

# Carryover Basis Repeal and Reform of the Transfer Tax System

Russell K. Osgood

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# CARRYOVER BASIS REPEAL AND REFORM OF THE TRANSFER TAX SYSTEM

Russell K. Osgood†

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Congress, being a political institution, boasts of its accomplishments and hides its embarrassments. For anyone familiar with the United States transfer tax system, the Crude Oil Windfall Profit Tax Act of 1980<sup>1</sup> contains a significant embarrassment but, as this Article shall argue, not necessarily a permanent one in the effort to reform the taxation of wealth. The Act reverses, except for certain eligible estates which elect to have whatever benefit may accrue from its coverage, Congress's decision in 1976 to expand the rule of carryover basis to cover property transmitted at death.<sup>2</sup> Instead, the tax system—and in this regard the focus is

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<sup>1</sup> Pub. L. No. 96-223, 94 Stat. 229.

<sup>2</sup> The Tax Reform Act of 1976 expanded carryover basis to include dispositions at death. Pub. L. No. 94-455, § 2005, 90 Stat. 1872 (1976). Section 2005(a)(1) retained the old

actually the income tax system—will have two separate rules. If an individual receives a gift as a result of a lifetime transfer, he will take the gifted property at the donor's cost basis, adjusted for any gift tax paid by the donor on the net unrealized appreciation in the gift under Internal Revenue Code section 1015.<sup>3</sup> If an individual receives property in a transfer occurring at or as a result of the death of the owner, then the cost basis to the recipient "steps-up" or "steps-down" (from the donor's cost basis) to its value on the valuation date.<sup>4</sup>

## I

## THE INCOME TAX CONTEXT

In reading the preceding paragraph the reader will note an unanalyzed and perhaps troubling switch from a focus on the repeal of carryover basis at death, as it was contained in section 1023, in the transfer tax context to a focus on its actual place in the income tax. An analysis of this dual role of unrealized appreciation in a decedent's property explains in part why carryover basis was repealed. Although it will be argued later that Congress

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step-up/step-down rule of I.R.C. § 1014 in the case of a decedent dying before January 1, 1977. The Revenue Act of 1978 delayed the effective date of I.R.C. § 1023, and the non-application date of I.R.C. § 1014, to estates of decedents dying after December 31, 1979, and before January 1, 1980, respectively. Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2884. The Senate Committee Report attributed the delay to I.R.C. § 1023's complexity and the need to give Congress a chance to reconsider the matter. *See* SEN. REP. NO. 1263, 95th Cong., 2d Sess. 213-14, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 6976-77. The repeal by Pub. L. No. 96-223, § 401, 94 Stat. 229 (1980) permits certain estates to retain coverage of I.R.C. § 1023.

<sup>3</sup> Prior to the 1976 Act the donor's basis in the gift was increased to reflect the full amount of any gift tax paid. Pub. L. No. 94-455, § 2005(c), 90 Stat. 1877 (1976) added I.R.C. § 1015(d) as part of the adoption of carryover basis and was not repealed. This section increases the donor's basis only in the amount of gift tax paid on the net unrealized appreciation in the gifted property. The Report of the House Committee on Ways and Means on the 1976 change labelled the old law as "too generous in that it permits the basis of the gift property to be increased by the full amount of the gift tax paid . . ." H.R. REP. NO. 1380, 94th Cong., 2d Sess. 44 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3398. The adjustment was described as excessive and necessary only to avoid the evil of a tax (income tax) on wealth already taxed by the gift tax. This evil existed, if at all, only with respect to the appreciation. The adjustment, however, is not absolute. If the fair market value of the property at the time of gift is less than the donor's basis the Code makes no adjustment and the donee receives, for gain purposes, only the donor's unadjusted basis. For loss purposes the donee's basis is the fair market value at the time of gift. A subsequent sale at a price between these two guideposts generates neither gain nor loss. I.R.C. § 1015(a).

<sup>4</sup> I.R.C. § 1014 ties valuation to the date of death or the alternative estate tax valuation date, if elected by the executor. I.R.C. § 2032. *See also* Treas. Reg. § 1.1014-1 (1978).

appears to have decided that unrealized appreciation of property passed at death should for the time being be taxed only in the transfer tax system, an explanation of its position in the income tax is important in understanding what Congress should do in light of the repeal of section 1023.

Carryover basis and stepped-up basis are choices available in designing an income tax. The rule which establishes the need to make this choice is that gifts and bequests, unlike other so-called windfalls, are not taxable income.<sup>5</sup> Section 102, which excludes the receipt of such items from the concept of income, prevents the United States income tax system from having a "comprehensive tax base."<sup>6</sup> Section 102 appears to have wide support and no serious attempts have been made in recent years to alter it.<sup>7</sup> This is particularly noteworthy in view of the wide discussion and apparently broad support for a more comprehensive tax base among prominent lawyers<sup>8</sup> and economists.<sup>9</sup>

The exclusion of gratuitous transfers from income and recognition is a fundamental policy of the income tax necessary to place the carryover basis/stepped-up basis in context. Another such policy, embodied at various points in the Code, is that a transfer which does not constitute a recognition event shall not result in any significant adjustment to the basis of the property received. Thus, the recipient of an inter-vivos gift takes it at the donor's basis, with an adjustment for any gift tax paid on the portion of the value of the gifted property which is net unrealized appreciation.<sup>10</sup> The recipient of stock in a non-taxable corporate reorganization takes the new stock, assuming no boot is received, at the same basis he had in the old stock he surrendered.<sup>11</sup> The

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<sup>5</sup> I.R.C. § 102. The exclusion of gifts from income has been a feature of the income tax system since 1913. J. CHOMMIE, *THE LAW OF THE FEDERAL INCOME TAXATION* 40 (1973).

<sup>6</sup> For the leading article on the comprehensive tax base, see Bittker, *A Comprehensive Tax Base As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

<sup>7</sup> B. BITTKER & L. STONE, *FEDERAL INCOME ESTATE AND GIFT TAXATION* 933 (4th ed. 1972).

<sup>8</sup> Although the American Bar Foundation's study on tax reform endorsed the comprehensive Haig-Simons definition of income, it intentionally and without explanation exempted gifts and bequests from its two proposed concepts of income, labelled BTB<sub>1</sub> and BTB<sub>2</sub>. Galvin, *History of the Substantive Tax Reform Project*, STUDIES IN SUBSTANTIVE TAX REFORM 9 (A. Willis ed. 1969). Apparently Professor Surrey has not decided whether the exclusion of gratuitous transfers is a tax expenditure or merely defines the concept of income. S. SURREY, *PATHWAYS TO TAX REFORM* 28-29, 286 n.6 (1973).

<sup>9</sup> See H. SIMONS, *PERSONAL INCOME TAXATION* (1938).

<sup>10</sup> See note 3 and accompanying text *supra*.

<sup>11</sup> I.R.C. §§ 307, 358, 1016(b).

owner of a home who sells it and reinvests the proceeds in a similarly priced new home within eighteen months takes the new home at the same basis he had in the old home, even though he may have realized a large gain on the sale of the old home.<sup>12</sup>

Viewed in light of section 102 and the norm of carryover basis for non-taxable exchanges and receipts, section 1014, revived by the Crude Oil Windfall Profit Tax Act of 1980, seems anomalous. It reinstates a serious internal tension in the income tax that may affect decisions made by estate planners.<sup>13</sup> This anomaly creates an income tax bias against lifetime gifts because testamentary and other death transfers secure a forgiveness of the pent-up income tax. A taxpayer is severely penalized if he sells highly appreciated property at any point in his life when death can be expected to come before the cash to be realized by such a sale is needed.<sup>14</sup>

The tension created by sections 1014 and 1015 can be illustrated by an example involving a wealthy individual who wants to give his vacation home to his children. Assuming that the transfer tax system aggregates all gratuitous transfers at death<sup>15</sup> and forgetting for a moment the \$3,000 annual exclusion,<sup>16</sup> the owner might give the property to his children either all at once or in undivided interests.<sup>17</sup> After the 1976 Tax Reform Act endorsed carryover basis and unification of gifts with death transfers, the only cost associated with such a gift was the income lost on any gift taxes actually paid. This cost was offset by the considerable advantages of excluding any post-gift appreciation of the property

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<sup>12</sup> I.R.C. § 1034.

<sup>13</sup> See I S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 915-22 (1972) (reprinting U.S. TREASURY DEP'T, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS (Comm. Print 1969)) [hereinafter cited as S. SURREY & W. WARREN].

<sup>14</sup> See, e.g., Miller, *Certain Aspects of Estate Planning for the Business Owner*, 33 N.Y.U. TAX INST. 81, 87 (1975).

<sup>15</sup> Gifts made before January 1, 1977, are not included in the taxable estate for estate tax computation purposes. I.R.C. § 2001(b). They are, however, included in all gift tax calculations. I.R.C. § 2502(a), (c). See notes 139-141 and accompanying text *infra*.

<sup>16</sup> I.R.C. § 2503(b) excludes the first \$3,000 worth of gifts of present interests in property to each individual in each year. A "present interest" is anything other than a "future interest." Treas. Reg. § 25.2503-3 (1958). A present interest must be a mandatory, immediate property interest. See notes 96-108 and accompanying text *infra*.

<sup>17</sup> Gifts of substantial undivided interests in property can qualify as gifts even if the donor retains a significant portion of the property, also in undivided form. See C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES 749-50 (1974). A donor might wish to make a gift of undivided interests in order to qualify for multiple annual exclusions with respect to a single donee.

and excluding the gift tax actually paid from the gross estate at death.<sup>18</sup>

The revival of section 1014 upsets the income tax neutrality between lifetime and death transfers accomplished by the 1976 Tax Reform Act.<sup>19</sup> Under the new Act, if the same owner gives the property to his children during his lifetime, they may take it at a basis lower than fair market value. If the children subsequently sell the property, they must pay a capital gains tax on the unrealized appreciation (in addition to paying indirectly the gift tax by way of a diminution of the father's estate before death). On the other hand, if the father transfers the property at death, its appreciation will be exempt from income tax on a subsequent sale. This new factor will frequently discourage inter-vivos gifts of appreciated property.

In view of the foregoing and the widespread criticism of the section 1014 rule, it was not surprising that the Tax Reform Act of 1976 replaced section 1014 with section 1023, providing a carryover basis, with certain adjustments, for the estates of decedents dying after December 11, 1976. Shortly after enactment, Congress began to change its mind and in the Revenue Act of 1978,<sup>20</sup> deferred its application to the estates of decedents dying after December 31, 1979. Finally, the Crude Oil Windfall Profit Tax Act of 1980 repealed it except for certain estates which may elect its coverage.<sup>21</sup>

## 11

### THE TRANSFER TAX CONTEXT

The demise of section 1023 does not change the fact that viewed from the income tax perspective, section 1014 does not fit well. The income tax is not the only relevant perspective; appreciated property is also subject to transfer taxation.<sup>22</sup> It is true

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<sup>18</sup> These advantages are secured only if the donor survives for three years after the date of the gift. I.R.C. § 2035. See notes 142-147 and accompanying text *infra*.

<sup>19</sup> The 1976 Act was not totally neutral. It "grandfathered" most appreciation earned as of December 31, 1976 through the "fresh-start" adjustment. I.R.C. § 1023(h). Property acquired after December 31, 1976, received no fresh start adjustment. The 1976 Act also continued a preference for lifetime transfers by not grossing up adjusted taxable gifts, made more than three years before death, to include any gift tax paid. JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, H.R. REP. NO. 10612, 94th Cong., 2d Sess. 526-27 (1976) [hereinafter cited as JOINT COMM.].

<sup>20</sup> Pub. L. No. 95-600, § 515, 92 Stat. 2884

<sup>21</sup> Pub. L. No. 96-223, § 401(d), 94 Stat. 229 (1980).

<sup>22</sup> I.R.C. § 2033 reaches all property owned by a decedent, including items of accrued but unpaid income, even though they still are taxable income when received. The pro rata

that the transfer tax system looks to the entire value of property, not just appreciation, but taxation by the two systems is contemplated.

Although the stillbirth of section 1023 may be puzzling in light of prevailing income tax notions, one can understand it in the transfer tax context. The 1976 amendments and the consistent congressional attitude toward this system over the years reflect five recurring, major themes in the transfer tax system. First, the transfer tax system, although not a great revenue raiser, is a serious and independent approach to the problem of finding individuals from whom tax dollars may appropriately be taken.<sup>23</sup> Section 102, excepting gratuitous transfers from the definition of income,<sup>24</sup> separates the taxation of income from the taxation of wealth transfers. Congress's revamping of the latter system indicates its intention to continue a dual tax system rather than move toward an accessions tax<sup>25</sup> or a more comprehensive income tax.<sup>26</sup>

Second, the transfer tax system is concerned with the very wealthy;<sup>27</sup> it is designed to tax great concentrations of wealth.<sup>28</sup> Congress has never precisely defined "great concentrations of wealth" and has typically aimed the transfer taxes at a level of wealth higher<sup>29</sup> than where many commentators<sup>30</sup> think it should be aimed.

Third, the transfer system ignores technicalities of title and ownership and focuses on the realities or substance of power and

portion of the estate tax attributable to the inclusion of such an item of income may be deducted from the gross income of the recipient. I.R.C. § 691(c).

<sup>23</sup> This assessment is supported by the finding of a recent study of the Organization for Economic Cooperation and Development (OECD) that the United States's transfer tax system collects more revenue, as a percentage of gross domestic product, than any other industrialized nation's. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, THE TAXATION OF NET WEALTH, CAPITAL TRANSFERS AND CAPITAL GAINS OF INDIVIDUALS 19 (1979).

<sup>24</sup> See note 5 and accompanying text *supra*.

<sup>25</sup> See note 92 and accompanying text *infra*.

<sup>26</sup> See note 6 and accompanying text *supra*.

<sup>27</sup> B. BITTKER & L. STONE, FEDERAL INCOME ESTATE & GIFT TAXATION 983-85 (4th ed. 1972).

<sup>28</sup> Only two percent of all decedents have gross estates that exceed the 1981 exemption equivalent, \$175,625, of the \$47,000 unified credit. S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION 832 (1977) [hereinafter cited as S. SURREY].

<sup>29</sup> *Id.* at 831-37.

<sup>30</sup> For a characteristically sensible suggestion as to an appropriate level for taxation to commence, see Bittker, *Federal Estate Tax Reform, Exemptions and Rates*, 57 A.B.A.J. 236 (1971).

control.<sup>31</sup> For example, the estate tax treats an individual who creates a trust and retains a life estate as the "owner" of the trust corpus at his death, even though he has parted with legal title and significant other aspects of ownership.<sup>32</sup> Section 2040 deems an individual who dies owning a joint tenancy interest in property as the owner of the entire property, except any portion which can be proven to have been attributable to contributions of any other joint tenants,<sup>33</sup> even if the respective joint tenants' interests are vested and alienable under state law.<sup>34</sup> Moreover, the generation skipping rules tax, at the bracket of the "deemed transferor," property held in trust at the expiration or termination of any prior power or interest in the property, even interests as insubstantial as special powers of appointment<sup>35</sup> or discretionary life interests in trusts created by someone other than the life tenant.<sup>36</sup>

Fourth, Congress has over the years extended the transfer tax system to include many transactions and property interests which have appeared and for which taxation is appropriate, given the basic rules of the estate tax.<sup>37</sup> The elaborate generation skipping system is solid evidence of this.<sup>38</sup> The excising of lump sum distributions, which receive favorable income tax treatment, from the extraordinary exemption accorded to interests in qualified pension plans under section 2039(c), is another.<sup>39</sup>

Finally, and most tentatively, Congress has taken steps to unify the gift and estate tax system. The 1976 Act created a unified tax base which includes taxable gifts made after December

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<sup>31</sup> See, e.g., Treas. Reg. § 20.2033-1 (1958).

<sup>32</sup> I.R.C. § 2036.

<sup>33</sup> I.R.C. § 2040 applies to real property and some types of personal property.

<sup>34</sup> Treas. Reg. § 20.2040-1(b) (1958).

<sup>35</sup> I.R.C. § 2613(d). I.R.C. § 2613(e)(1) exempts a special power of appointment if (1) the holder has no other present or future power or interest in the trust; and (2) if that power is exercisable only in favor of a person or class of persons who are lineal descendants of the grantor assigned to a generation or generations younger than the power holder.

<sup>36</sup> I.R.C. § 2613(d)(1)(A) covers mandatory income interests and § 2613(d)(1)(B) covers discretionary income interests. See JOINT COMM., *supra* note 19, at 566-67.

<sup>37</sup> Progress on this front has been slow since the early 1950's. Congress was active in the previous decades correcting legislative oversights in response to avoidance schemes. The historical development of the power of appointment provision of the estate tax, I.R.C. § 2041, is illustrative. See S. SURREY, *supra* note 28, at 513-15.

<sup>38</sup> Although many practitioners thought the generation skipping tax came out of nowhere, it was the result of a Treasury and an American Law Institute study that detailed the "abuses" it was designed to eliminate. See U.S. TREAS. DEP'T, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS pt. 3, at 388-92 (Joint Comm. Print 1969); Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515 (1967).

<sup>39</sup> I.R.C. § 2039(c), (f).

31, 1976, and a decedent's taxable estate.<sup>40</sup> A single unified credit<sup>41</sup> replaced the old gift tax and estate tax exemptions<sup>42</sup> and Congress amended section 2035 to gross-up the estate by the amount of any gift tax paid along with any gift, made within three years of death.<sup>43</sup>

### III

#### REPEAL AND THE FUTURE

The 1976 transfer tax changes and the themes described above seem politically secure. One cannot help but think that this stability and the fate of section 1023 are linked. The linkage appears to be that Congress's choice to retain the two system approach to revenue raising may make it difficult to tax appreciation in property passed at death.<sup>44</sup> This is not to say that section 1023 did not make sense as an income tax matter, but that tightening the transfer tax system made it impossible to change simultaneously the long-standing rule which appeared, in a crude way, to prevent imposition of a double tax. The 1976 Act may, therefore, have been politically unstable because it appeared to indicate that Congress was rejecting the comprehensive tax base approach and at the same time was making a significant concession to those who wished to move in that direction.<sup>45</sup>

This assessment of the reasons behind the repeal of section 1023 is, of course, speculative. The Senate Finance Committee attempted to rationalize the repeal by stating:

Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. The committee believes that the carryover basis provisions are unduly

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<sup>40</sup> I.R.C. §§ 2001(b), 2001(c), 2502.

<sup>41</sup> I.R.C. §§ 2010, 2505. In the case of a deceased deemed transferor who fails to consume his entire unified credit in his estate's final tax accounting, the unused portion may be applied to offset any generation skipping tax. I.R.C. § 2602(c)(3).

<sup>42</sup> The 1976 Act repealed I.R.C. § 2052, which provided a \$60,000 exemption from the gross estate, and repealed I.R.C. § 2521, which provided a \$30,000 lifetime exemption for inter-vivos transfer.

<sup>43</sup> Pub. L. No. 94-455, § 2001(a)(5), 90 Stat. 1848 (1976) (amending I.R.C. § 2035(c)).

<sup>44</sup> This was the justification for the bifurcated income tax rule as it existed before 1976. See S. SURREY & W. WARREN, *supra* note 13, at 898.

<sup>45</sup> Replacement of I.R.C. § 1014 with a carryover rule is a softer approach to trying to change the rule of I.R.C. § 102. See Bittker, *supra* note 6, at 945-46.

complicated. The committee therefore believes that the carryover basis provisions should be repealed.<sup>46</sup>

The literature is devoid of complaints by those who receive the benefit of similarly complex carryover basis provisions in the Code.<sup>47</sup> If it is so hard to cope with carryover basis at death, why has section 1015 worked without much comment for gifts?<sup>48</sup> Congress could have greatly reduced the complexity of section 1023 by eliminating the "fresh-start" adjustment<sup>49</sup> and the other softening adjustments.<sup>50</sup> Alternatively, it might have levied capital gains taxes on the net unrealized appreciation at death as a part of the final income tax return of the decedent or the decedent's estate.<sup>51</sup> Significantly, Congress did not address the problem it identified, but instead simply repealed the provision.

The Senate committee's explanation for the repeal of section 1023 is particularly unpersuasive in light of the continued vitality of the carryover basis rule to gifts under section 1015.<sup>52</sup> How can Congress justify such a distinction when no income tax policy supports it? With the trend towards unification of the gift and estate taxes, what transfer tax policy supports such radically differing income tax consequences? Administrative considerations and prevention of tax avoidance may partially answer these questions.

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<sup>46</sup> S. REP. No. 394, 96th Cong., 2d Sess. 122, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1008, 1128-29.

<sup>47</sup> Corporate reorganization plans, for example, often employ extraordinarily complex procedures to obtain the advantages of carryover basis. *See* B. BITTKER & J. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* 14-1 to 14-152 (1971).

<sup>48</sup> The only apparent distinction is the fact of the donor's death. This may complicate determining the original cost basis for carryover purposes. Treas. Reg. § 1.1015(a)(3) (1971) provides that, if a donor's basis is unknown to the donee (and incidentally the District Director), then the basis is assumed to be the fair market value of the property at the time the donor acquired it. The 1976 Act reports endorsed this sensible regulation for I.R.C. § 1023 purposes also. *JOINT COMM., supra* note 19, at 563.

<sup>49</sup> I.R.C. § 1023(h) provided for an upward adjustment to the December 31, 1976, value of any carryover basis property, for gain purposes only. The adjustment was to actual market value in the case of marketable bonds and securities and to a deemed value, based on a fractional formula, for other property.

<sup>50</sup> I.R.C. § 1023(c) provided an upward adjustment for applicable federal and state estate taxes and § 1023(d) provided an upward adjustment to \$60,000, if the aggregate basis of all carryover basis property was less than that figure. In addition, I.R.C. § 1023(b)(3) provided an exemption for up to \$10,000 worth of personal or household effects.

<sup>51</sup> In 1963 President Kennedy proposed taxing accrued but unrealized appreciation at death. *See* HOUSE WAYS AND MEANS COMM., *PRESIDENT'S 1963 TAX MESSAGE*, 88th Cong., 1st Sess., 20 (1963). The Treasury re-endorsed this idea in 1969. U.S. TREAS. DEP'T, *supra* note 38, at 118.

<sup>52</sup> *See* note 3 and accompanying text *supra*.

If Congress has decided that gifts and bequests should properly be handled entirely outside the income tax system, then the step-up and step-down rule of section 1014 should logically be extended to gifts. A major difficulty with extending the step-up/step-down rule to inter-vivos gifts, however, is that it would introduce a significant possibility for evasion of income taxes. One can easily imagine family members triggering a step-up in basis through an intra-family gift of property followed by a sale and use of the proceeds for shared consumption. The value returned to the donor would escape taxation under the present system because, in general, shared consumption by members of the same household does not constitute a taxable "transfer."<sup>53</sup> The family would escape all income tax on the unrealized gain attributable to the donor's ownership. The only tax—although its magnitude should not be underestimated—would be the gift tax.<sup>54</sup>

Even more fundamental than the possibility of an avoidance through shared consumption is the fact that merely by changing the order of events a donor could produce very different tax consequences. If he sold appreciated property and gave the proceeds away, he would be in receipt of income and might have to pay a gift tax. But if he gave the property directly to the donee who then sold it, both could escape the income tax. Such radically different consequences stemming from essentially the same transaction are indefensible. The well-advised would give first and the unadvised might not.

Section 1015—not section 1014—may now be the greater anomaly. If so, it is understandable primarily as a prophylactic provision aimed at an unrelated but serious problem: the potential for evasion inherent in the lifetime family gifts. Section 1014 should be viewed as the norm; a step-up or step-down of basis with a reliance on the transfer tax system to assess and collect any revenue. Because death removes the donor, abuse of the shared consumption type is not a consideration. Viewed in this way, the holding of appreciated property until death does not result in avoidance of the income tax system; instead, it is a function of the need to eliminate the administrative difficulty of discovering and

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<sup>53</sup> I.R.C. § 2511.

<sup>54</sup> Even if the donor does not directly share in the consumption, one can conceive so many analogous situations that the meat-axe approach of I.R.C. § 1015 seems justified. Thus, a gift of stock to a grown child to pay for educational expenses, although it does not directly benefit the donor, approximates such a benefit.

taxing shared consumption in the family context after an inter vivos transfer<sup>55</sup> and from the more fundamental problem discussed above.

If this view is correct, and Congress has decided to leave taxation of net unrealized appreciation at death to the transfer tax system, then what is the proper response to the Crude Oil Windfall Profit Tax Act of 1980? The options include doing nothing, bringing section 1015 into line with section 1014,<sup>56</sup> or strengthening the transfer tax system.

If the thesis advanced above as to why Congress withdrew section 1023 is correct, then it is also a good reason for Congress to continue reforming the transfer taxes. If they really are to cover the ground which section 102 gives them, then the rules should not treat wealth taxation in a hit or miss or formalistic manner. In addition, the revenue loss arising from the repeal of section 1023 justifies the production of more revenue through the transfer taxes themselves.

## IV

### MORE TRANSFER TAX REFORM

#### A. *Increasing the Yield*

Even though the 1976 Act reforms tightened and unified the transfer tax system, they were intended to reduce the estate yield.<sup>57</sup> The enactment of the unified credit, which when fully

<sup>55</sup> See Hanrahan, *A Proposal for Constructive Realization of Gains and Losses in Transfers of Property by Gift and at Death*, 15 KAN. L. REV. 133 (1966).

<sup>56</sup> See Heckering, *The Death of "Stepped-Up" Basis at Death*, 37 S. CAL. L. REV. 247 (1964).

<sup>57</sup> The following chart shows the pre- and post-1976 yields for various decedents in some not untypical situations. In each pre-1977 case, full utilization of the \$60,000 estate and \$30,000 gift exemptions is assumed. In all cases it is assumed that no taxable gifts have been made and that there are no other deductible items.

Original Gross Wealth	Pre-1977 Taxable Estate	Unmarried Pre-1977 Tax	Pre-1977 Tax With Maximum Marital Deduction
\$ 150,000	\$ 60,000	\$ 9,500	\$ 3,000
400,000	310,000	84,900	37,200
750,000	660,000	201,700	91,300
2,090,000	2,000,000	753,200	325,700
5,090,000	5,000,000	2,469,200	998,200
10,090,000	10,000,000	6,088,200	2,468,200
25,090,000	25,000,000	17,638,200	8,013,200

phased in on January 1, 1981, will more than make up for the elimination of the flat exemptions for lifetime gifts and estates, accomplished this.<sup>58</sup> In addition, Congress unified the estate, gift, and generation skipping tax tables in the uppermost range of wealth at a marginal rate below the estate tax rate in effect before the 1976 Act.<sup>59</sup>

Congress reduced the estate tax yield for at least three reasons. First, the old gift tax rates were three-quarters of the old estate tax rates and Congress apparently tried to levy a unified tax with a gentler impact. Second, section 1023 promised significant increases in income tax revenue which balanced out any losses in transfer tax revenues.<sup>60</sup> Finally, the tax reduction may have facilitated the passage of the new Act and in particular the generation skipping tax.

The reduction in yield projected by the 1976 Act, in the light of the repeal of section 1023 in 1980, is no longer reconcilable with the major goals of the transfer tax system. If the aim of the system is to level great concentrations of wealth, it is hard to understand why Congress reduced from seventy-seven percent to

1981 Taxable Estate	Uumarried 1981 Tax (with uni- fied credit)	1981 Tax With Maximum Marital Deduction (with unified credit)
\$ 150,000	\$ 0	\$ 0
400,000	74,800	0
750,000	201,300	66,300
2,090,000	777,900	317,250
5,090,000	2,566,800	1,002,650
10,090,000	6,066,800	2,535,300
25,090,000	16,566,800	7,785,300

<sup>58</sup> See note 42 and accompanying text *supra*.

<sup>59</sup> See I.R.C. §§ 2001, 2501, 2601. The 1976 Act adopted a large exemption equivalent (\$175,625) and high marginal rates from the onset of taxability. Thus, the 1976 Act potentially increased the yields in estates ranging from \$1,000,000 to \$15,000,000. Congress did not explain why transfer tax increases were appropriate for estates in this range when the marginal rate for estates in excess of \$10,000,000 were reduced.

<sup>60</sup> The Joint Committee on Taxation estimated the following long range revenue effect of the 1976 Act changes: (1) unified rates and credit, —\$1.23 billion, (2) marital deduction, —\$158 million, (3) valuation, —\$14 million, (4) extension of time, less than +\$500,000, (5) unification, +\$300 million (6) generation skipping, +\$280 million, and (7) carryover basis +\$1.08 billion: for a net gain of \$263 million. See JOINT COMM., *supra* note 19, at 21 n.7. By contrast, Congress projected the revenue effect of the repeal of carryover basis in I.R.C. § 1023 at —\$36 million in 1981, —\$95 million in 1982, —\$330 million in 1985, and —\$950 million in 1990. S. REP. No. 394, 96th Cong., 2d Sess. reprinted in [1980] U.S. CODE CONG. & AD. NEWS 1008, 1129.

seventy percent, the marginal tax bracket of a decedent with total taxable gratuitous transfers in his lifetime and at death in excess of \$10,000,000.<sup>61</sup> In following up on the repeal of section 1023, Congress should increase the transfer tax unified rates to produce revenue proportional to estate tax revenues before 1976. Finally, the repeal of section 1023 will involve a significant revenue loss<sup>62</sup> and because of Congress's decision to rely on the transfer tax system to tax (and raise revenue from) gratuitous transfers, increasing the yield is appropriate.

### B. Ending Unjustifiable Exemptions

The repeal of section 1023 also should be the occasion to pursue reform in line with the themes Congress has endorsed by revising some provisions of the current estate and gift tax system. Although there may be other appropriate curtailments, any agenda for reform must include the section 2039(c) exclusion of certain payments from qualified pension plans, the sections 2522 and 2055 exemptions for gifts and bequests to qualifying charities, and the section 2053 \$3,000 per donee annual exclusion.

#### 1. Section 2039(c)

First, Congress should remove the exclusion from the gross estate<sup>63</sup> of a deceased participant in a qualified retirement plan of the value of a survivor annuity or any other payment payable to anyone other than the executor<sup>64</sup> (other than a lump sum distribution taxed preferentially in the income tax system). The section 2039(c) exclusion is inconsistent with the notion that the holding of substantial power over property justifies taxation. The exclusion is not an inducement to the adoption of qualified plans<sup>65</sup> because of the indirect and uncertain possibility of the

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<sup>61</sup> See note 59 and accompanying text *supra*. In an excellent article published in 1956, Louis Eisenstein concluded that Congress created the transfer tax system to raise revenue. Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223 (1956). Mr. Eisenstein frankly admitted, however, that as time went on and Congress tinkered with that system (including occasional major tax reductions), the only continuing justification for the transfer tax system has been to level great concentrations of wealth. *Id.*

<sup>62</sup> See note 60 and accompanying text *supra*.

<sup>63</sup> I.R.C. § 2039(c). Section 2039(c) has been everyone's, including the Treasury's, favorite loophole to close, but it has escaped repeal. See U.S. TREAS. DEP'T, *supra* note 38, at 376-77.

<sup>64</sup> Payments to the executor are excluded because such payments become part of the probate estate subject to the claims of creditors.

<sup>65</sup> The primary goal of such plans is the maximization of *retirement* income, and it is hard to see how a benefit dependent upon a death before a complete pay-out of benefits

conference of the section 2039(c) benefit on any particular person or group.<sup>66</sup> In addition, the power a deceased participant has over such interests is indistinguishable from a power over an insurance policy or a non-qualified plan annuity.<sup>67</sup> Finally, no dreamy notion that the employer is actually conferring the benefit on the survivor (and the decedent was not, therefore, the "owner") should defeat taxation. The reality is that the decedent controls the beneficiary's identity<sup>68</sup> and has other powers sufficient to justify taxation.

## 2. Sections 2522 and 2055

More controversial, but in policy terms very similar to the section 2039(c) exemption, are the sections 2522 and 2055<sup>69</sup> exemptions for qualifying<sup>70</sup> gifts and bequests made to qualifying charities.<sup>71</sup> It is clear that a donor exercises substantial power

can be related to this purpose. See generally PRESIDENT'S COMM'N ON PENSION POLICY, AN INTERIM REPORT 19-26 (May 1980), reprinted in [May 30, 1980] PENS. PLAN GUIDE (CCH) Supp. 270; Osgood, *Qualified Pension and Profit-Sharing Plan Vesting: Revolution not Reform*, 59 B.U.L. REV. 452 (1979).

<sup>66</sup> Conference of the I.R.C. § 2039(c) benefit depends on death before distribution to a retired participant. Because one of the requirements for qualified status is that benefits be paid out at or during retirement and not "hoarded" in the qualified plan until death, it is particularly difficult to engineer one's estate into a position to benefit under I.R.C. § 2039(c). See Treas. Reg. § 1.401-1(b)(1)(i) (1976); Rev. Rul. 56-656, 1956-2 C.B. 280; Rev. Rul. 72-241, 1972-1 C.B. 108. If a retired employee receives all of his interest in the plan and then dies, I.R.C. § 2039(c) protects nothing, but if he resists distribution, dies, and his designated beneficiary elects any form of payment other than a preferentially taxed lump-sum treatment, I.R.C. § 2039(c) excludes it completely.

<sup>67</sup> A participant typically can elect the form of the survivor benefit and the identity of the beneficiaries. Such powers are incidents of ownership which would bring a life insurance policy into a decedent's gross estate under I.R.C. § 2042. Non-qualified plan annuities are fully taxable (e.g., the value of any survivor benefits) under I.R.C. § 2039(a). The I.R.C. § 2039(c) exclusion applies only to the portion of the value of the benefits, typically 100%, attributable to employer, as opposed to employee, contributions.

<sup>68</sup> Although it is hard to ascertain the origin of this argument, which is still occasionally advanced, it may be related to the exemption from I.R.C. § 2033 for the Social Security death and survivor benefits.

<sup>69</sup> The gift and estate tax charitable deductions are very similar to each other and both are different from the income tax charitable deduction of I.R.C. § 170.

<sup>70</sup> A gift of less than a fee interest in property including a remainder interest or an income interest must be in the form of a (1) charitable remainder unitrust, (2) charitable remainder annuity trust, (3) pooled income fund, or (4) charitable lead trust. I.R.C. § 2055(e)(2). I.R.C. § 644 governs (1) and (2), I.R.C. § 642(c) governs (3); and I.R.C. § 2055(e)(2)(B) governs (4).

<sup>71</sup> The transfer tax system's two definitions of qualifying charitable donees are not coterminous with those charities qualifying for tax exemption under I.R.C. § 501(c)(3). For instance, veterans organizations are not (c)(3) organizations, but are eligible donees under I.R.C. §§ 2055(a)(4) and 2522(b)(5).

over property when he makes a charitable transfer during life or by will.<sup>72</sup> Commentators defend these exclusions<sup>73</sup> as necessary inducements to charitable giving which enhance the pluralistic character of American society.<sup>74</sup>

The inducement argument actually has been aimed, for the most part, at ensuring the continuance of the income tax—not the transfer tax—deduction.<sup>75</sup> Most charitable gifts are made during life. Wealthy people tend to make gifts of appreciated capital to offset taxation of current income.<sup>76</sup> Such donors also are relying in some way on not having to pay a transfer tax on their gift to a charity.

There is widespread agreement among tax commentators on the undesirability of the present income tax deduction accorded for gifts to charities.<sup>77</sup> They attack it as a double benefit, permitting apples (gifts of capital) to be used to substitute for oranges (taxation of current income) and as a subsidy that benefits only the wealthy because most non-wealthy people who make charitable contributions do not usually have itemized deductions in excess of their zero bracket amount.<sup>78</sup> This generalized attack on the charitable deduction has led commentators to call for elimination, curtailment, or replacement<sup>79</sup> of the section 170 deduction. In rare cases there has been discussion of the transfer tax deductions.

The attack on the income tax deduction has failed to generate congressional action, except for some gentle narrowing of the rules governing the deductibility of interests of appreciated and ordinary income property. Moreover, the charities recently have launched an effort to place the charitable deduction "above the

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<sup>72</sup> The power aspects, especially in the context of bequests to family-controlled charities, became so troubling not only as to appropriateness of the donee but in the sense of continued control that the Tax Reform Act of 1969 placed certain limits on the deductibility of such gifts. I.R.C. § 2055(e)(1), 2422(c)(1).

<sup>73</sup> See S. SURREY, *supra* note 28, at 863-67. For an alternative explanation, see Bittker, *Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility*, 31 THE RECORD 159 (1976).

<sup>74</sup> See *Hearings Before the House Ways and Means Committee on Federal Estate and Gift Taxes*, 94th Cong., 2d Sess. 1090 (1976).

<sup>75</sup> See S. SURREY, *supra* note 28, at 863-67.

<sup>76</sup> See A. FELD, M. O'HARE & J. SHUSTER, *THE PATRON NOBODY KNOWS* (1980) (Study for the Twentieth Century Fund).

<sup>77</sup> See, e.g., McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX. L. REV. 377 (1972).

<sup>78</sup> See A. FELD, M. O'HARE & J. SHUSTER, *supra* note 76, at 407-09.

<sup>79</sup> See, e.g., McDaniel, *supra* note 77; Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 S. CAL. TAX INST. 27 (1968).

line," meaning to have charitable contributions deductible in addition to (not first counted against) the zero bracket amount.<sup>80</sup>

The transfer tax charitable deduction is as anomalous as the income tax deduction and Congress should curtail it. The transfer tax system taxes the donor's wealth and power.<sup>81</sup> There are very few instances in which a decedent or a living person can exercise power over property in a significant way and escape taxation;<sup>82</sup> section 2039(c) is one and should be eliminated. The marital deduction is another, but it is distinguishable because there is a good prospect of ultimate taxation in the survivor's estate.<sup>83</sup>

Imbedded in the inducement argument made by proponents of the charitable transfer tax deduction are two notions. First, the eleemosynary character of the recipients justifies exemption. This argument focuses on the identity of the donee contrary to the general policy of the transfer tax system. The transfer tax is levied on the aggregate of the individual's wealth and is not, unlike an inheritance tax, based on the number of beneficiaries or their consanguinity to the testator or donor, as the case may be. The marital and orphan's deductions are two exceptions to the statute's lack of interest in the beneficiary. The marital deduction is distinguishable again because of the prospect of taxation within the same generation. The argument for the orphan's deduction, based on the potential need of the recipients,<sup>84</sup> is weak and does not justify the deduction.

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<sup>80</sup> The recent Senate proposal to this effect, S.219, 95th Cong., 2d Sess., and the House version, H.R. 1785, 95th Cong., 2d Sess., had numerous sponsors.

<sup>81</sup> By contrast, an inheritance tax focuses on the recipient's identity and wealth. The once discredited inheritance tax concept has been modified and given respectability under the name of an "accessions" tax. See Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967). Professor Andrews's support for an accessions tax fits nicely with his support of an income tax system based on consumption. Andrews, *A Consumption Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

<sup>82</sup> Two other provisions which focus on the donee or the nature of the property interest provide tax breaks regardless of donor power. I.R.C. § 2032A provides for preferential "use" valuation for certain farming or small business property. Qualification for this exception involves compliance with stringent initial and continuing tests. A lapse in compliance triggers a "recapture" of the foregone tax. Many commentators think these rules are so stringent that estates will avoid I.R.C. § 2032A. See, e.g., Hajorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609 (1978); Holtorf, *Analysis of the Actual Use Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860 (1977). Other related preferences accorded estates of deceased small business owners are the low interest and deferment features of I.R.C. § 6166. To qualify, a small business must constitute a substantial proportion of an estate. See I.R.C. § 6166A for the old 10-year extension in the case of estates which are somewhat more liquid.

<sup>83</sup> See notes 113-138 and accompanying text *infra*.

<sup>84</sup> The word "orphan" means parentless, not poor, and the I.R.C. § 2057 deduction is only available to people in the first category and then without regard to the deceased

Second, proponents of the deduction argue that a transfer to a charity is a transfer for the public interest (under the Code's definition) and resembles a voluntary payment of tax more than an exercise of power.<sup>85</sup> Many transfers, such as gifts to needy friends or relatives, are logically within the ambit of this argument and yet fall outside the Code rules. At the same time, a deduction is available for gifts to veterans' organizations, to fraternal lodges, to museums named for and glorifying the donor, to wealthy private schools educating primarily children of the wealthy, and to a variety of organizations supporting causes which it is unlikely that the government would support. The voluntary payment of tax argument is at variance with what is included in and what is excluded from the scope of sections 2522 and 2055.

The transfer tax charitable deduction should, for the reason that it is an unjustifiable and extraordinary exception to the rule that power over wealth is the incident of taxation, be eliminated. If Congress finds the political opposition to the elimination of the charitable deduction too fierce, several steps could be taken to harmonize it with the rest of the transfer tax system. One possible modification would be to remove the charitable gift or bequest from the estate before the calculation of any marital deduction.<sup>86</sup> Presently, a charitable bequest remains in the gross estate for marital deduction purposes but is removed for calculation purposes.<sup>87</sup> An alternative modification would be to remove it from the estate for all purposes. Of course, if sections 2522 and 2055 are repealed and charitable transfers made non-deductible, they should be included in the estate for any marital deduction computation as well.

A second partial curtailment of the charitable deduction would be to place a flat dollar ceiling on the amount of property that could be transferred on a deductible basis under sections 2522 and 2055.<sup>88</sup> Such a ceiling would permit limited bequests to

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parent or orphan's other wealth. A "poor" orphan's parent's estate needs no deduction and I.R.C. § 2057 provides no refundable credit.

<sup>85</sup> See B. BITTKER & L. STONE, *supra* note 7, at 190.

<sup>86</sup> This could be done by amending the definition of the computation base in I.R.C. § 2056, the "adjusted gross estate," to remove bequests deductible under I.R.C. § 2055.

<sup>87</sup> Under the present law, if a decedent dies with a federal gross estate of \$10,000,000, leaving half to his wife and half to a qualifying charity, no tax is due. If, however, a decedent dies with \$10,000,000 of property, owing \$5,000,000 to a creditor and leaving the other half to his wife, the allowable marital deduction is only \$2,500,000. His estate will pay a tax of over \$900,000. Exclusion of the charitable bequest would bring results of the first case in line with the second. See I.R.C. §§ 2056(c)(2), 2055.

<sup>88</sup> Professor Paul R. McDaniel has suggested replacing the income tax charitable contribution deductions with a federal matching grant program. McDaniel, *supra* note 77, at

the main class of charities which rely on such gifts—educational institutions<sup>89</sup>—while protecting the integrity of the transfer tax system. Congress could impose such a ceiling in conjunction with the earlier suggestion of removing charitable gifts from the gross estate for marital deduction computation purposes. A flat dollar limitation, rather than a percentage limitation, would better serve the goal of leveling great concentrations of wealth.<sup>90</sup> Although any ceiling is inconsistent with the power argument made earlier, a ceiling would at least prevent the funding of massive charitable institutions which perpetuate a particular donor or his family at the expense of the Treasury.

A third partial way to cut back on the charitable deduction is to leave the charitable gift in the taxable estate when the tentative tax<sup>91</sup> is computed. Under the post-1976 system, a deemed tax is then computed on all prior taxable gifts and this amount is subtracted from the tentative tax. Charitable gifts could be treated as prior taxable gifts for purposes of computing an offset to the tentative tax. Under this procedure the marginal rate of the tax on the taxable portion of a gift or estate would reflect the true aggregate wealth of the decedent.

A simple example illustrates this proposal. Assume that an individual with a gross estate of \$2,000,000 dies unmarried, having made \$100,000 of taxable gifts after December 31, 1976, but more than three years before death. Under the present system a \$1,000,000 bequest to charity reduces this decedent's gross estate by \$1,000,000, leaving a taxable estate of \$1,000,000. A tentative tax is computed on the sum of the taxable estate (\$1,000,000) and the prior gifts (\$100,000) or \$1,100,000. Next, the tax on \$100,000 is determined and subtracted from the tentative tax on \$1,100,000. The tax due, without regard to the unified credit, is \$363,000.<sup>92</sup> If the charitable bequest was left in the taxable estate, as proposed here, the tentative tax would first be computed on a base of \$2,100,000. From that tax the tax on \$1,100,000

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395-406. Professor David Westfall has suggested a percentage limitation on the estate tax charitable deduction and other limitations on the gift tax charitable deduction. *See* Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 986, 1005 (1970).

<sup>89</sup> Sunley, *Dimensions of Charitable Giving Reported on Federal Estate, Gift and Fiduciary Returns*, reprinted in COMM'N ON PRIVATE PHILANTHROPY & PUBLIC NEEDS, STUDY (1974).

<sup>90</sup> *But see* Westfall, *supra* note 88, at 1005.

<sup>91</sup> The tentative tax of I.R.C. § 2001 is computed on the value of the taxable estate plus adjusted taxable gifts made after December 31, 1976. The taxable estate is the gross estate less allowable deductions including the charitable deduction of I.R.C. § 2055.

<sup>92</sup> The tentative tax on \$1,100,000 is \$386,800 less the deemed tax on \$100,000, \$23,800, producing a tax due of \$363,000. I.R.C. § 2001(c).

would be subtracted, leaving a tax due, without regard to the credit, of \$443,000.<sup>93</sup>

This change may at first appear incorrect because it seems as though the extra \$80,000 is a tax on the charitable gift. The tax on the \$1,000,000 is fully backed out at the end, and is of course a *phantom* tax; no tax is paid on a charitable gift. In reality, this operation insures that the taxable portion of the estate, \$1,000,000, is taxed at the rates applicable to a decedent with gross wealth of \$2,100,000. This is correct, and it is interesting that this operation is the opposite of the present system, which leaves in the charitable bequest for the marital deduction computation (and therefore maximizes it) but takes it out for the tax computation.<sup>94</sup>

Congress could adopt the partial approaches suggested separately or together. Examples set out in the margin compare the results of total abolition, the present system, and adoption of the change in the marital deduction and computation method.<sup>95</sup>

<sup>93</sup> The tentative tax on \$2,100,000 is \$829,800 less the deemed tax on \$1,100,000, \$386,800; producing a tax due of \$443,000. I.R.C. § 2001(c).

<sup>94</sup> See note 87 and the accompanying text *supra*.

<sup>95</sup> 1981: Deceased Married Taxpayer; No appreciation; Bequest of \$500,000 to charity; 1/2 of estate to surviving wife.

	Present System	Abolition	Removal of Charitable Contribution from the 2056 concept of an Adjusted Gross Estate	Leave Charitable Contribution in for all purposes and treat as a prior gift taxable transfer
(a) Original Gross Wealth	\$2,100,000	\$2,100,000	\$2,100,000	\$2,100,000
(b) Taxable Gifts Made more than 3 years before death not to the spouse	100,000	100,000	100,000	100,000
(c) Gross Estate	2,000,000	2,000,000	2,000,000	2,000,000
(d) Charitable Contri- bution Deduction	500,000	0	500,000	0
(e) Marital Deduction	1,000,000	1,000,000	750,000	1,000,000
(f) Taxable Estate	500,000	1,000,000	750,000	1,000,000
(g) Adjusted Taxable Gifts	100,000	100,000	100,000	100,000
(h) Code § 2001 Tax Base: Sum of (f) & (g)	600,000	1,100,000	850,000	1,100,000

Adoption of the unlimited marital deduction, as suggested below, would deprive the change in the marital deduction computation of any substantial revenue vitality.

### 3. Section 2503

Congress should revise the \$3,000 per donee annual exclusion of gifts of present interests. The success of the taxpayer in *Crummey v. Commissioner*<sup>96</sup> and the Commissioner's apparent acquiescence<sup>97</sup> in the court's broad definition of present interest illustrates that what was intended as a modest administrative exemption has become a major vehicle for abuse.<sup>98</sup> Congress could overrule *Crummey* by amending section 2503 to provide that all trust interests shall be deemed to be future interests, except an irrevocable right to receive a sum of money in the year of creation.<sup>99</sup> Moreover, the Service should rule that the gift of a life insurance policy, except to the extent of any cash surrender value, and the payment of premiums, shall be gifts of future interests.<sup>100</sup> Finally, the qualifying exclusions should only

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(i) Tentative Tax	192,800	386,800	287,300	386,800
(j) Prior Gift Taxes Payable Base	100,000	100,000	100,000	600,000
(k) Code § 2001(b) Gift Taxes "Payable" on amounts on line (j)	0	0	0	145,800
(l) Code § 2001 Tax Due (Line (i) minus line (k) minus unused credit)	145,800	339,800	240,300	241,000

<sup>96</sup> 397 F.2d 82 (9th Cir. 1968).

<sup>97</sup> See Rev. Rul. 415, 1975-2 C.B. 374, in which *Crummey* is cited as support for the proposition that an income interest that commences with the occurrence of some significant event (e.g., quitting college) is not a present interest.

<sup>98</sup> See S. SURREY, *supra* note 28, at 688-89.

<sup>99</sup> This amendment need only cover vested, mandatory income interests. Other interests in trusts, vested or contingent remainders, or discretionary income interests do not now constitute present interests. Treas. Reg. § 25.2503-3(a) (1958). See Westfall, *supra* note 88, at 993.

<sup>100</sup> Treas. Reg. § 25.2503-3(a) (1958) would have to be revised to provide that the gift of a life insurance policy or the payment of a premium on a policy owned by someone else is a gift of a present interest only to the extent that the policy has a cash surrender value, or in the case of a premium payment only to the extent that the cash surrender value is thereby increased. Recently, in Rev. Rul. 80-289, I.R.B. 1980-43, at 16, the Service conceded yet another issue in its battle to resist sophisticated tax planning involving the present interest exclusion and interests in group life insurance maintained by employers. The ruling holds that a new execution of an assignment of such interest will not restart the three-year clock of I.R.C. § 2035 if occasioned by the employer's change of its group life carrier.

be allowed up to some annual ceiling, fixed at some reasonably low level, and only in the case of gifts to individuals whom the donor has a legal obligation to support.<sup>101</sup>

In 1954, Congress created a statutory exception to the requirement that a gift be a present interest in order to qualify for the exclusion, which should now be reconsidered. Section 2503(c)<sup>102</sup> excludes from the definition of a future interest a gift for the benefit of a minor, if "the property and the income therefrom" are distributed to the minor (or pass according to his will or exercise of a general power of appointment if he dies before attaining age twenty-one). A number of courts<sup>103</sup> have interpreted this provision to qualify a minor's income interest in a trust so long as the trust requires distribution of all accumulated income when the minor attains age twenty-one, even if the corpus is retained for later distribution. The courts arrived at this interpretation by construing the word "property" to refer to the income and remainder interests in the trust separately. These decisions permit the discounted value of the minor's income interest to generate a present interest exclusion but not the discounted value of the right to the remainder.<sup>104</sup> If the word "property" had been interpreted to refer to the accumulated income and corpus together, then there would be no present interest exclusion unless both were distributable to the minor upon attaining age twenty-one.

In response to this case law, which is contrary to the intent but not the language of section 2503, Congress might amend the statute to require a distribution of both the accumulated income and the corpus at age twenty-one. This solution is unsatisfactory for several reasons. First, section 2503(c) is a provision that is used

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<sup>101</sup> Administrative policing problems justify a limited exemption for donees with whom the donor has some very close connection. The selection of the legal obligation to support standard is a reasonable one for identifying that group.

<sup>102</sup> For a description of the origin and development of this section, see C. LOWNDES, R. KRAMER & J. McCORD, *supra* note 17, at 823-33.

<sup>103</sup> See, e.g., *Commissioner v. Herr*, 303 F.2d 780 (3d Cir. 1962); C.E. Weller, 38 T.C. 790 (1962). The Commissioner's acquiescence can be found in Rev. Rul. 670, 1968-2 C.B. 413.

<sup>104</sup> Aggressive taxpayers and their lawyers have attempted to add to the qualifying present interest portion of a gift in trust the value of a mandatory income interest which commences at the time of the minor's attaining his majority and running for some period thereafter. In *Estate of Levine*, 63 T.C. 136 (1974), *rev'd*, 526 F.2d 717 (2d Cir. 1975), the Tax Court permitted the discounted value of this subsequent income interest to be "tacked onto" the minority interest and thus allow both to qualify as present interest gifts, but the Second Circuit reversed. See *Commissioner v. Estate of Levine*, 526 F.2d 717 (2d Cir. 1975).

by the very wealthy. It requires that a trust be established by an inter-vivos gift, which is generally done only by the very wealthy after obtaining professional advice.<sup>105</sup> Second, to the extent that Congress wishes to protect minors, it should only make an exception from normal rules, in this case the requirement of a present interest, when there is a compelling reason, such as to assist minors who are genuinely without adequate support. The orphan's deduction, if revised to have a means test, might respond to this need. For the foregoing reasons Congress should repeal section 2503(c). To replace it, Congress should rationalize criteria for making outright gifts to minors.<sup>106</sup>

A problem related to the abuse of the \$3,000 per donee exclusion involves noninterest bearing demand loans to close relations. In *Crown v. Commissioner*<sup>107</sup> the Seventh Circuit rejected the Service's position, set forth in Revenue Ruling 73-61,<sup>108</sup> that such a loan generates a taxable transfer in each calendar quarter that the loan remains unpaid, equal to an arm's length interest rate appropriate to the transaction. Although neither the Seventh Circuit nor the *Ruling* fully discuss the reasons why family loans are administratively difficult, the *Ruling* does point out that in most cases the \$3,000 per donee exclusion will protect such transactions from generating any tax liability.

*Crown* and the earlier district court decision in *Johnson v. United States*<sup>109</sup> are understandable only because they arise in a family context. Although the mere presence of a family relationship is evidence of an intention to make a gift in many situations for income tax purposes,<sup>110</sup> such a result would be inappropriate in the transfer tax situation because the definition of and results flowing from a characterization as a gift differ in the two systems.<sup>111</sup> The logic supporting *Crown* is that an individual is not

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<sup>105</sup> U.S. TREAS. DEP'T, *supra* note 38, at 353.

<sup>106</sup> A major reason for the enactment of I.R.C. § 2503(c) was to end the confusion and diversity of results which obtained under various state law regimes with respect to outright gifts to children. The different results were produced as a result of variances under state law as to whether and when a minor could own property. Present subsection (c) goes beyond clearing away these variances. Instead, Congress might provide that a gift to a qualifying state law custodian of a minor's property would constitute a gift of a present interest. One test of a qualifying custodianship might be a requirement that income be distributed at least once a year.

<sup>107</sup> 585 F.2d 234 (7th Cir. 1978).

<sup>108</sup> Rev. Rul. 61, 1973-1 C.B. 408.

<sup>109</sup> 254 F. Supp. 73 (N.D. Tex. 1966).

<sup>110</sup> See J. CHOMMIE, *supra* note 5, at 40.

<sup>111</sup> Treas. Reg. § 25.2511-1(g) (1958). Donative intent is not an element of a transfer tax gift. Instead, the issue is whether there has been a transfer for a consideration reducible to

obliged to act in an economically sensible fashion toward family members. He may lend money to a relative without interest and not thereby make a gift of either the interest or the principal. Although this analysis appeals to privacy instincts, the gift tax has always utilized a mechanical definition of "gift": whether an adequate consideration in money or money's worth has been received on account of a transfer.<sup>112</sup> This test is sound, especially when loans of the magnitude of those found in the *Crown* case are involved. Congress, therefore, should reinforce the statutory definition of a gift in the interest free loan context by way of a joint resolution endorsing the principles set out in Revenue Ruling 73-61.

### C. Marital Deduction

Any plan to strengthen the transfer tax system must confront the marital deduction. In a common law state an individual can, while alive, give \$100,000 tax free to his spouse. The next \$100,000 is potentially taxable, and the value of each gift to the extent it exceeds \$3,000, after the \$200,000 point, is 50% taxable.<sup>113</sup> At death, an individual may pass to his spouse tax-free the greater of \$250,000 or one-half of his adjusted gross estate (adjusted downward by half the difference between full taxation of lifetime gifts, if he made gifts totalling between zero and \$200,000 to his spouse while living).<sup>114</sup>

In community property states an individual may give to his spouse on a deductible basis only separate property.<sup>115</sup> At death he may leave, tax free, the greater of one-half of his separate property or \$250,000 (less his wife's share of the community property) worth of his share of community property to his surviving spouse.<sup>116</sup> The creation of community property by the action

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money or money's worth. Although *Commissioner v. Duberstein*, 363 U.S. 278 (1960), does not fully embrace donative intent in the income tax situation, it does embrace something very close to it.

<sup>112</sup> I.R.C. § 2512. The Seventh Circuit skirts around another issue, whether a transfer has occurred. This is really part of the same question because once it is conceded that the non-collection of interest in a calendar quarter is a gift, then it follows that a transfer has occurred.

<sup>113</sup> I.R.C. § 2523(a)(1), (2).

<sup>114</sup> I.R.C. § 2056.

<sup>115</sup> I.R.C. § 2523(f).

<sup>116</sup> A husband who gives his one-half of the community property to his wife (assuming she has not worked during the marriage) cannot utilize the marital deduction because she has already received the other half tax-free, as in effect a marital deduction transfer. I.R.C. § 2056(c)(1)(C) and (c)(2)(B) accomplish this by backing community property out of the

of one spouse is not a taxable event to the other.<sup>117</sup> In either a community property or a common law state, to secure a deduction the donor-spouse must transfer the property outright, or in the case of nonfee ownership gifts of property give substantial powers.<sup>118</sup>

The marital deduction permits the tax free transfer of enormous quantities of wealth to surviving spouses. Congress's justification is that the wealth will be taxed on the death of the spouse and transfer taxation should be levied only once in a generation.<sup>119</sup> Although the generation skipping system supports this general notion, the transfer tax system, as a whole, does not establish a generalized norm of once-in-a-generation taxation. If individuals make multiple gifts of the same property within a single generation, the Code taxes each transfer. Moreover, a surviving spouse can consume or give away a substantial portion of a marital deduction gift or bequest, thus preventing imposition of even a single tax in a generation. Finally, the generational theory justifies an unlimited marital deduction rather than one of fifty percent.<sup>120</sup>

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"adjusted gross estate," as defined in I.R.C. § 2056(c)(2)(A), and property eligible for such a deduction in I.R.C. § 2056(c)(1)(A). The only exception to this rule is that if the wife's interest in her deceased husband's community property is less than \$250,000, then she may receive tax-free from her husband a portion of his community property up to the point that she has received from him \$250,000. A corollary of this approach is that a husband or wife with community property worth in the aggregate more than \$500,000 can receive a marital deduction only by giving or bequeathing separate property to each other.

If the justification for the marital deduction is that it equalizes the treatment of the two major American state property law systems, then no deduction should theoretically be required for a gift of separate property by a community property decedent. Congress unfortunately focused on a decedent owning all community property as the model, and then chose the 50% rule for common law decedents. This in turn allows the community property decedent's estate to deduct one-half of all separate property.

<sup>117</sup> See S. SURREY, *supra* note 28, at 200-01.

<sup>118</sup> Gifts of "terminable interests" are, with few exceptions, nondeductible. I.R.C. § 2056(b). The classic terminable interest is a life estate for the surviving spouse in real estate with a remainder to a third party. See I.R.C. § 2056(b)(1); Treas. Reg. § 20.2056(b)-1 (1958).

<sup>119</sup> This justification is post-hoc. Congress added the marital deduction to the Code in 1948 to equalize taxation of couples living in common law and community property states. C. LOWNDES, R. KRAMER & J. McCORD, *supra* note 17, at 436-38. The rationale that property need be taxed only once in a generation is a recent theory. See note 166 and accompanying text *infra*. I.R.C. § 2013 is in line with the more recent justification of the marital deduction. It provides a diminishing credit towards any estate tax owed by an estate, usually of a surviving wife, based on the amount of estate tax previously paid on property received by the decedent within 10 years of death.

<sup>120</sup> Congress has moved in the direction of an unlimited marital deduction for small estates by providing that the first \$250,000 of property passed to a surviving spouse, assuming no inter-vivos marital gifts, is nontaxable. I.R.C. § 2056(c)(1)(A)(i).

An unlimited marital deduction is attractive for several reasons. First, it would equalize the transfer tax results for couples living in common law or community property states whether they both work or not. The current marital deduction promises to develop into a deduction which, over time, will severely disadvantage working couples living in community property states. To illustrate this, assume the following about two couples: (1) all spouses earn approximately equal amounts; (2) no one makes any lifetime gifts; (3) no spouse owns any separate property; (4) the husband of each couple dies first and all property is owned jointly; (5) one couple resides in a community property state and the other in a common law state; and (6) the gross wealth of each couple is \$1,000,000. Table I indicates the husbands' gross and taxable estates, if all their property is left to their wives.

TABLE I

	Common Law Decedent	Community Property Decedent
Gross Estate	\$500,000 (Wife legally owns the rest under sections 2033 and 2040)	\$500,000 (Husband's share of community property)
Marital Deduction	\$250,000	0
Taxable Estate	\$250,000	\$500,000

The community property decedent's estate receives no marital deduction because community property is removed from section 2056 (as long as the wife gets at least \$250,000 of it) by sections 2056(c)(1)(C) and 2056(c)(2)(B).<sup>121</sup> By contrast, the common law decedent may pass tax-free at least one-half of his wealth to his wife at death, assuming no prior taxable gifts.<sup>122</sup> An unlimited marital deduction would eliminate this serious problem.

Second, the adoption of the unlimited marital deduction would facilitate other reforms. Congress has demonstrated political weakness in the transfer tax area. The unlimited marital deduction is politically attractive because it benefits the group most

<sup>121</sup> See note 116 and accompanying text *supra*.

<sup>122</sup> I.R.C. § 2056(c)(1)(A), (c)(2)(A).

frequently cited as deserving of transfer tax protection—surviving, aged dependent spouses.<sup>123</sup> Such a change would focus even more attention on the problem of disappearance of the marital deduction bequest through consumption, resulting in no transfer tax in a generation. This is only an “abuse” if the wealth passes to younger family members. Thus, the need to modify and rethink, as discussed above, the \$3,000 annual exclusion is even more imperative.

In endorsing an unlimited marital (and dependent child) deduction the Canadian Carter Commission also proposed that to protect the integrity of the deduction against marriages entered into for tax avoidance purposes, inter-spousal transfers would not be tax-free until the marriage had lasted five years or a natural child had been born.<sup>124</sup> Policing the “genuineness” of marriages seems distasteful at best; therefore, after acceptance of the unlimited marital deduction, Congress should make gifts or bequests to a surviving spouse potentially taxable as generation skipping transfers.<sup>125</sup> Presently, spouses are automatically assigned to the same generation by section 2611(c)(2). This rule could be modified to provide that a donee spouse, in line with the generation skipping system, would be deemed to be a generation younger if he or she was more than twelve and one-half years younger than the donor spouse.<sup>126</sup> The Code would levy a generation skipping tax on an outright gift to such a spouse, using the rest of the generation skipping system. In addition, any beneficiary spouse more than twelve and one-half years younger than the creator spouse would be assigned to a generation younger for purposes of determining whether a trust or trust equivalent is a generation skipping trust.<sup>127</sup>

The adoption of an unlimited estate tax marital deduction would require a rethinking of two statutory corollaries of the present 50% marital deduction. The first is the gift tax marital

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<sup>123</sup> Cost has always been a major element in the opposition to an unlimited marital deduction. Adoption of all the suggestions made here, including the generation skipping limitation on the marital deduction, would respond to the cost argument.

<sup>124</sup> 3 ROYAL COMM'N ON TAXATION, REPORT OF THE ROYAL COMM'N ON TAXATION 146 (1966).

<sup>125</sup> “Taxable marital deduction generation skipping transfers” could be added to I.R.C. § 2603 as a new category of taxable transfers.

<sup>126</sup> The 12 1/2 year rule could be softened by phasing out gradually the unlimited marital deduction as the number of years of difference increases, beginning at a certain level such as 10 years.

<sup>127</sup> See I.R.C. § 2611(c).

deduction, which parallels the present estate tax rules. The first \$100,000 of interspousal gifts by a common law domiciliary are tax free; the next \$100,000 are potentially taxable and the value of any gifts after total gifts equal \$200,000 is 50% taxable.<sup>128</sup> In a community property state, interspousal gifts of a portion of community property are fully taxable<sup>129</sup> because the creation of community property, although in some sense a transfer, is non-taxable.<sup>130</sup> The second statutory corollary is the split gift provision of the gift tax. Section 2513 treats a gift by one married person to a third person, even if a gift of that spouse's separately owned property, to be a gift to the extent of one-half of its value made by each spouse, as long as the nonowner spouse consents to such treatment by the signing of an appropriately filed gift tax return.<sup>131</sup> This provision equalizes gifts of noncommunity property with gifts of community property.

The objection to a change from the rules just described to an unlimited gift tax marital deduction are stronger than the objections to providing such a deduction at death. The essence of this objection is the fear that a husband and wife could conspire to reduce their transfer taxes by dividing the family wealth into two parts and giving the parts away separately, as two different aggregations of wealth. A weakness of this objection is that such "schemes" are possible under the present system.<sup>132</sup> Moreover, the prospect of marital failure is a powerful countervailing force against abuse of an unlimited gift tax marital deduction.<sup>133</sup>

The adoption of an unlimited marital gift tax deduction seems advisable. With such a change Congress could eliminate the split gift provisions. The Service could be given special authority to ensure that simple gift-regift schemes between spouses would have to establish that the donee spouse's ownership, especially if of a temporary nature, be substantial and not merely a sham to

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<sup>128</sup> I.R.C. § 2523.

<sup>129</sup> I.R.C. § 2523(f)(1). The \$100,000 tax free, interspousal gift rule does not apply to a community property donor because it cannot be clear before death whether the aggregate community property on the date of the death of the first to die will exceed \$200,000. This fact would have to be known to extend the common law \$100,000 tax free rule to gifts by community property domiciliaries.

<sup>130</sup> See note 117 and accompanying text *supra*.

<sup>131</sup> I.R.C. § 2513(a)(2).

<sup>132</sup> The split gift rule of I.R.C. § 2513 permits this directly and also by allowing an owner spouse to hide \$3,000 per donee of gifts each year by virtue of the other spouse's consent.

<sup>133</sup> See F. SANDER & H. GUTMAN, *TAX ASPECTS OF DIVORCE AND SEPARATION* (1975).

split the gift tax burden. Also, if this turned out to be a large and uncontrollable problem, Congress could consider adopting a rule automatically attributing a gift by a donee spouse back to the original donor if it occurred within some reasonable short period, such as ten years.

#### D. *Unified Credit*

Liberalizing the marital deduction would permit a revision and reduction of the \$47,000 unified credit<sup>134</sup> which permits tax free lifetime gifts and bequests of \$175,625 worth of property *in addition to any marital deduction* transfer. The credit is justified as an administratively desirable exemption for a modest amount of gratuitous transfers.<sup>135</sup> The credit, however, offsets every taxpayer's liability; even an extremely wealthy taxpayer may transfer \$175,625 tax free (in addition to any marital deduction transfer).

The credit, although rate bracket neutral,<sup>136</sup> is inconsistent with the goal of leveling great accumulations of wealth. A unified credit is consistent with this goal only if it is limited to smaller estates. With large estates there is no administrative simplicity argument not to tax the first \$175,625, because a return will be filed (and reviewed) in any event. The credit should, therefore, be recast to phase out when taxable wealth exceeds some significant level.<sup>137</sup> A convenient way to do this would be to back the credit out of the tax calculation offset provided in section 2010.<sup>138</sup> At the same time the amount of the credit should be reduced because there is no justification to exempt transfers of wealth of the magnitude presently permitted.

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<sup>134</sup> I.R.C. § 2010.

<sup>135</sup> An alternative explanation made to the author by another tax professor is that it is an unabashed effort by Congress to keep "modest" estates out of the transfer tax system which should tax only the very wealthy. Any statistically honest definition of the very wealthy begins with estates below \$175,625. See notes 27-29 and accompanying text *supra*.

<sup>136</sup> It is rate bracket neutral in that dollar for dollar it abates each taxpayer's liability at his effective transfer tax rate. The old \$60,000 estate exclusion reduced tax at each taxpayer's marginal bracket and, thus, became increasingly valuable as the marginal bracket (and size) of the estate increased.

<sup>137</sup> An obvious choice would be to phase it out beginning with taxable estates exceeding \$175,625.

<sup>138</sup> For each dollar in the taxable estate above \$175,625, 30 cents of credit could be forfeited. Thirty cents is appropriate because the maximum estate tax bracket is 70%. A steeper rate would make the rates at the lower end of the phasing out too suddenly progressive.

*E. More Unification*

Comprehensive reform of the transfer tax system consistent with the above noted five themes must include an attempt to "unify" more completely the gift and estate taxes. The Code currently cumulates all taxable gifts for gift tax purposes, but cumulates only post-1976 gifts for estate tax purposes.<sup>139</sup> Congress created this distinction because donors of pre-1977 gifts may have "relied" in some sense on the non-cumulation of lifetime gifts into the taxable estate.<sup>140</sup> Such reliance does not constitutionally prohibit an inclusion of all gifts into the taxable estate.<sup>141</sup> Although pure uniformity would be furthered by an inclusion of all gifts into the taxable estate, it is probably undesirable to change the 1976 Act's fair-minded grandfathering of pre-1977 gifts.

One significant change made by the 1976 Act was the revision of section 2035. Section 2035 includes in the taxable estate gifts made within three years of death without regard to whether such gifts were made in contemplation of death.<sup>142</sup> In addition, such gifts when brought back into an estate also carry in (or are "grossed up" to reflect) any gift tax actually paid.<sup>143</sup> Under the previous non-gross-up rule a wealthy individual could reduce his estate taxes by making deathbed gifts even though the gifts were brought back into the estate by the contemplation rule.<sup>144</sup> The new rule of section 2035(c), which includes gift taxes paid, should apply without regard to the period of time between gift and death. The only exception would be that pre-1977 gifts and gift taxes would be excluded<sup>145</sup> on reliance grounds.

If the "gross-up" rule of section 2035 is expanded, as suggested here, what residual purpose would section 2035 serve?

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<sup>139</sup> I.R.C. §§ 2001, 2502. The generation skipping tax, levied at the deemed transferor's rates, likewise should include all prior gifts, especially in the case of a generation skipping transfer before death. Presently, it parallels the estate tax system by only including gifts made after December 31, 1976. I.R.C. § 2602(a)(1)(C). See notes 168-72 and accompanying text *infra*.

<sup>140</sup> This feature of the old system helped only the very rich. JOINT COMM., *supra* note 19, at 526-27.

<sup>141</sup> The constitutional limits on a tax of the excise variety are difficult to discern, and one commentator has concluded that the similar grandfathering of pre-1976 trusts in the generation skipping system was not constitutionally required. R. COVEY, *GENERATION SKIPPING TRANSFERS IN TRUST* (1976). See notes 168-72 and accompanying text *infra*.

<sup>142</sup> Prior to 1976, I.R.C. § 2035 only taxed transfers made in contemplation of death.

<sup>143</sup> I.R.C. § 2035(c).

<sup>144</sup> B. BITTKER & L. STONE, *supra* note 7, at 1126-27.

<sup>145</sup> The change would actually be accomplished to include in the I.R.C. § 2001 term "adjusted taxable gifts" the amount of any gift tax paid on such a gift.

At present, as a corollary to including gifts made within three years of death, section 2035 operates to bring in post-gift appreciation. Thus, if property is transferred within three years of death and the donee holds it, or clearly traceable substitute property, at the time of the donor's death, then any appreciation or depreciation in the value of that property is reflected in the estate.<sup>146</sup> In other words, section 2001 includes the property, not the gift; therefore, such property ceases to be an adjusted taxable gift under section 2001.<sup>147</sup> This attempt to "hold onto" property seems inconsistent with true unification but it exists because of another concern—the evasion potential in a fully unified system which ignores gifts of rapidly appreciating property, made near the end of the donor's life.<sup>148</sup>

Significant revision or abolition of sections 2036 to 2038 would be another major step towards fuller unification. These provisions, which have never been coordinated with the gift tax, make little sense. Two examples involving section 2036 illustrate this. First, if a donor creates a trust with the income reserved to himself for life, remainder to his daughter, the actuarial value of the remainder interest is a taxable gift at the time of creation.<sup>149</sup> When the donor dies, section 2036 includes the entire value of the corpus at its current value. Section 2012 provides a credit for the prior payment of any gift taxes. Second, suppose a donor creates a trust providing income to his son for life, corpus to his son at age forty, and retains a power to alter the trust at any time during his life by requiring a distribution of the corpus to his son. The creation of such a trust is a fully taxable gift under section 2511<sup>150</sup> because it is a completed transfer for purposes of the gift tax. Yet, when the donor dies, section 2038 includes the entire value of the corpus in the donor's gross estate because his power to accelerate is too significant.<sup>151</sup>

Sections 2036 to 2038 served important purposes when gifts were *not* cumulated into the gross estate, but now the complexity

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<sup>146</sup> Treas. Reg. § 20.2035-1(e) (1958) (not revised to reflect the 1976 changes in I.R.C. § 2035).

<sup>147</sup> I.R.C. § 2001(b) excludes from the definition of "adjusted taxable gifts" those "gifts which are [otherwise] includible in the gross estate of the decedent."

<sup>148</sup> The major post-1976 justification for the retention of I.R.C. §§ 2035-2038 is the possibility of including post-gift appreciation in the estate. *See* S. SURREY, *supra* note 28, at 274.

<sup>149</sup> Treas. Reg. §§ 25.2511-1(e), 25.2512-5 (1958).

<sup>150</sup> Treas. Reg. § 25.2511-2(d) (1958).

<sup>151</sup> *See* Treas. Reg. § 20.2038-1(a) (1958).

and confusion surrounding these provisions is hard to defend. They pull back into the estate the gifts (with appreciation or depreciation).<sup>152</sup> The theoretical justification for taxation of this appreciation is that the donor continues to benefit from the appreciation either by receiving large income payments or by retaining ownership-like power over the property.<sup>153</sup>

In 1969 the Treasury made a series of proposals designed to achieve complete unification of the gift and estate taxes. Table II summarizes the Treasury's proposals.

TABLE II

	<u>Gift Tax</u>	<u>Estate Tax</u>
Donor Retains:		
(i) A primary life estate	None	Fully includible
(ii) A defeasible future interest that does not fall in before the donor's death	Full	None (except includible as an adjusted taxable gift)
(iii) A defeasible future interest which falls in before the donor's death	Full	Full (taxed twice; once as an adjusted taxable gift; once as property includible in estate)
(iv) A vested future interest	Prior interest taxable if capable of valuation	Property value less value of prior interests includible in estate
(v) Retention of a limited power of appointment	Full	None (except includible if an adjusted taxable gift)
(vi) Retention of a general power of appointment	None	Full <sup>154</sup>

<sup>152</sup> See notes 147-48 and accompanying text *supra*.

<sup>153</sup> The Supreme Court's decision in *Byrum v. United States*, 408 U.S. 125 (1972), which threatened to limit the reach of I.R.C. § 2036, was legislatively overruled by I.R.C. § 2036(b).

<sup>154</sup> U.S. TREAS. DEP'T, *supra* note 38, at 351-87.

In the first example described above, *no* gift tax would be paid and the corpus would be includible in the estate. In the second, the creation of the trust would be a fully taxable gift and nothing would be brought back into the estate (except as an adjusted taxable gift) at the time of the donor's death because of his power to accelerate a distribution of the corpus.

Commentators have labelled the Treasury's proposals the "easy-to-complete" gift approach and have criticized them for several reasons.<sup>155</sup> First, commentators claim the proposals will permit greater "evasion" and that, if anything, the law should make it harder to complete a gift tax transfer.<sup>156</sup> The fear of "evasion" referred to is a function of their belief that appreciation in the gifted property should be taxed to a donor, who retains significant powers. Second, they argue that the easy-to-complete gift approach would make the income and transfer tax systems even less compatible than at present with respect to when a donor will be deemed to still be an owner of property.

Congress should adopt the Treasury's 1969 unification proposals as a way of eliminating the confusion surrounding the continued existence of inconsistent gift and estate tax definitions of "completion" in a new statutory mold of cumulation of all gifts into a decedent's estate. The criticisms, described above, can be met to a certain degree by modifying the Treasury's proposals. For instance, the definition of a primary life estate should be expanded to include a retained power to select among beneficiaries. Such power may be held alone or in conjunction with others, even if such other person has a substantial adverse interest.<sup>157</sup>

#### F. *Generation Skipping*

Congress should also revise several of the rules of the generation skipping system in line with the goals described above. First, Congress should eliminate the exclusion for each child of the deemed transferor of the first \$250,000 worth of generation skipping transfers benefiting grandchildren.<sup>158</sup> No valid policy supports this provision, which benefits only the well advised and

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<sup>155</sup> See S. SURREY, *supra* note 28, at 441-42.

<sup>156</sup> *Id.*; Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

<sup>157</sup> Congress has taken a step in this direction by including in the present statutory definition of this idea the implied retention of power over a gift of stock in an enterprise which the donor controls. I.R.C. § 2036(b).

<sup>158</sup> I.R.C. § 2613(b)(6).

wealthy trust donor. The exclusion is indefensible on administrative grounds (as a small trust exemption) because small trusts benefiting people other than grandchildren are not covered.

A second desirable change involves a "deeper" statutory issue. The generation skipping tax works "internally."<sup>159</sup> If an individual dies after he has been the deemed transferor of a generation skipping transfer, the value of the property passed by that transfer is not included in his estate as an adjusted taxable gift or otherwise.<sup>160</sup> This sound decision is based on the fact that the deemed transferor becomes such by statutory fiat and not as a result of any act or the accrual of any particular benefit.<sup>161</sup> In spite of this, section 2601 permits the use of the value of prior or simultaneous generation skipping transfers to be added in and, therefore, enlarge the property base upon which a deemed transferor's marital deduction is calculated.<sup>162</sup> This exception to the rule of internal operation is indefensible, for all it does is arbitrarily confer an increase in the otherwise allowable marital deduction to a class of people not identifiable as deserving a larger marital deduction.

Third, Congress should consider changing the definition of a generation skipping trust and the generous grandfathering of all pre-existing trusts and many wills. A basic requirement for generation skipping taxation is that property be held in a generation skipping trust or trust equivalent. For a trust to be a generation skipping trust, it must have beneficiaries assigned to at least two separate generations younger than the grantor's.<sup>163</sup> If a donor creates a testamentary trust providing income to her husband<sup>164</sup> for life, remainder to her children, it is not a generation skipping trust. The reason for this is that because the trust property was taxed in the donor's estate or will be taxed in the husband's (if it is a qualifying marital deduction trust over which he had a general power of appointment), no generation skipping tax should be imposed. The donor or the donor's spouse pays the first generation's tax and the children or the trust are not taxed again because no generation has been skipped.<sup>165</sup>

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<sup>159</sup> Stephens & Calfee, *Skip to M'Lou*, 32 TAX. L. REV. 443, 454-55 (1977).

<sup>160</sup> I.R.C. § 2001.

<sup>161</sup> Under the present statute, a deemed transferor need not have any interest in the trust. I.R.C. § 2612.

<sup>162</sup> I.R.C. § 2602(c)(5).

<sup>163</sup> I.R.C. § 2611(b).

<sup>164</sup> Her husband is automatically assigned to the same generation, regardless of age. I.R.C. § 2611(c). See notes 110-27 and accompanying text *supra*.

<sup>165</sup> See Stephens & Calfee, *supra* note 159, at 563-64.

The idea behind the two generation rule is that property should be taxed at least once in every generation that benefits from it.<sup>166</sup> Thus, a trust providing income to a donor's children for life, remainder to his great-grandchildren, bears one level of the generation skipping tax on the death of the children, even though it skips through another generation before landing on the great-grandchildren. The operation of the two younger generation rule makes sense in the context of the children-great-grandchildren trust. The rule makes less sense in the case of a sibling trust. If a brother transfers property to a testamentary trust for his sister's life with the remainder to her children, such a trust is not a generation skipping trust. The only tax which is paid currently is the estate tax on the property in his estate which will fund the trust. If, however, the brother left the property to his sister outright and she then left it to her children, the Code would have imposed two estate taxes.

This divergence of results justifies modifying the definition of a generation skipping trust to include any trust with interest or power holders assigned to at least two generations, only one of which need be assigned to a generation younger than the grantor. Such a reformulation of the rule would be consistent with the idea which the generation skipping system was designed to fulfill.

Adoption of this change would potentially affect the common situation in which the surviving spouse is the life tenant and the children are the remaindermen. Under present law such a trust, if it is of the marital deduction variety, is not taxed in the husband's estate but is taxed in the wife's because she has a general power of appointment over the corpus.<sup>167</sup> These results would remain even with the new definition of a generation skipping trust because the wife's interest is, and would be, taxable as a complete ownership interest without any need for taxation of a "deemed" ownership by the generation skipping system. The more interesting situation is when there is a nonmarital deduction trust, like a family trust, in which the wife is the primary income beneficiary. One might initially think that under the definition of a generation skipping trust, proposed above, such a trust should be deemed to be a generation skipping trust. If so, then two taxes would be paid: (1) the husband's gift or estate tax at the time of the creation of the family trust, and (2) the generation skipping tax on the

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<sup>166</sup> See JOINT COMM., *supra* note 19, at 572-73.

<sup>167</sup> I.R.C. § 2056(b)(5).

death of the wife. This initial reaction fails to take into account that the family trust, unlike the sibling trust, involves the marital deduction rules.

The issue of whether to except from the proposed new definition of a generation skipping trust nonmarital deduction family trusts in which the wife is the life tenant and the children are the remaindermen is complex. At present, property placed in such a trust is taxable in the husband's estate and upon the death of the wife will not be taxable as a generation skipping trust, as long as only the children have interests in the trust. If the new definition of a generation skipping trust were adopted, then the latter event would be potentially a taxable generation skipping transfer. The only reason not to include such trusts is that inclusion might seem inconsistent with another proposal advanced here—the unlimited marital deduction. Viewed from the perspective of an unlimited marital deduction, the application of the new definition of a generation skipping trust would in the family context seem to tax *twice* what is ordinarily taxed only once. This appearance is incorrect; the new definition should apply to family trusts as well. The reason for this is that the family trust does not, by definition, come within the marital deduction, whether it be a 50% or an unlimited marital deduction, and, therefore, the logic of the proposed new definition of a generation skipping trust extends to these family trusts with equal force.

The final significant change which Congress should make is to apply the generation-skipping rules to pre-1976 trusts and wills.<sup>168</sup> Irrevocable trusts executed before June 11, 1976, and wills or revocable trusts in existence on June 11, 1976, of decedents dying before January 1, 1982, are exempted from the system.<sup>169</sup> This exemption is justified on the same grounds as the failure to add pre-1977 gifts into the taxable estate.<sup>170</sup> There is a major difference between the two provisions, which should lead Congress to eliminate this exception. Pre-1977 gifts were made in a cumulative gift tax system that eschewed cumulation into the estate. Taxpayers did make taxable gifts in particular reliance on that statutory choice.<sup>171</sup> The generation skipping system is entirely new, so no specific reliance can be demonstrated. Perhaps

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<sup>168</sup> Pub. L. No. 94-455, § 2006(a)(c), 90 Stat. 1520 (1976) as amended by Pub. L. No. 95-600, § 702(a)(1), 92 Stat. 2763 (1978).

<sup>169</sup> *Id.*

<sup>170</sup> See Stephens & Calfee, *supra* note 159, at 609.

<sup>171</sup> See note 140 and accompanying text *supra*.

it can be said that people relied on the fact that trusts *could* skip through generations but this reliance interest is remote. Moreover, the tax burden falls on the trust, not the estate of the decedent who made the gifts,<sup>172</sup> like a pure excise which should be applied to everyone.

## V

## MORE RADICAL APPROACHES

In 1977 Professor George Cooper of Columbia Law School attacked the post-1976 transfer tax system as ineffective.<sup>173</sup> Professor Cooper pointed to certain exotic techniques—preferred stock recapitalizations and charitable lead trusts—which permit elimination or reduction in an individual's transfer tax burden. He also showed how certain provisions, such as the survivor annuity exclusion, countenance total tax exemption for certain types of wealth. Professor Cooper then attempted to formulate proposals to close these loopholes but rejected his own proposals because he decided that the system could not be improved by piecemeal reforms and concluded by suggesting that a wealth tax would be a desirable alternative.

More recently, Professor Gilbert Verbit of Boston University, after studying<sup>174</sup> the major western European wealth tax proposals, endorsed the Progressive Annual Wealth Accessions Tax (PAWAT) system.<sup>175</sup> PAWAT combines features of a transfer tax, an accessions tax, and a wealth tax. Tax payments are made as transfers are received<sup>176</sup> but are calculated on the basis of what the present value of annual wealth tax payments would be for the particular donee of the particular gift.<sup>177</sup> The PAWAT computation projects the wealth tax payments to age eighty-five and, thus, if a donee gives away the *gifted* property before he attains age eighty-five he gets a rebate of the payments he is deemed to have paid<sup>178</sup> on account of the years, if any, remaining to age eighty-

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<sup>172</sup> I.R.C. § 2603.

<sup>173</sup> Cooper, *supra* note 156.

<sup>174</sup> Verbit, *Taxing Wealth: Recent Proposals from the United States, France and the United Kingdom*, 60 B.U.L. REV. 1 (1980).

<sup>175</sup> *Id.* at 45. The PAWAT was endorsed by the Meade Commission Study in England. INSTITUTE FOR FISCAL STUDIES, REPORT OF A COMMITTEE CHAIRED BY PROF. J.E. MEADE, THE STRUCTURE AND REFORM OF DIRECT TAXATION 516 (1978).

<sup>176</sup> INSTITUTE FOR FISCAL STUDIES, *supra* note 175, at 321.

<sup>177</sup> *Id.* at 322-23.

<sup>178</sup> *Id.* at 321.

five from the year of regift. A gift of saved property does not generate a rebate.

The Cooper and Verbit proposals may well represent desirable, more fundamental approaches to transfer tax reform. This Article does not purport to suggest that a patch-up of the present system is inherently preferable to a wealth tax or a PAWAT. This Article does assume, however, that the events of 1976 make it unlikely that Congress will lurch out in a fundamentally new direction in this area. Three years have passed since the Cooper article appeared, and apart from significant academic discussion it has failed to generate interest.<sup>179</sup>

The proposals made here and justified by Congress's retreat on carryover basis are consistent both with the 1976 Act and with the continued development of the unique American transfer tax system. Many of the "abuses" Professor Cooper fixes on—the charitable lead trust and the section 2039(c) exclusion—should be eliminated. With respect to some of the other "abuses" genuine questions can be asked about whether they are likely to be employed and, if so, whether the tax and other risks a donor undertakes in employing them are so significant that rather than being abuses they are legitimate transactions entitled to their present treatment. Adoption of the proposals made here would go a long way to making the American transfer tax system at least a credible alternative to Professor Cooper's wealth tax or Professor Verbit's PAWAT system.

#### CONCLUSION

This Article argues for continuing reformation of the transfer tax system along the broad outlines endorsed by the 1976 Act by reference to the repeal in 1980 of the rule of carryover basis. One objection to the line of argument made here for a tactical acceptance of the return to a bifurcated income tax rule is that the success of the reform proposals in tightening up the transfer tax system would focus even greater attention on the income tax inconsistency between inter-vivos and testamentary transfers. If the transfer tax becomes more effective in taxing wealth, then marginal considerations, like the continuing advantage created by section 1014, will become even more significant in tax planning.

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<sup>179</sup> Professor Cooper endorsed the wealth tax approach in greater detail in a relaxed Mortimer Hess Memorial Lecture before the House of the Association of the Bar of the City of New York on May 22, 1978. See Cooper, *Taking Wealth Taxation Seriously*, 34 THE RECORD 24 (1979).

This possible objection to the proposals and the approach of this Article can be answered in several ways. First, most individuals are reluctant to make lifetime gifts. Before 1976 Congress explicitly encouraged lifetime gifts by setting the gift tax rates at three-quarters of the estate tax rates. In addition, gifts and gift taxes were not included in the estate. Even with these substantial incentives the amount of reported taxable lifetime gifts was small.<sup>180</sup> Although these tax benefits do play a role in planning decisions, it is fairly clear that taxpayers resist lifetime giving. Consequently, the difference between sections 1014 and 1015 may not have as much an incentive effect as is supposed: people wish to hold property until death in any event. Second, section 1015 may well be the anomaly, not section 1014. If so, prevention of tax avoidance in the context of inter-vivos family transfers of appreciated property, not congressionally sanctioned income tax policy, justifies its special rule. Third, the extra "cost" associated with lifetime giving (a carryover basis) may act to counterbalance the advantage of removing possible further appreciation and the gift taxes paid from the donor's estate. Significantly, taxpayers are unlikely to sell quickly the kinds of assets which Professor Cooper mentions in his article as used to secure this advantage, *e.g.*, closely held stock. When sold, these assets carry an income tax "bite" which seems altogether fitting. Finally, the fact that Congress has found it impossible to stick with the decision embodied in now-repealed section 1023 should not be a justification to prevent further reform of the transfer tax system. To the extent that such reform focuses more attention on the income tax inconsistency between sections 1014 and 1015 and forces Congress to reconsider it, then anyone interested in a consistent, effective tax system should be pleased.

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<sup>180</sup> Cooper, *supra* note 156, at 170-87.