EconoFact Chats: Taxing the Great Wealth Transfer
John Sabelhaus, The Brookings Institution
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Michael Klein:
I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:
The phrase 'OK Boomer,' became a meme in 2019 as a response to an older man's TikTok rant condemning millennials and those in Gen Z. This dismissive response by thousands of viewers reflects, among other concerns, dissatisfaction with the world being left to them – environmentally degraded, riven by divisive politics, and with fewer economic opportunities. A few striking relevant economic facts along these lines. First, the national federal government debt, which must be paid by future generations, is about 100% of GDP, its highest level since just after the end of World War II. Second, the wealth of households that can be bequeathed to their heirs relative to GDP rose by over 70% between 1997 and 2021, and virtually all of this went to older families. Third, three quarters of this increase went to the wealthiest 10% of households. Finally, there is increasing income inequality, so wealth could become even more skewed with the bequests of these fortunate wealthy older households. But what if this great wealth transfer was taxed in a way that reduced both the government's debt, and income inequality? John Sabelhaus addresses this issue with his co-author Bill Gale in a series of articles and also in a new EconoFact explainer on our website, *'How Should the U.S. Tax the Great Wealth Transfer?'* John is a senior fellow in the Economic Studies program at the Brookings Institution, and also at the Urban-Brookings Tax Policy Center. Prior to these positions, he served on the Federal Reserve Board and the Congressional Budget Office. John, welcome to EconoFact Chats.

John Sabelhaus:
Thanks, Michael. I'm glad to be here.

Michael Klein:
To begin, John, how much has wealth increased in the United States over the past few decades?

John Sabelhaus:
So our preferred measure of wealth for bequest purposes has risen from about 270% of GDP in 1997 to about 465% of GDP by 2021, the last year for which we have our data.

Michael Klein:
And as you point out in your EconoFact Explainer, the vast majority of this increase went to older folks, right?

John Sabelhaus:
Yes. We estimate that 96% of the increases in wealth relative to GDP went to households where the respondent was 55 or older.

Michael Klein:
Okay, boomer indeed. And these are also the richest group of older households, right?

John Sabelhaus:
Yes. So again, using this Survey of Consumer Finances data set that we base our research on, 74% of the gains in wealth went to the top 10% within the group that's 55 or older. And we can actually further break this down into within the top 10%, about half of that gain went to just the top 1%. And we know from other research that a disproportionate share of the wealth gains have accrued even within the top 1% to the top 0.1%. As a good example, in 2006, you needed only $1 billion to make it into the Forbes 400. Now that's almost $4 billion.

Michael Klein:
Well, I guess that increase has cut me out of the Forbes 400. I don't know about you, but can't make it these days. So, John, what was the source of this big increase in wealth and why was it skewed towards older, richer people?

John Sabelhaus:
So when we think about the components of wealth, housing is a big component for most people, but stock market wealth, and business wealth really dominates the top of the wealth distribution. So, the changes in the price of housing and the value of stocks, along with income tax policy, have really reinforced these gains in wealth among older and especially wealthier households. Income tax policy, in particular, has consistently favored high-income business owners and families with investment incomes this century. The tax treatment of pass-through businesses is an important policy issue in its own right. And the downstream effect of lower income taxes on the income flows of the wealthiest families is that it leads to increased wealth concentration.

Michael Klein:
As I mentioned in the beginning, this has occurred at a time of rising government debt and widening inequality. So it seems like taxing the transfer of wealth from the older generation to the younger generation could help address some of these issues. Could they?

John Sabelhaus:
Indeed. So the direct impact on wealth inequality depends on the relative wealth of the people who are making transfers, and those receiving those wealth transfers. If wealthy decedents give money to less wealthy heirs, it's spread across more heirs, there is a direct impact on wealth inequality in principle. But our work and other research from many countries shows that a much better way to describe what happens in practice is that most of these dollars that are bequeathed flow from the super wealthy to the already very wealthy. So it's really not moving far down the wealth distribution. There's little direct impact of the

actual wealth transfers. And also, it's important to keep in mind that most substantial wealth transfers occur when the recipients are themselves close to or even in retirement. This does not mean that increasing wealth concentration and untaxed transfers don't matter. It just means that there are advantages to being born into very wealthy families that go beyond receiving a huge transfer of cash or assets when you're, say, 60 years old.

Michael Klein:
What are the existing ways in which governments tax the transfer of wealth and what's the current approach in the United States?

John Sabelhaus:
So in the US, the main mechanism we have for taxing wealth transfers, is an integrated estate and gift tax system. There are other ways to do it. You could, for example, tax inheritances. And in fact, that's a preferred option among many OECD countries.

Michael Klein:
The difference there is when you're taxing inheritances, you're taxing the people who get the money, and when you're taxing estates or gifts, you're taxing the people who are giving the money. Is that correct?

John Sabelhaus:
Exactly. And there in principle lies, what could potentially be a difference, which is, it’s one large block sum to the estate, but then it's dissipated across one or more heirs when the transfer occurs. But in general, it's the same tax base. But it's also important to think about…when we think about this tax base is what we don't tax when someone dies. So any unrealized capital gains, which are often generated as a result of some income tax avoidance strategy that the decedent pursued while they were living, those gains are stepped up at death, which means the heirs will never pay the income tax that the decedent would have paid if those capital gains were realized and paid before death.

Michael Klein:
So that doesn't really depend upon if it's the tax on the estate or the tax on inheritance. It depends upon the way that these capital gains are taxed, right?

John Sabelhaus:
Exactly. And that's one of the key principles that in our work where we're studying what would happen if we moved across different systems for taxing wealth transfers, how might that change? And one of the key things in principle, the tax bases are the same, but there are other aspects that could really depend on the design elements of the tax. For example, if we move to an inheritance tax, we would actually have to have an exclusion for unrealized capital gains in order to give it the same tax treatment as we have under the estate tax because those unrealized capital gains receive step-up in basis in the current system.

Michael Klein:
So right now, inheritance taxes, you do have the capital gains that you have to pay, but the estate tax you don't, right?

John Sabelhaus:
Correct. Once the money has flowed through the estate tax system, then any unrealized gains that are part of that transferred wealth receive this step-up in basis.

Michael Klein:
So I've never uttered these words before in a podcast, but I'd like to ask you about the 'angel of death.'

John Sabelhaus:
Right, so this 'basis step-up,' this is often referred to in colloquial ways as the angel of death, as you say. And so basically, a capital gain is the increase in the value of an asset over time. So as such, it represents income to the asset's owner and really should be part of the income tax base. But historically, because of this step-up in basis rule, that type of income is untaxed, so long as the estate is untaxed. And the changes we've had in the estate tax system means more of that untaxed income is then being passed forward to death.

Michael Klein:
John, I noticed in one of your papers you gave a simple numerical example that really crystallized this idea for me. Could you repeat that for us, please?

John Sabelhaus:
Right. So the way to think about it is imagine you have an asset, say it's a stock in a company, and the decedent had paid $100 for this stock. But by the time they die it's risen in value to say $300. Under what's called a carryover basis system, the heir, the person who receives that asset, when they sell the asset they would have to pay the capital gains tax the same way that the decedent would have paid it. But under step-up in basis or the so-called angel of death, the difference in value, that increase of $200, is effectively forgiven. Zero part of that capital gain is then subject to taxation in the current system. So in fact, shifting the implied capital gains tax forward to the heir, was something that was enacted in 1976, but then it was repealed in 1980 before it ever went into effect. which gives you some sense of how important this exemption for that type of wealth transfer is among the very wealthy. They really never wanted to see that enacted.

Michael Klein:
So how much money has the angel of death taken out of the government's coffers?

John Sabelhaus:
The step-up in basis turns out to be quite a big deal from a budgetary perspective. So the Congressional Budget Office in 2024 estimated that switching from the current 'angel of death' exclusion to a carryover basis starting in 2025 would have raised over almost $200 billion in revenue over the next 10 years. And

going back again to where we started in terms of wealth concentration, about 27% of all wealth, and 41% of the wealth held by the top 1% of wealth owners takes the form of unrealized capital gains. It's a huge component of wealth. Increases in stock prices, house prices, value of businesses has really driven up the value of these assets and never been subject to tax. So it not only loses billions of dollars in revenues, but it's an enormous tax cut for the very wealthiest families, distorts their behavior, and makes the lock-in effect even worse.

Michael Klein:
Is there a solution to this?

John Sabelhaus:
So the simplest solution to this problem would be to just end the basis step-up in death, and switch over to this carryover basis regime. And so the basis of an asset, the taxable basis, would not change when bequests are made. When the asset is later sold by an heir, the taxable basis would be the same as when the decedent owned it, set at the time of the decedent's purchase. But again, this brings us back to how we think about a wealth transfer tax in a more general sense. In a world with an effective estate tax, the unrealized gains are at least being subject to some level of taxation because they're part of the estate. But the erosion of the estate tax because of dramatic increases in the exemption levels and increasing use of tax-avoiding trusts, along with increasing income tax avoidance, has really meant that we've moved from a system where we were avoiding potentially double-taxing that income by having an estate tax, to where that income, because it's in your unrealized capital gains and not subject to estate taxes, effectively never taxed income. So if, you know, again, take us back to where we started, if accumulating income is much more lightly taxed, wealth concentration rises and if that transfer of wealth is not taxed, we're creating very high wealth dynasties, and persistent correlations of wealth among the wealthiest families over time.

Michael Klein:
John, I've also heard that there's a tax strategy called ‘buy, save, die.’ What does that refer to?

John Sabelhaus:
Yeah, that’s a great example of this, and it connects directly to the unrealized gains phenomenon. There's actually two variants, buy borrow and die, and buy save and die. But effectively what it means is that you have a strategy which avoids an income tax. You buy an asset, you never sell that asset, so the unrealized gains become part of the value, but then you either borrow against that asset to spend, or you borrow against that asset to reinvest and that's where the saving part comes in. So most of us have to pay tax on our income as we go through life. But if you're using this strategy, you're effectively deferring all of these income taxes to the end of life. And those deferred income taxes are part of the value of that asset. It's reflected in unrealized capital gains. So you're able to get a much higher rate of return on that strategy because you're not paying taxes along the way.

Michael Klein:
So these are all strategies not for the average person, but for people who are very wealthy, or very, very wealthy, right?

John Sabelhaus:
Yeah, you'd be surprised how far down the wealth distribution these strategies can be used. The change in income tax laws in particular, and the emergence of pass-through business forms, which dominates a huge swath of income tax research, shows that even what we might think of it as modest size, large, but modest size businesses, $10 million, $20 million…that you can use interconnected partnerships and other types of legal structures to move cost basis back and forth across entities and avoid income tax most of your life. But, again, what that leads to is if I'm accelerating depreciation on an asset and then shifting those costs to a profitable enterprise, I'm just generating more unrealized capital gains, which would then be realized to death. And you don't have to be on the Forbes 400 list in order to employ those kinds of strategies.

Michael Klein:
Right, but you also can't be working the second shift at a factory to be able to use those as well, right?

John Sabelhaus:
No, one of my favorite interviews I ever did ended up with a quote saying, if you're getting a W-2, you're a sucker. And it's because most of us who get W-2s, that's what goes on our tax form. And for people who can buy and sell properties and investments, they're able to, in effect, determine what ends up on that income tax form. So they're able to avoid a lot of income tax by simply never realizing that income. Whereas those of us with W-2s, that's not feasible.

Michael Klein:
So I've mentioned the angel of death, and now I'll invoke devil's advocate. To play devil's advocate, I could ask you the question, why shouldn't those who have wealth be able to pass it down to their heirs as their legacy?

John Sabelhaus:
So I couldn't agree more that in a world of equivalent taxation of all types of income, at some point over the life of an individual, that would seem to be a fair principle. You probably don't want to double tax income that has been earned and saved and generated more income. But everything should be taxed once. And in fact, if we go back to when the income tax and the estate tax emerged, they're just over a century old in the United States. This was during the so-called Gilded Age. So the income tax came first. It really reflected a desire to pay for government in a fairer way. All we had before that was tariffs. And it took a constitutional amendment to implement an income tax to address these rising perceived inequities. The estate tax was added shortly after as a further backstop against persistent intergenerational wealth concentration. But what we've seen over the past, especially the past quarter century, is an unwinding of how these two systems work together. And it used to be the case 25 years ago, we could probably say most income was taxed at least once. And now, sometimes based on arguments that were concerned about double taxation, you tax the income while it was being earned, and the wealth while it was being transferred…we've actually moved so far in the other direction that a huge swath of wealth is changing hands without ever having been taxed. And that's what Bill and I call, “never taxed income”.

Michael Klein:
And in fact, you mentioned the Gilded Age. People are referring to the present day as kind of the Neo-gilded Age, right?

John Sabelhaus:
I think that's right. And the question is how much has policy contributed to this new Gilded Age? Is there something about the fact that we're taxing less and less income and wealth transfers that is really reinforcing what's happening in what some people would perceive as trends that are associated with technology and innovation? So yes, we have technology companies that are rising in value very rapidly. And we can think about why that's happening. But why are the owners of those technology companies, why is their wealth rising so rapidly, becoming more and more concentrated? And part of it is because we're not taxing that wealth. We're not taxing the income as it accumulates. And so I personally believe that we are fueling a new Gilded Age. And it's something that we think policy should address. And getting back to where you started, part of the deterioration in our long run fiscal situation, the increasing deficit, is because we're not taxing these types of incomes. There's an interesting story from the 1990s, which I like to tell. When the dot com bubble surged and many, many millionaires and billionaires were being created during this period because of the rising value of stocks. I was working at the time at the Congressional Budget Office and watching income tax revenues. And although GDP was not growing very rapidly, tax revenues were. And it's because the system that we had in place in the 1990s was effectively taxing these gains as they were being realized. So the rich were getting richer, wealth was becoming more concentrated, but there was a positive spillover on the federal budget. Now that connection has been severed. And so the rich are getting richer and the rest of us are…we're not seeing any sort of compensation in terms of higher taxes.

Michael Klein:
Okay, Boomer. I guess that the Millennials and Gen Z have a valid point with these things because they're the ones who are going to have to be paying off some of these things in the future when the bills become due. So John, thank you very much for explaining these complicated issues today in a very clear way, and also demonstrating how important they are. I really appreciate the work that you've done for EconoFact with your explainer, and for you joining me today on this podcast.

John Sabelhaus:
Thank you, Michael. I really enjoyed it.

Michael Klein:
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