the tax credit allowed for estates and lifetime gifts totaling $600,000 or less to be transferred tax-free and the annual exclusion was $10,000 per recipient per year. The limit on the size of the estate that was exempt from tax began to rise in 1998 and increased over time from $600,000 to $5.25 million in 2013 (with no tax due on estates transferred in 2010).[1] Because the amount is per decedent, a married couple can bequeath $10.50 million. The annual exclusion also changed over time. It was $10,000 for a substantial period, from 1982 to 2001 and has since adjusted periodically in round numbers to account for inflation, reaching $14,000 in 2013.

Because the annual gift exclusion is per donor-recipient pair, a wealthy individual wishing to maximize the spend-down of his estate has substantial scope to do so. Consider a married couple with two children. If each of those children is married with two children of their own the couple can give a combined total of $224,000 in 2013 tax-free ($2 \times 8 \times \$14,000$). Given the heated rhetoric surrounding the estate tax one would imagine this gift giving option to be exploited fully.

II. Data

To measure the extent to which individuals are using this mechanism to reduce the tax eventually owed by their estates, one needs detailed information not only on bequeathable wealth and transfers, but also on the number of potential heirs to whom an individual might wish to transfer resources, most obviously, children, children-in-law, and grandchildren. (Although note that an altruistic individual could also give amounts up to the annual exclusion to parents, siblings, more distant relatives, as well as to non-relatives, all without incurring tax consequences.) Here I focus only on the most likely class of recipients—children. Data with this level of detail are rare, particularly with regard to information on inter vivos giving. Measures of such giving are not often obtained in large nationally representative surveys and even less so in panel data or along with comprehensive measures of wealth. The Health and Retirement Study (HRS) is unusual in collecting these data, and does so not just for particular parent-child pairs but collects information on gifts from parents to *each* of their children (and grandchildren). With these data it is possible to assess how much parents give to their immediate descendants, relative to their potential to make tax-free gifts, both in cross section and over time. The HRS also contains extremely detailed information on assets that is more complete than many other panel surveys (Smith 1995). One can use this information on net worth to infer who in the sample is most likely at risk for leaving an estate that would be subject to tax.

The HRS is a biennial panel survey begun in 1992 with a cohort of individuals born between 1931 and 1941 and their spouses or partners. A second cohort of individuals born in 1923 or earlier (and their spouses) was interviewed in 1993 and 1995, merged with the original HRS cohort in 1998 and continued to be interviewed biennially. Two new cohorts were added at this time, making the sample approximately representative of the population ages 50 or older. Refresher samples were added in 2004 and 2010. I use data from 1992 to 2008. I limit my sample to those respondents who had children and who have valid data on asset holdings and transfers in at least one wave. I use the household weights provided in the HRS in the tabulations.

When collecting information on transfers, respondents are specifically asked whether they made a transfer of $500 or more to any of their children since the previous wave (approximately

[1] The actual law in 2010 was more complicated with estates having the choice to forego a step up in basis value and avoid the estate tax or pay the estate tax at the 2011 rates and limits and retain the step up in basis value.

two years), and if so, how much.[2] On average, 39 percent of respondent households reported that they made a cash transfer to at least one of their children in the past year and the mean and median amounts transferred to all children, conditional on a positive amount being transferred, were $10,229 and $3,600 (in nominal dollars). Despite the changes over time in the annual exemption, the size of estates subject to tax, and the highest marginal tax rate, the likelihood of giving over time is relatively constant and exhibits no clear pattern. The average and median amounts transferred rise in nominal terms, but there is no such trend when measured in real dollars.

Because the focus of this study is on the use of the annual gift giving exemption as a mechanism to reduce the eventual tax paid by the estate, I base much of the analysis on a subsample of extremely wealthy respondents. In cross section, it is relatively easy to determine who in the sample has bequeathable assets above the taxable limit in that specific year and I thus define "wealthy" as assets above the relevant tax-free maximum (or twice the limit for a couple) for all cross-section calculations. However, because the wealth holdings of individuals change from wave to wave, and the limits defined by the federal estate tax law also change, there is no obvious definition of "wealthy" when examining behavior across the panel—individuals may have bequeathable wealth above the taxable limits in some waves and not others. I therefore experimented with alternative definitions of wealthy including limiting the sample to those with wealth above the taxable limits in every period, those with average wealth above the average taxable limit, and most simply, those with wealth above $1 million per person in every period. The results presented in this paper use the simple $1 million definition of wealthy but the conclusions are unchanged with other definitions. (Comparing the amount that can be transferred tax-free across years, the modal amount is $600,000 and the average is $1.7 million. One million was the amount that would have been in effect were the Bush tax cuts let to expire, and thus perhaps a prominent number affecting individual planning.)

[2] In 1994 and 1995 the questions asked about transfers of $100 or more. I eliminate all transfers between $100 and $500 in these years for consistency with other waves. The transfer question at the first interview asked about gifts in the previous year while follow-up interviews is about transfers since the previous survey.

When focusing on the giving of just the wealthy reported in each year, the probability of making a transfer across all waves at approximately 60 percent is much higher than for the entire sample and the conditional mean and median amounts are also higher ($24,100 and $10,000). The nominal values for the mean and median increase over time, but as was the case for the full sample, there is no obvious pattern over time in the probability of giving or in the real values.

III. Results

Giving in the Cross Section.—I begin the analysis by assigning to each respondent household a maximum amount of tax-free giving per year including only children as potential recipients (and doubling the amount for married couples). The actual capacity for giving, even when limited to direct descendants, is much greater than this figure would suggest as transfers could also be made to grandchildren and children-in-law (and anyone else). However, as I show below, wealthy individuals fail to give anywhere near even this conservative amount, so the fraction fully exploiting the opportunity would be far smaller if additional potential heirs were included.

In stacking observations for all waves, the average number of children for households defined as wealthy in a particular wave (i.e., bequeathable wealth above the taxable limits for that year) is 3.0 (conditional on having at least one child). The majority of these observations (81 percent) are for married couples so the potential for these households to give is twice as large as for single individuals with the same number of children. Using the applicable annual exclusion in each year, and the roughly two-year period between waves, the average potential tax-free giving to children per HRS household, per wave, is $110,000. The median is $88,000. Actual giving for this group of wealthy individuals averages just $14,300, or approximately one-eighth of the potential, suggesting substantial scope for additional tax avoidance—particularly if grandchildren and children-in-law are included. In fact, only 3.7 percent of respondents gave an amount equal to or above the exclusion.[3] One could argue that rather than the higher amounts seen in recent years, the annual exclusion of $10,000 that was in place for 20 years led to individuals using that value as a norm for tax-motivated giving. Even using this lower number in each year, only 3.8 percent made transfers equal to or above this amount.

Some parents may not wish to transfer any resources to their children either posthumously or before. I therefore look at the extent of giving conditional on making a transfer to at least one child, asking whether those who give something to a child appear to be responding to the tax exclusion. Even conditional on making a transfer, the average amount given is $24,100, far short of the potential tax-free amount.

Giving in the Panel.—In analyzing panel data, an important question is the extent to which giving persists across years. To begin to look at these year to year changes, I examine the probability of giving in two successive periods. Among the subset of wealthy in any particular wave who are observed again in the subsequent wave, the probability of making a transfer in the second wave, conditional on making a positive transfer in the first is 73 percent. This conditional probability is higher than the unconditional probability of approximately 60 percent so there is some persistency in terms of giving, although giving in both years is far from universal even among these "givers." Among the small fraction of 3.6 percent those who gave an "optimal" amount in one period (defined as an amount equal to or above the annual exemption $\times$ number of children), only 26 percent gave "optimally" in the second period. If large gifts were made as part of a strategy to reduce the eventual estate tax, one would expect them to be made period after period. The fact that they are rare, and not persistent, even among those seemingly maximizing giving in one period, suggests that the wealthy do not exploit fully (or anywhere near fully) the potential to give, and even those who make large gifts do not appear to be doing so as part of a program of planned giving. Rather transfers may respond to the needs of a child or to various events in the child's life (McGarry 2012). The variation in giving from year to year also points to the importance of examining behavior in the panel in order to assess more accurately the degree to which wealthy parents engage in tax-motivated giving.

Unsurprisingly, giving is less common for the non-wealthy, but the probability of giving in the second period conditional on giving in the first is similar; just over 60 percent of those who transferred funds to children in one survey year gave again in the following wave. With respect to large gifts, less than one-half of one percent of the lower-wealth population gave an amount greater than or equal to the annual exemption for each child, but the conditional probability of an "optimal amount" in the second period was nearly 15 percent.

Given the obvious result that many wealthy individuals do not transfer anywhere near the amount they are permitted to give on a tax-free basis, it is useful to see how often they do give, whether they give large amounts in some years but not others, and whether there is a subset of families (albeit small) who are using the annual exemption as part of a program of estate planning and who frequently give at or above the annual exclusion. Using the panel, I can observe gift giving behavior from 1992 to 2008. Households are observed for varying numbers of years as new cohorts enter the sample and households attrit due to death or lost to follow-up. Because of the differences in the length of the panel, I examine the frequency with which individuals give to their children, by looking at the fraction of survey waves in which individuals are observed to have made a transfer to at least one child as well as the actual number of years for which they give by whether they are observed for five, six, seven, eight, or nine waves. I exclude those with fewer observations because the patterns observed for these households may be less representative of giving behavior over time. The conclusions are the same regardless of which method I use. The wealthy do give frequently to their children. Among those who are observed for five or more waves, only 6 percent of the wealthy never transferred resources to their children and 18 percent

[3] Even amounts above the exclusion are unlikely to be taxed. First, the potential amount here excludes the potential to give to a grandchild or children-in-law. Second, gifts for health care or educational expenses are excluded from taxable giving regardless of the amount. And finally, amounts above the exclusion are simply deducted from the lifetime exemption. Furthermore, it may be optimal from a tax avoidance strategy to make taxable bequests early as inter vivos gifts. See Joulfaian (2005) and Poterba (2001) for a discussion.

did so in every wave. For those observed seven, eight, or nine times, giving in all but one wave is the most likely outcome. For those observed for nine waves, 20 percent made a transfer in eight waves and 50 percent made a transfer in at least seven waves.

However, when examining giving at or above the amount dictated by the annual exemption, the story changes dramatically; 80 percent never made a transfer of this magnitude and none of the wealthy families in the sample made these large transfers in every wave, or even in all but one wave. For those observed for nine waves, 75 percent never transferred an amount equal to or greater than the annual exemption × number of children for each spouse, 17 percent did so just once, and 8.5 percent did so more than once. Similar patterns are observed for other years. Thus, while the wealthy are likely to give and give in many (if not most) waves, they rarely, if ever give near the tax-free maximum. This result casts doubt on the importance of the annual exemption as a means of reducing the estate tax burden, or even on its role as a target amount or upper bound on giving.

Multivariate Analysis.—Although individuals do not give the maximum they can tax-free, it is worth asking whether they respond at all to changes in the estate tax. It is difficult to assess the elasticity of giving with respect to estate tax rates or the estate tax credit (which determines the level at which the estate tax binds) because the observed changes in these amounts were typically known long in advance as a result of existing legislation. However, even though it was known that the annual exemption would increase with inflation, one was still bound by existing law in any one period and could not increase giving in anticipation of a coming change. As such, it is useful to examine the relationship between giving to children and the annual exclusion to assess whether the wealthy increase their giving when the limit increases. To do so, I stack data for each survey year and regress both an indicator for whether a gift was made to any child, and the total amount given, on the amount of the annual exemption, a dummy variable indicating the individual is wealthy and the interaction of the two variables. I also include a set of controls including the number of children, race, cubics in assets and income, the amount of liquid assets, education (average for couples), marital status, and the number of years of expected life remaining for the household (based on the Social Security actuarial tables and equal to the sum of the life expectancies for each spouse in the case of a couple and the individual's own life expectancy for singles), and dummy variables for the survey year.

My focus in these regressions is on the coefficients on the effect of the amount of the annual exclusion itself and on the interaction of the indicator of wealthy with the annual exemption. Increases in the annual exemption ought to be unlikely to affect the *probability* of giving for either the wealthy or the less wealthy, but ought to be positively related to the amount given for those who are wealthy enough to anticipate facing the estate tax, as they increase their giving to take advantage of the expanded opportunity for tax avoidance. The results of this analysis demonstrate that the annual exclusion does not have a significant effect on giving for either group. In the equation for the probability of a transfer, the coefficient on the linear annual exemption is not statistically different from zero and the coefficient on the interaction of wealthy and the amount of the exemption is actually negative—indicating that the wealthy actually give less when the annual exclusion increases. (Being wealthy by itself does significantly increase the likelihood of a transfer beyond the increase associated with the actual value of income and wealth.) The same pattern holds for the amount transferred. The annual exclusion has no effect on the amount given for the non-wealthy and a slight negative effect for the wealthy that is offset by the linear wealthy effect and asset levels.

IV. Conclusion

Despite the public's focus on the burden of the estate tax, few wealthy households appear to use the simple mechanism provided by the annual exclusion to reduce a potentially taxable estate. In cross section and panel analysis, the wealthiest individuals in the sample continually give away far less than the tax-free potential and no respondent in the survey appears to exploit the annual exemption year-in and year-out. Thus, while some individuals may be concerned about their estate being subject to the estate tax, if they are altering their behavior because of this concern, they are doing so through mechanisms other than annual gifts to potential heirs.

Furthermore, the results documented here suggest that the annual exclusion is not binding in the vast majority of cases and does not limit inter vivos giving.

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