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INTRODUCTION

Douglas A. Kahn*

While the estate and gift tax area has by no means been ignored in the legal literature, it has not been one of the more popular subjects. For that reason, a symposium on transfer taxation would be welcome at any time, but this is an especially propitious moment for one to appear.

In 1976, after some twenty-five years of relatively little congressional attention, the transfer tax and related laws were radically altered. In the backwash of the Tax Reform Act of 1976, a flurry of amendments were adopted clarifying, modifying, and correcting the work of that Act. For example, the effective date of the carryover basis rule for property acquired from a decedent was postponed several times by Congress, and the rule itself was finally repealed in 1980. This increase in congressional activity has sparked a renewed interest in the field.

In 1981, as part of the Economic Recovery Tax Act (ERTA), Congress made another radical alteration of the transfer tax system. The moment is therefore ripe for scholarly attention to the current state of the transfer tax system and to the type of planning for clients that is dictated by the tax law changes of the past six years. Among the planning considerations that might be considered is the advice which lawyers should give to their clients concerning marital deductions and the Qualified Terminal Interest Property (QTIP) device.

Most of the commentators who have addressed the question of the optimum division of a testator's property between a surviving spouse and the rest of the testator's family have recommended that tax deferral be the principal goal—assuming, of course, that such a division is not contrary to the personal objectives of the testator. In other words, if maximization of the value of assets that ultimately will pass to the descendants of the decedent is a major objective, the widely held assumption is that this objective can best be accomplished by leaving the surviving spouse all the testator's property in excess of the maximum amount that can be included in the testator's taxable estate without incurring any federal estate tax. The testator will thus utilize the unified credit (and possibly the credit for state death taxes) by bypassing the surviving spouse so that those assets will not be subject to a death tax upon the spouse's demise. The amount of the bypass bequest plus all appreciation thereon will be exempt from transfer tax on the death of both the testator and the spouse. The balance of the testator's estate will be left to the spouse in such a manner as to qualify for the marital deduction so that the property will not be taxed at the

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testator's death. However, the property passing to the spouse plus any appreciation thereon will be subject to transfer taxation on either the spouse's death or on transfer of all or part of the property during the spouse's life (other than gifts within the annual exclusion). Thus, the commentators have opted for tax deferral at the time of the testator's death rather than for a division designed to equalize the size of the testator's estate and that of the surviving spouse.

In a recent article, an author examined this question of division and, contrary to the current conventional wisdom, concluded that, while tax deferral is sometimes preferable, it is not always so.¹ The preferability of balancing the size of the spouses' estates rather than deferring the tax payable on the decedent's death depends upon a number of factors, including the size of the spouses' estates; the number of years the spouse survives the decedent; whether the decedent's properties appreciate in value after his death and, if so, at what annual rate; and whether the surviving spouse is a person who is likely to be psychologically prepared to make annual gifts of substantial amounts. Other factors that must be considered are the liquidity position of the decedent's estate and the likely significance, if any, of obtaining a new income tax basis for assets included in the gross estate of the surviving spouse on that spouse's demise. Obviously, there are many contingencies to be taken into account, and perhaps since the difficulty of predicting so many events is so great, and since the tax reduction potentially available from balancing estates even under optimum circumstances is likely to be relatively small, the parties might do better to follow conventional wisdom and opt for death tax deferral. In any event, this is an extremely important issue, warranting further study.

In addition to the numerous technical questions that a new enactment inevitably spawns, the 1981 Act's expansion of the marital deduction to cover QTIP may subject lawyers to agonizing conflict of interest issues. These issues have long been present in the estate planning area, but the availability of the QTIP as a vehicle for qualifying for the marital deduction increases the prospect that such conflicts will arise.

One of the important characteristics of QTIP is that such property can qualify for a marital deduction even though the surviving spouse has only an income interest therein and has no power to dispose of the property either during life or at death. A major reason for utilizing a QTIP arrangement is that the testator does not trust the spouse sufficiently to give that spouse control of the disposition of the property, albeit there are other reasons for using this type of arrangement.

1. Carlock, *Estate Tax Unlimited Marital Deduction Has Limited Advantage in Larger Estates*, 56 J. TAX'N 236 (1982).

In many instances, a husband and wife will consult an attorney together to have a common estate plan designed and to have the appropriate documents drafted. If the lawyer agrees to represent them both, and if one of the testators privately informs the lawyer of a lack of confidence in the other's judgment, it seems clear that the lawyer should advise the testator of the availability of a QTIP arrangement. Indeed, regardless of whether such a private disclosure is made, the lawyer may be obligated to inform his clients of all reasonable planning options, including the QTIP, and the consequences of each option. Is a lawyer required to present this QTIP alternative to clients even if there is reason to believe that raising its availability to the clients may engender a serious dispute?

Let us assume that the lawyer discusses the QTIP option only in a private conference with a testator who then chooses to utilize that device in a will. Is the lawyer then bound to inform the testator's spouse of the meaning of the QTIP provision, its effect of precluding him or her from having any control over the assets, and the likely reason that the testator chose that approach? In informing the spouse, will the lawyer thereby violate a confidence of the testator client; and will the lawyer thereby risk causing a conflict between the spouses and possibly even a breakup of their marriage? If the lawyer seeks to avoid this dilemma by refusing to represent both parties, which one should be represented—the one who controls the marital estate and with whom the lawyer likely has a continuing professional relationship or the other? If the former, how does the lawyer explain to the spouse that because each spouse may have conflicting interests, each should have separate counsel? Is such an explanation itself likely to instigate a marital conflict?

Of course, the threshold issue in any study of estate and gift taxation is the broad impact of the ERTA changes. The significance of revenue collection from transfer taxation has always been minor, and recently its relatively small contribution to the revenue collected by the government has diminished as the percentage of collections represented by transfer taxes has decreased. Only a little more than one percent of the revenue collected by the federal government is attributable to transfer taxes. The taxes apply only to a very small percentage of the population. Nevertheless, transfer taxes are extremely important to the families that are subject to them, and such families usually have the means to hire counsel to deal with these issues. Also, issues of social policy, such as the extent to which a family should be permitted to pass significant wealth down from generation to generation, permeate the transfer tax system and cause those taxes to evoke a more heated public response than even the income tax typically generates. According to some views, little or no wealth should be permitted to pass to a younger generation; to other views, the imposition of a large bite on property that was subject to income tax when initially acquired by the

decendent is an especially unkind cut. These underlying social issues and the strength of feelings they arouse make transfer taxation a particularly interesting subject for scholarly inquiry.

For a decendent dying in 1981, the available unified credit essentially insulates \$175,625 of the decendent's property from transfer taxation. In other words, a \$47,000 unified credit is the equivalent of exempting \$175,625 from the decendent's taxable estate. In adopting ERTA, Congress increased the unified credit and therefore the amount of exemption equivalent; this increase is phased in over a six-year period. For a decendent dying in 1982, the exemption equivalent is \$225,000. This amount increases each year until 1987; for decedents dying in that year or later, the amount of the exemption equivalent is scheduled to be \$600,000.

One might conclude that the staged increases in the unified credit will so reduce the number of estates subject to transfer taxes as to make that matter of interest to only a few highly specialized attorneys. The increase in credit and therefore in the amount of exemption equivalent may be somewhat less significant than appears on first inspection. For example, let us assume that the nation will suffer inflation for several years at a rate of 12% per year, and let us then determine what the value of the amount of exemption equivalent available in future years will be in terms of 1981 dollars. In other words, to compare the \$175,625 exemption equivalent that was available in 1981 with the \$600,000 exemption equivalent that is scheduled to become available by 1987, the two figures must be normalized by determining the purchasing power that each would have in the same year. One way to make this comparison is to determine the value that \$175,625 would have if it grew at a 12% annually compounded rate.

After six years, the \$175,625 figure would grow to \$345,981 if invested at 12% compounded annually. The 1981 exemption of \$175,625, therefore, is essentially equivalent to an exemption of \$346,000 in 1987 when the \$600,000 exemption is scheduled to take effect. The difference between that \$600,000 exemption and the \$346,000 figure is the only real increase in exemption, assuming inflation at the rate indicated, and even that difference has a reduced significance when translated to 1981 values. By 1992, five years after the exemption reaches the \$600,000 plateau, the equivalent value of the 1981 exemption of \$175,625 will be greater than \$611,000, assuming that inflation continues at a 12% rate. Similarly, the amount of exemption allowable only five years after the \$600,000 figure first comes into effect will be less, in true economic terms, than the exemption provided for decedents dying in 1981. Of course, inflation may be brought under control; if so, the scheduled unified credit figures will significantly reduce the reach of the tax. Inflation, however, could worsen. It is, therefore, premature to announce the extinction of a transfer tax system in this country.

It is interesting to speculate on whether congressional action in the near future will further erode the significance of the transfer tax system or even eliminate it entirely, or whether Congress will reverse the trend and broaden the reach of such taxes. I look forward to reading the speculations on and analyses of these and other issues by the prominent contributors to this symposium.