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Can Government Inaction Result In Rising Gift Tax Revenue?

Hugh H. Lambert
St. John Fisher University, hlambert@sjf.edu

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Can Government Inaction Result In Rising Gift Tax Revenue?

Abstract

James Alm noted in 1988 that tax uncertainty is particularly problematic for taxpayers, and he identified two risk areas that can cause changes in taxpayer behavior: variations to the tax base (tax base risk) and modifications to the tax rates (tax rate risk).1 This report studies how estate and gift tax laws passed with sunset provisions created taxpayer uncertainty in 2010 and 2012, and how that uncertainty led to increased gifting activity by wealthy taxpayers, which in turn increased the amount of gift tax revenue collected by the federal government in 2011 and 2013. The sunsetting of a tax law means that its provisions (usually favorable to taxpayers) will remain in effect for a fixed period before expiring (that is, "sunsetting") and returning the tax base and rates to the levels (usually less favorable to taxpayers) that existed before the passage of the law. In the case of tax cuts, a sunset provision effectively reverses the favorable tax conditions that were created when the law was first passed.

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by Hugh H. Lambert

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Can Government Inaction Result in Rising Gift Tax Revenue?

by Hugh H. Lambert

Hugh H. Lambert

Hugh H. Lambert is an assistant professor of accounting and a Family Business Program faculty fellow at St. John Fisher University in Rochester, New York.

In this report, Lambert studies data showing increased wealth transfers — and ultimately, increased federal gift tax revenue — as a result of Congress's failure to extend expiring estate and gift tax provisions until late in the sunset years.

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Introduction

James Alm noted in 1988 that tax uncertainty is particularly problematic for taxpayers, and he identified two risk areas that can cause changes in taxpayer behavior: variations to the tax base (tax base risk) and modifications to the tax rates (tax rate risk).[1] This report studies how estate and gift tax laws passed with sunset provisions created taxpayer uncertainty in 2010 and 2012, and how that uncertainty led to increased gifting activity by wealthy taxpayers, which in turn increased the amount of gift tax revenue collected by the federal government in 2011 and 2013. The sunsetting of a tax law means that its provisions (usually favorable to taxpayers) will remain in effect for a fixed period before expiring (that is, "sunsetting") and returning the tax base and rates to the levels (usually less favorable to taxpayers) that existed before the passage of the law. In the case of tax cuts, a sunset provision effectively reverses the favorable tax conditions that were created when the law was first passed.

This report demonstrates that it was not an act of Congress that drove taxpayer uncertainty and gifting activity, but congressional *inaction*. In 2010 and 2012, Congress eventually acted to pass legislation resolving tax base and tax rate uncertainty, but it let most of the year pass without guidance on what the provisions of the estate and gift tax laws would be after December 31 of those years. While legislators were deciding what to do, taxpayers made wealth transfers in the face of uncertainty, which resulted in an increase in gift tax revenue. More specifically, the congressional delay in passing new legislation drove the taxpayer response, such that gifts made during 2010 and 2012 generated higher gift tax revenue for transfers made in those years.

If Congress were to allow the gift tax laws to sunset at the end of 2010 and 2012, the tax base would have broadened, meaning that smaller transfers would have been subject to gift tax. Also, the dollar amount of tax-free lifetime gifts would have been much lower than it had been, subjecting taxpayers to tax base risk. Further, gift tax rates were scheduled to increase when the laws expired at the end of 2010 and 2012, thus making any future gifting more expensive and exposing taxpayers to tax rate risk. Congress eventually passed legislation to address the sunsetting provisions, but it did so in a way such that

[1] Alm, "Uncertain Tax Policies, Individual Behavior, and Welfare," 78 *Am. Econ. Rev.* 237 (1988).

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taxpayers went almost the whole year with no guidance and much uncertainty about the future tax base and tax rate.

These findings are particularly relevant because estate and gift tax laws will sunset again at the end of 2025. What will Congress do? Will new legislation be passed well before the sunset date, thereby reducing taxpayers' uncertainty? Or will Congress wait until late in the year, like it did in 2010 and 2012? If the latter occurs, 2025 gifting activity of wealthy taxpayers will likely increase, resulting in higher gift tax revenue collected in 2026.

This report uses IRS data to show the increase in 2010 and 2012 gift tax activity, as measured by the number of gift tax returns filed, the dollar value of gifted assets and taxable gifts, as well as the resultant increase in gift tax revenue collected in 2011 and 2013. It also examines the timeline for congressional action to address the sunsetting of estate and gift tax laws, which demonstrates that uncertainty related to tax base risk and tax rate risk drives taxpayer behavior. Specifically, the fear of increased future costs of making lifetime wealth transfers increases gifting activity and results in government gift tax revenue. Although earlier studies have demonstrated that higher tax costs drive taxpayer behavior,[2] this study is the first to examine that behavior in the context of gift taxes and the sunsetting of tax laws in 2010 and 2012. It also explores the gift tax revenue implications for 2025, when the gift tax laws are scheduled to sunset again.

The Estate and Gift Tax Today

By 2045, wealth transfers are expected to be $84.4 trillion,[3] and a portion of those transfers will be taxed through the federal estate and gift tax system. The estate tax and gift tax regimes are unified, meaning that they have the same tax base and tax rates.

For individuals dying in 2024, the basic federal estate tax lifetime exclusion, also called the unified credit, is $13.61 million (up from $12.92 million for 2023). Individuals may use the unified credit for gifts made during life, but if they use the entire amount, the first dollar of wealth in their estate will be taxable. For 2024, married couples have a lifetime exclusion that allows them to transfer up to $27.22 million as a couple (up from $25.84 million for 2023) without paying federal estate or gift taxes. In 2024 individuals can make gifts of up to $18,000 (up from $17,000 for 2023) to an unlimited number of recipients without having to pay gift taxes.

If an individual makes taxable gifts, gift tax returns are due in the year following the year in which the gifts were made. For example, if an individual made a taxable gift in 2023, the gift tax return and payment is due April 15, 2024, with a six-month extension to October 15 available for completion of the final gift return (although the tax payment still must be paid by April 15). When an individual dies with a taxable estate, the estate tax payment is due nine months after the date of death, with a possible six-month extension to file the estate tax return (but with payment for the estate tax liability still due nine months after the date of death).

Over the years, the provisions of the estate and gift tax systems have changed, including changes to the tax rates imposed on wealth transfers and the thresholds that result in taxable gifts (that is, the tax base) both during a taxpayer's lifetime and upon death. When laws regarding the estate and gift tax system change, wealthy individuals often respond with their own behavior changes. The next section examines historical estate and gift tax changes over the last few decades.

History of the Estate and Gift Taxes

The creation of the estate tax dates back to 1916, when Congress called for a tax on amounts bequeathed to beneficiaries upon a taxpayer's death. The gift tax was created in 1932 to tax the value of gifts given away during a taxpayer's lifetime. Before 1932, making lifetime gifts was a tax avoidance strategy used by taxpayers to reduce their estate tax. For years, the estate and gift tax systems had their own tax rates and exemption levels. The Tax Reform Act of 1976 united the estate and gift tax systems by creating

[2] Robert Carroll, "Do Taxpayers Really Respond to Changes in Tax Rates? Evidence From the 1993 Tax Act," Treasury Office of Tax Analysis working paper no. 79 (Nov. 1998); Martin Feldstein, "Behavior Responses to Tax Rates: Evidence From TRA 86," National Bureau of Economic Research working paper no. 5000 (Jan. 1995).

[3] Cerulli Associates, "U.S. High Net Worth and Ultra High Net Worth Markets 2021: Evolving Wealth Demographics" (Jan. 2022).

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a unified credit.[4] Before unification, there had been two separate credits, one for the gift tax and another for the estate tax, which made the administration of these two taxes cumbersome. TRA 1976 also unified tax rates for estate and gift tax transfers.

TRA 1986 further modified estate and gift taxes such that estates with assets valued up to $600,000 would be tax free. The tax rate for estates exceeding $600,000 started at 37 percent and went as high as a flat rate of 55 percent for estates exceeding $21.04 million.[5] The $600,000 limit gradually increased until 2001, when Congress made significant changes to the estate and gift tax regime under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which President George W. Bush signed into law. EGTRRA increased the estate and gift exemption amounts (shrinking the tax base, such that fewer estates and gifts would be subject to taxation) and lowered estate and gift tax rates through 2010, as detailed in the table.

Estate Tax Exemptions: 1997-2010

Year	Estate and Gift Tax Exemption	Top Estate Tax Rate
1997	$600,000	55%
1998	$625,000	55%
1999	$650,000	55%
2000	$675,000	55%
2001	$675,000	55%
2002	$1,000,000	50%
2003	$1,000,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%

Estate Tax Exemptions: 1997-2010 *(Continued)*

Year	Estate and Gift Tax Exemption	Top Estate Tax Rate
2009	$3,500,000	45%
2010	$5,000,000 or $0	35% or 0%

EGTRRA's provisions resulted in no federal estate tax for taxpayers dying in 2010, but only for that single year. Key provisions of EGTRRA were scheduled to expire at the end of 2010. The estate and gift tax rates and thresholds would revert to their pre-EGTRRA levels unless Congress passed new legislation and the president signed the bill before the expiration date. Otherwise, the cost of wealth transfers would increase significantly on January 1, 2011. When EGTRRA was passed in 2001, no one had any idea which political party would control the executive and legislative branches of government in 2010.

According to William G. Gale and Peter R. Orszag, before 2001, sunset provisions in tax legislation traditionally involved only minor provisions.[6] They also explain that sunsets can be used to manipulate government budget limits and that, when used on major provisions (as was the case with EGTRRA), sunset provisions create taxpayer and adviser uncertainty about the future tax base and tax rates. Gale and Orszag's report, written when they were both with the Brookings Institution, makes the case for reinstating "pay as you go" rules requiring that "mandatory spending increases or tax cuts be financed by other changes in taxes or spending."[7]

As discussed later, President Obama created a temporary solution to the expiration of EGTRRA in 2010, which led to another sunset provision, albeit a shorter, two-year one. And in 2017 President Trump signed the Tax Cuts and Jobs Act, containing provisions that sunset at the end of 2025. Thus, it appears that lawmakers will continue to draft legislation with sunset provisions, perhaps because they help politicians support their tax cuts. This sunset approach to legislation also kicks the can down the road for a

[4] *See* Howard Zaritsky, "Tax Revisions of the Tax Reform Act of 1976," 34 *Wash. & Lee L. Rev.* 353 (1977).

[5] David Joulfaian, "The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences," Treasury Office of Tax Analysis paper no. 80 (Dec. 1998); Joulfaian, "The Federal Gift Tax: History, Law and Economics," Treasury Office of Tax Analysis paper no. 100 (Nov. 2007); Joulfaian, *The Federal Estate Tax* (2019).

[6] Gale and Orszag, "Sunsets in the Tax Code," *Tax Notes*, June 9, 2003, p. 1553.

[7] *Id.*

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future Congress and president to deal with. Most sunsetting occurs 10 years from the date the legislation becomes effective, so the president who signs that legislation probably won't be in office when it expires. As such, the problem of whether to extend the legislation or pass new laws will most likely fall on new legislators and a new president. However, if Donald Trump is elected president in 2024, he presumably would be in office to deal with the sunset of the TCJA.

Sunset Advising Quandary

Although the estate and gift tax system is unified, taxpayer wealth transfer planning opportunities arise primarily in the context of lifetime transfers. After a taxpayer has died, it is too late to plan to reduce taxes, although some attorneys use postmortem planning techniques. Estate planners and their clients typically execute their wealth transfers through lifetime gifts, known as *inter vivos* gifting. After the passage of EGTRRA in 2001, estate and gift tax exemptions and tax rates were known with certainty — at least for a 10-year period — allowing planners to craft systemic strategies for efficient passage of wealth to the next generation. However, as 2010 approached, uncertainty grew about what would happen on January 1, 2011, after the EGTRRA sunset, when estate and gift tax limits would return to their pre-EGTRRA levels.

Through 2010, wealth advisers, attorneys, appraisers, and accountants waited for Congress to reexamine the EGTTRA provisions and pass new legislation for the post-2010 period. However, lawmakers were focused on problems following the financial crisis of 2008 to 2009 and the ensuing Great Recession, as well as other matters that were deemed more pressing than the sunsetting of EGTRRA and the reversion of the estate and gift tax provisions.

Congress's inattention to estate and gift taxes created a quandary for wealth transfer advisers: How were they to counsel their clients for the period after December 31, 2010? If Congress did not extend EGTRRA, clients making gifts in 2011 would be faced with a larger tax liability, whereas gifts made in 2010 could be made with certainty, at more favorable tax rates, and with a lower tax base. At a minimum, gifting in 2010 had cost certainty and would have lower wealth transfer tax rates than those expected for 2011 (assuming that EGTRRA tax rates and wealth thresholds expired December 31, 2010). The uncertainty about 2011 and beyond led to increased gifting activity in 2010.

The uncertainty about gift and estate tax rates beyond 2010 resulted from congressional *inaction*. That is, without an action by Congress and a bill signed into law by then-President Obama, the estate and gift tax rates would increase and wealth thresholds would decrease, meaning: (1) More individuals would be subject to the estate and gift tax, and (2) it would cost those individuals more to transfer wealth than it had in the past 10 years because of an increase in the wealth transfer tax rates. Raising tax revenue through inaction is much more politically palatable than acting to raise taxes. In the latter scenario, there will be scapegoats — the legislators who voted for increasing taxes and the president who signed the legislation into effect. By contrast, the passive act of doing nothing and having taxpayers make their own wealth transfer decisions out of fear of a higher future wealth transfer rate (after the legislation sunsets) creates an environment in which no politician need take the blame for the higher tax rates or broadened tax base.

Uncertainty for 2011 and beyond was resolved late in 2010. On December 17 Obama signed into effect the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 tax relief act), which extended the Bush-era EGTRRA tax cuts, but only for two years. On December 31, 2012, the 2010 act itself would sunset unless the legislative and executive branches of government could agree on new legislation.

The resolution of uncertainty regarding the sunsetting of EGTRRA helped planners, but only for a two-year period. In 2012 several factors pushed the United States toward a fiscal cliff. The fiscal cliff was an expected government budgetary contraction as the result of the expiration of tax cuts and tax credits, automatic spending cuts (sequestration), and other spending changes.[8] Economists predicted that the combination of tax

[8] Fernando M. Martin, "A View From the Fiscal Cliff," *Regional Economist*, Apr. 1, 2013.

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increases and spending cuts could throw the U.S. economy back into recession and drive unemployment back to 9 percent.[9]

During 2012, Congress and Obama made proposals and counterproposals as they negotiated the budget process, but these issues (one of which was the expiration of the two-year patch for the EGTRRA sunset) remained unresolved throughout 2012. As such, gift and estate tax provisions were again uncertain, but this time, the uncertainty lasted through the end of 2012. When the 2010 tax relief act expired, the $5.12 million estate and gift tax exemption reverted to $1 million — a huge change to the estate and gift tax base. Much smaller wealth transfers became taxable, and the maximum wealth transfer tax rate rose substantially, from 35 percent to 55 percent. There were additional negative repercussions from the expiration of the 2010 act, but they were all short lived. In fact, the duration of these significant changes could be measured in hours and minutes, versus days or years.

The resolution uncertainty regarding the fiscal cliff and the federal estate and gift tax system occurred at 2 a.m. on January 1, 2013 — just a couple of hours after the expiration of the 2010 tax relief act. That is when Obama signed the American Taxpayer Relief Act of 2012 (ATRA).[10] Indicating the importance of resolving the fiscal cliff and other issues, the Dow Jones Industrial Average closed up by 2.4 percent the first day of stock trading after the passage of ATRA.

The Urban-Brookings Tax Policy Center wrote the following:

> ATRA permanently extends and modifies the estate tax provisions in EGTRRA and subsequently modified by the 2010 Tax Relief Act. It retains a unified exemption for estate and gift tax purposes of $5 million, indexed for inflation after 2011 ($5.25 million for 2013) but raises the estate and gift tax rate from 35 percent to 40 percent. It makes permanent the portability of the exemption between spouses, allowing a decedent to elect to permit the surviving spouse to claim any unused exemption amount.
>
> Under pre-ATRA law, in 2013 the estate tax would have reverted to a $1 million exemption with a 55 percent top statutory rate, with an additional 5 percent surtax on the value of certain estates. In addition, the credit for state-level wealth transfer taxes would have been restored. ATRA instead makes permanent the deduction for state-level taxes enacted by EGTRRA.[11]

A couple of things are noteworthy regarding legislative changes at the end of 2010 and 2012. First, both EGTRRA and the 2010 tax relief act were passed with sunset provisions, which created a time bomb: the reversion of the laws' provisions to their pre-passage levels. This reversion characteristic threatened a return to a higher tax environment, in terms of both tax rates and taxability thresholds, unless the legislative and executive branches reached an agreement on a new law.

Second, the resolution of the uncertainty in 2010 and 2012 was delayed until very late in those years. In fact, the 2010 tax relief act was allowed to expire for two hours. Without resolution of that uncertainty, taxpayers making gifts were faced with a choice of gifting now, before tax rates and the tax base revert to their less favorable levels, or waiting and taking a risk that the reversion will happen, creating an unfavorable tax scenario. Waiting until the eleventh hour (or beyond) to enact a new law creates an increase in gifting activity whereby wealthy taxpayers rush to transfer wealth ahead of the increasing rates and lower tax thresholds. This is rational economic behavior: Transact before the cost of transacting increases (in this case, before the cost of gifting increases through unfavorable changes to the tax base and tax rates). The wealthy have an incentive to transfer their wealth before the cost of doing so increases.

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[9] Matt Smith, "Obama Signs Bill Warding Off Fiscal Cliff," CNN, Jan. 3, 2013.

[10] This last-minute resolution required Obama to sign ATRA by electronic pen from Hawaii, where he was vacationing. John Treu, "What the American Taxpayer Relief Act of 2012 and Portability Mean to Utah Estate Planners," 27 *Utah Bar J.* 20 (2014).

[11] James Nunns and Jeffrey Rohaly, "Tax Provisions in the American Taxpayer Relief Act of 2012 (ATRA)," Urban-Brookings Tax Policy Center (Jan. 9, 2013).

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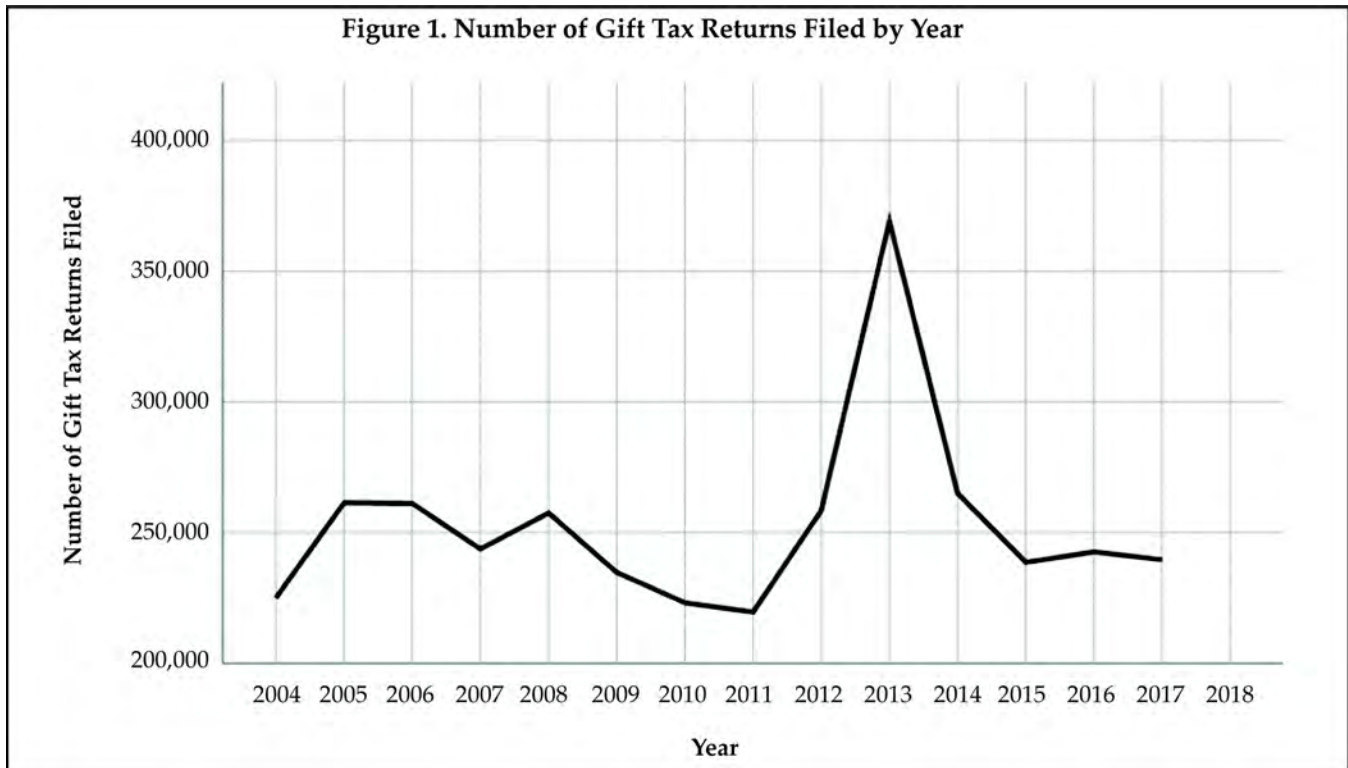

The data presented below demonstrate that there was an increase in gifting activity in 2010 and 2012, which led to increased gift tax revenue in 2011 and 2013. Again, gift taxes are paid by taxpayers and collected by the government in the year after the year in which the gift was made, so the increase in 2010 and 2012 gifts is evidenced by increasing gift tax revenue in 2011 and 2013.

Data on Gifting and Tax Revenue

Three measures can be used to study gifting behavior: (1) the number of gift tax returns filed in a year; (2) the dollar amount of gifts; and (3) gift tax receipts collected by the IRS. Each of these measures is useful in its own regard. The number of gift tax returns provides a good general assessment of gifting activities. It does not account for the size of each gift or even the average gift size; it is merely a volume measure of the number of gift tax returns filed. The size of gifts provides a new metric: the dollar value of gifts. This measure helps us to convert gifting activity by volume to a dollar amount. However, not all gifts made will be taxable because of the unified credit/lifetime exclusion. Therefore, a third measure must be examined: the gift tax revenue collected by the IRS.

The data presented in Figure 1 for 2011 gift tax returns (related to 2010 gifts) show an unexpected result: a *decrease* in the number of gift tax returns filed. However, Figure 2 shows that the dollar amount of gifts increased. And Figure 3 indicates that gift tax revenue collected increased significantly, as measured by the increase in 2011 (which would relate to gifts made during 2010), the year EGTRRA was scheduled to sunset.

Data from the IRS in Figure 1 show that the number of gift tax returns filed in 2011 (related to gifts made in 2010) did *not* increase. However, the number of gift tax returns filed in 2013 (for 2012 activity) was 369,000 compared with 258,000 in the previous year. Although the number of gift tax returns filed in 2011 was not materially different from the number filed in 2010, gifting activity in 2013 was materially higher than in the prior year.

In addition to examining the volume of gift tax returns filed, the dollar amount of gifts made for the same years can also be examined. For the gifts made in 2010, the number of gift tax returns (filed in 2011) did not increase, but the dollar value of gifts increased by approximately 30 percent — from $38 billion to $51 billion. The dollar value of gifts made in 2012 and reported on 2013 gift tax

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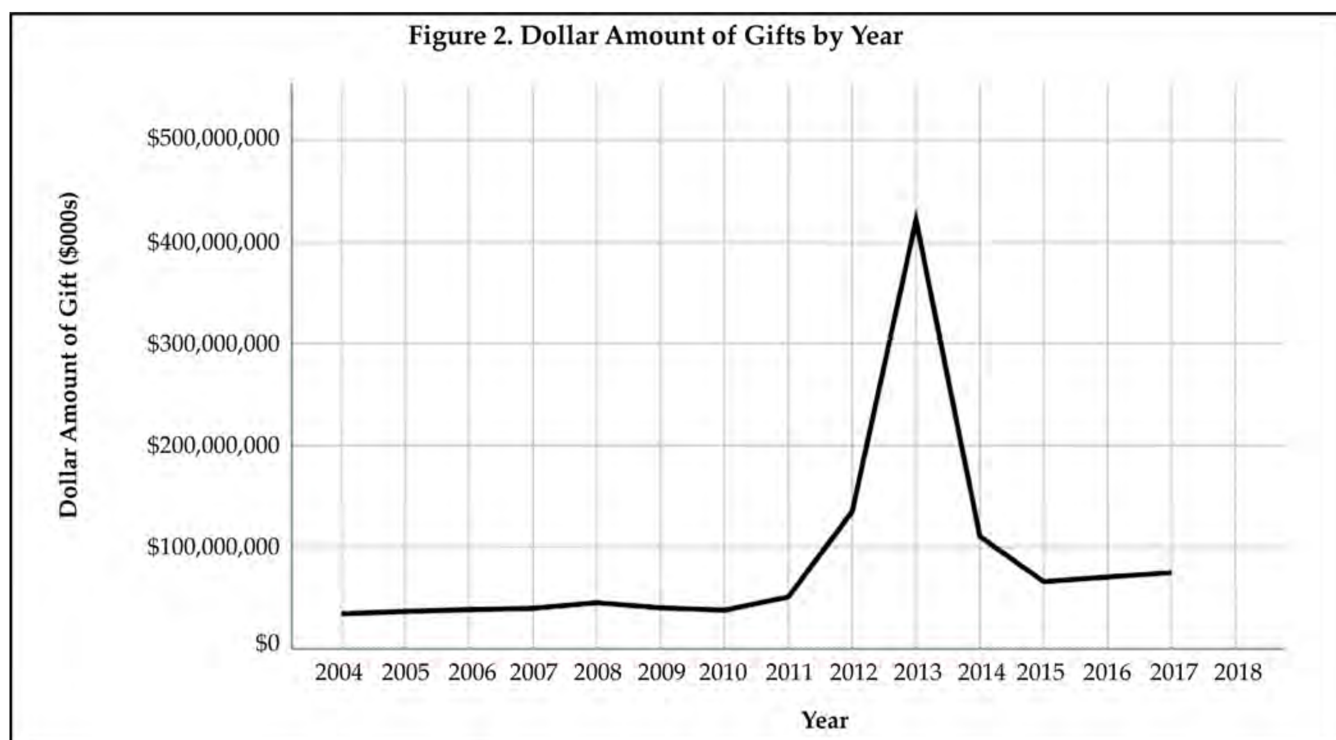

returns is even more significant, rising over 200 percent, from $135 billion to $421 billion.

Finally, and perhaps most importantly, is the gift tax revenue collected by the IRS. Figure 3 shows that in 2010 the gift tax revenue collected was approximately $2.5 billion, but because of the potential sunsetting of EGTRRA and Congress's lack of action to extend the EGTRRA tax cuts, Treasury collected $6.2 billion in gift taxes in 2011 (for gifts made in 2010). It collected $1.8 billion in 2012 (for gifts in 2011), which rose significantly to $4.7 billion in 2013 (for 2012 gifts).

Conclusion and Implications

The federal government was able to raise revenue significantly, without raising gift tax rates, by (1) creating laws that had sunsetting provisions; (2) waiting until the end of the year (as close as possible to the laws' expiration dates) to pass new laws, creating periods of uncertainty and an expectation of higher future costs related to wealth transfer; and (3) allowing the behavior of wealthy individuals — the fear of those higher costs — to drive their gifting behavior. This demonstrates that the wealthy are rational economic actors; when the expected future cost of a good or service (in this case, taxes on wealth transfer) is expected to rise, people transact in certain lower-cost environments (that is, the year in which wealth transfer tax rates are known and expected to be lower than those of future years).

An interesting result of the sunsetting process is that neither political party has to broaden the tax base or increase tax rates in order for gift tax revenue to increase. Simply doing nothing and letting time pass will generate an increase in gifting activity, a higher dollar amount of wealth being transferred through gifting, and higher gift tax revenue. This is true because tax legislation, when it sunsets, returns the tax rates and base to levels that are unfavorable to the taxpayer. This increasingly used sunset strategy has political benefits in that one political party can claim to lower taxes, which is true — for the 10-year period during which the tax cut law remains in place. When the law approaches its expiration, federal coffers benefit from increased taxpayer gifting activity, as has been demonstrated with data related to 2010 and 2012 gifts. Also, if legislation sunsets as scheduled, federal coffers will increase from a broadening tax base and higher tax rates. Further, these revenue increases can be enjoyed without either political party having to expend any political capital on tax increases. Although the number of taxpayers subject to estate and gift taxation is small, these taxpayers tend to be

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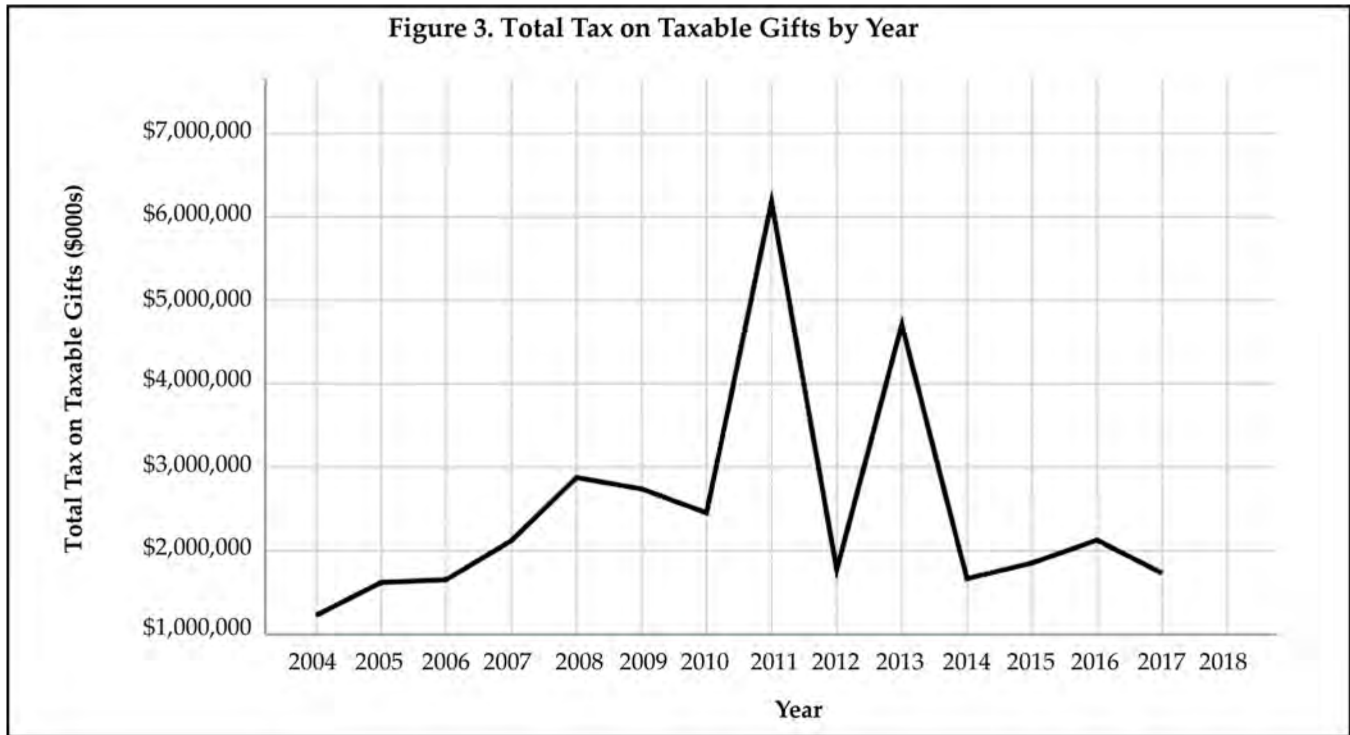

wealthy individuals who have the potential for some degree of political influence.

The TCJA and Implications for 2025

The TCJA doubled the size of estates that were subject to the estate tax, from $5.49 million in 2017 to $11.18 million in 2018. That amount will also be adjusted annually for inflation. However, like EGTRRA and the 2010 tax relief act, the TCJA has a sunset provision. If its provisions are not extended beyond December 31, 2025, the law will revert, and the threshold for a taxable estate will return to $5.49 million. Will Congress again wait until the eleventh hour to pass new legislation, resulting in another spike of gift tax revenue? Will it matter which party controls the House and Senate and the executive branch?

We will not know until after the 2024 presidential election which individual and political party will inherit the problem of sunsetting estate and gift tax laws. As in prior election cycles, estate and gift taxes are on the agenda during policy discussions and debates, and old, familiar rhetoric will likely be paraded out. It is impossible to predict what crises may consume the attention of Congress and the president. But it would be reasonable to predict that Congress will not act to address the sunsetting of the TCJA until late in 2025, thereby triggering increased taxpayer gifting activity in that year, which will increase the amount of federal gift tax revenue collected in 2026. ■

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