



Fair inheritance taxation in the presence of tax planning



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ABSTRACT

This paper presents an analysis of the extent to which tax planning affects the level of the inheritance tax rate that is perceived to be fair. In a survey with an experimental design conducted in Germany, tax planning was found to increase the fair tax rate by approximately 4 percentage points. The fair tax rate is determined by not only the size of the bequest, the relationship of the heir to the bequeather, and the type of bequest, but also by the perceived intentions of the bequeather. The preferred interpretation of the result is that families with pro-social motives should be taxed less than those without pro-social motives. The analysis described in this paper finds support in optimal tax theory. To this end, a simple model was developed that shows that taxation should not prevent individuals with joy-of-giving motives from contributing substantially more to the social good than individuals who do not share these motives.

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1. Introduction

For many years and in many countries, the estate tax or the inheritance tax has been very controversial, although its share of overall tax receipts is rather small. It has been denounced as an immoral “death tax” that taxes wealth already taxed once or more (“double tax”) (for a discussion of this exercise in rhetoric, see Gale and Slemrod, 2001; Prabhakar, 2008). In the sociological discourse on inheritance taxation, the tax is mainly justified on the grounds of the principles of justice and equality of opportunity (see Beckert, 2008). However, according to the family principle, inheritance taxes interfere with the unity of the family, which could be considered as an entity that outlives the deceased, and undermine family solidarity (see Kohli, 1999, 2004; Beckert, 2008). From an economist’s point of view, there is an equity efficiency trade-off involved (for an overview on the economic literature, see Cremer and Pestieau, 2006; Boadway, Chamberlain, and Emmerson, 2010; Kopczuk, 2013b). On the one hand, because wealth is increasingly unequally distributed, because the distribution of wealth transfers is also strongly positively skewed, and because the administration of an annual wealth tax is rather costly, the inheritance tax

may be an important instrument to redistribute from the rich to the poor. On the other hand, the tax distorts the savings of farsighted bequeathers and the labor supply of heirs. According to the deterministic infinite-life model of Chamley (1986) and Judd (1985), the optimal capital income tax is zero in the long run because a tax on capital income creates an ever-growing distortion of inter-temporal choices. Atkinson and Stiglitz (1976) argued that a non-linear earnings tax is a more efficient tool for redistribution. However, recent research has shown that the negative results mentioned depend heavily on the restrictive model assumptions. Piketty and Saez (2013) showed that the welfare-maximizing inheritance tax rate is positive and is larger as more bequests are concentrated and the weight of those receiving little inheritance increases. Furthermore, it has long been recognized that the assessment of inheritance taxation depends strongly on bequest motives (see Cremer and Pestieau, 2006). While taxation of accidental bequests is non-distorting, this is not so with altruism or exchange motives. In particular, the economic literature has stressed that transfer taxes should internalize externalities from giving (see Kaplow, 2008, 2010; Kopczuk, 2013a).

In the public debate, there is a widespread feeling that it is relatively easy, especially for the wealthiest families, to avoid the estate tax (Gale and Slemrod, 2001). One way to do this is to skip generations or use trusts (Boadway, Chamberlain, and Emmerson, 2010). Kopczuk (2007) showed that the onset of a terminal illness leads to a significant reduction in the value of estates reported on

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tax returns, reflecting tax planning. Although optimal tax theory focuses on asymmetric information about the ability of the taxpayer, most of the literature on wealth transfer taxation assumes that bequests are observable and that the estate tax can neither be avoided nor evaded. However, it has been shown that the zero-taxation result breaks down if wealth transfer is not observable (see Boadway, Marchand, and Pestieau, 2000; Cremer, Pestieau, and Rochet, 2003). Finally, although it is claimed that wealth-transfer taxes impose intolerable burdens on family-owned businesses, there is very little evidence for this damaging effect on small businesses (see Gale and Slemrod, 2001; Boadway, Chamberlain, and Emmerson, 2010).

This paper presents an analysis of the effect of tax planning on the inheritance tax rate that is perceived to be fair by the German public and links the findings to an optimal taxation model in the spirit of Diamond (2006). In Germany, inheritances and also inter vivos gifts are both subject to taxation (for a brief overview, see Kessler and Eicke, 2009). Tax rates vary from 7% to 50%, depending on the relationship between the bequeather and the heir and the value of the inheritance. Partners and children face the lowest tax rates, close relatives the second-lowest, and others belong to the high-tax-rate category. Substantial personal allowances and further special allowances together with sharply increasing tax rates make the tax highly progressive. Business property is tax-exempted provided that the wage bill is not reduced substantially over a certain period of time. The transfer of a privately owned home to a partner or to children is also tax-free up to some threshold. Due to the large allowances, in 2011, only 133,624 transfers were effectively taxed; the average tax liability was 31,589€. The average tax rate, calculated as tax revenue over transfers in excess of any allowances and deductions, was 16.73%, and 55% of tax revenue came from the 6% of tax payers whose tax liabilities exceed 500,000€ each (see Federal Statistical Office, 2012). Because of a constitutional court ruling in 2007 and a major inheritance tax reform in 2009, the tax has been intensively discussed in recent years and the public is relatively aware of the tax rules.

To analyze the effect of tax planning on the level of the inheritance tax rate that is perceived as fair and appropriate, we conducted a survey with an experimental design. The respondents made judgments of fictive descriptions that have been constructed by randomly selecting the level of tax planning. Because we are interested in attitudes rather than behavior, the survey approach is the method of choice. The main advantage of the experimental design is that it does not lead to biased estimates but reduces the likelihood of socially desirable answers, since it conceals that we are mainly interested into the attitude toward tax planning. In particular for multidimensional issues, the factorial survey approach – applying experimental designs in survey research – has proven useful in studying determinants of positive beliefs and normative judgments (see, e.g., Rossi and Anderson, 1982; Hox, Kreft, and Hermkens, 1991; Beck and Opp, 2001). In our experiment with two different randomly assigned scenarios, the respondents had to choose the fair inheritance tax that an heir has to pay when she inherits a medium-sized company from her father, a situation in which, under German tax law, business property tax relief would apply. In one of the two scenarios, most likely to benefit from tax relief, the bequeather bought the firm when he discovered that he would die soon; in the other scenario, the deceased owned the firm for many years. Our main result was the following: in a simple bivariate analysis, tax planning by the bequeather was found to increase the tax rate perceived as fair by 3.75 percentage points. Because this change corresponds approximately to a 30% increase, the effect of tax planning on the fair tax rate was huge. After controlling for family values and judgments on public redistribution policy, the effect was even stronger (4.15 percentage

points). In additional regressions, we controlled for various characteristics of the respondent but socio-demographic variables (age, gender, income level, education, country of birth, etc.) and experience with and expectations of bequests and inheritance tax did not influence the assessment systematically.

Our interpretation of the judgments is that the entrepreneur-turned-manager was considered as purely selfish, whereas the all-time entrepreneur was to some extent regarded as pro-socially motivated job creator. As compared to the all-time entrepreneur, the entrepreneur-turned-manager was less pro-socially motivated or even anti-socially motivated. Looking at the results that way, fair taxes should be adjusted with respect to the motives of the taxpayers. That is to say, the tax system should it make costly for taxpayers without pro-social motives to mimic taxpayers with pro-social motives. Interestingly, we found that the fairness consideration we discovered empirically has an equivalent in optimal taxation theory. Optimal taxes do not prevent individuals with pro-social motives from contributing substantially more to the social good than individuals who are not so motivated. However, the magnitude of the optimal tax relief depends on the strength of the pro-social motives and the welfare weights of individuals with and without pro-social motives.

The paper is organized as follows. Section 2 describes the survey and presents the empirical results. Section 3 links the findings to the theoretical literature on reciprocity in games and optimal taxation in the presence of a joy-of-giving motive. Section 4 presents conclusions.

2. The survey

The data source of our study was the WISO-Panel which is an online access panel with more than 10000 registered users. It was founded at the University of Erlangen-Nuremberg and moved recently to the University of Freiburg. The study was conducted in September 2012 with 524 participants as part of a broader project on normative judgments on the inheritance tax. Although the panel population is heterogeneous in its various socio-demographic dimensions, it is not fully representative of the German population. In our sample, the proportion of women (53%) was slightly larger than in the population, and the respondents were significantly younger and better educated: more than 51% were younger than 45 years and 58% held at least a degree from a higher secondary school. Some respondents' data were provided by the panel organizer; most data were taken from our survey. Our survey included several questions on socio-demographic variables, on judgments on the government's role in redistribution, and on family values. However, the survey focused especially on the respondents' experience with and expectations of gifts, bequests, and the inheritance tax, and on their judgments on evasion and avoidance of the inheritance tax.

The description was varied only along one dimension. The question started with the following sentence: "Please, indicate for the case described below how large the share of the inheritance that the person should pay as inheritance tax to the government should be." After the description we asked: "In your opinion, how large is the share of the inheritance the daughter of Mr. Müller should pay as inheritance tax to the government?" The respondent could choose a number between 0 and 100, in increments of 5, for the inheritance tax in percent. Hence, the interviewee was required to calculate the average tax rate for the gross transfer rather than the net transfer.

The two scenarios were the following:

The no-tax-planning scenario: "For many years, Mr. Müller re-invested the money in his medium-sized company, with 20

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