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RESTRUCTURING FEDERAL ESTATE AND GIFT TAXES: IMPACT OF PROPOSED REFORMS ON ESTATE PLANNING

Verner F. Chaffin*

IT is undeniable that estate and gift taxes, in contrast to income taxes, have not received the legislative attention that they deserve. Congress has largely ignored these important segments of our tax structure for many years, and during that time a host of defects and inequities have become apparent. This congressional indifference in the estate and gift tax field can be attributed to the fact that these taxes, unlike the income tax, affect relatively few people, and that they produce less than two per cent of our total tax revenue.¹ It is understandable, therefore, that while the major thrust of the Tax Reform Act of 1969² was to correct certain inequities in the income taxation of individuals, corporations, trusts, and estates, the Act did not deal directly with estate and gift taxation.³

The Treasury Department had proposed major reforms in estate and gift taxation in 1969, however,⁴ and hearings were held before the House Ways and Means Committee in March of that year.⁵ While the proposals were not fully deliberated by the Congress during 1969, there is every indication that the suggestions are still very much alive and that later this year or in early 1971 Congress will

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1. TAX FOUNDATION, INC., *FACTS AND FIGURES ON GOVERNMENT FINANCE* 93 (15th ed. 1969). In 1966 there were only 67,000 estate tax returns filed giving rise to tax liability and only 30,000 such gift tax returns, compared to 57,000,000 such income tax returns. Kurtz, *Federal Estate and Gift Tax Changes: Some Arguments in Favor of Treasury's Reform Proposals*, 108 TRUSTS & ESTATES 458 (1969).

2. Tax Reform Act of 1969, P.L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.).

3. Many of the income tax reforms contained in the Act will have profound effects on estate planning. Although these income tax innovations are beyond the scope of this Article, it should be noted that the major changes relevant to estate planning deal with the taxation of charitable trusts, the new throwback and multiple-trust rules applicable to accumulation trusts, and the taxation of trusts having income for the benefit of the grantor's spouse. Changes were also made affecting charitable contributions, and new curbs were placed on private foundations. See Joint Sess. of Tax Section & Trusts & Estates Law Section of the N.Y. Bar Assn., *Tax Reforms Affecting Trusts and Estates*, 109 TRUSTS & ESTATES 339 (1970).

4. U.S. TREASURY DEPT., 91ST CONG., 1ST SESS., *TAX REFORM STUDIES AND PROPOSALS*, pt. 3, at 329-409 (Comm. Print 1969) [hereinafter 1969 Proposals].

5. *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 11, at 3969-4104 (1969) [hereinafter *Tax Reform Hearings*]. For transcripts of selected testimony, both pro and con, taken at these hearings, see Kurtz, *supra* note 1; Panel Discussion—*Federal Estate and Gift Tax Reform: Transcripts of Selected Testimony on Treasury Proposals*, 108 TRUSTS & ESTATES 674 (1969).

give them priority attention.⁶ One may expect, therefore, that comprehensive changes in our estate and gift tax laws will be seriously considered during the next two-year period.

The changes suggested by the Treasury Department include an overhaul of the marital deduction, the institution of tax-free gifts between husband and wife, the integration of the gift and estate taxes, the imposition of a capital gains tax on the unrealized appreciation of assets held by a decedent until the time of his death, and the imposition of additional taxes on generation-skipping transfers.⁷ These sweeping innovations are responsive, in part at least, to the demands for wholesale review of the gift and estate tax laws that have been made with increasing frequency during the past several years.⁸ The major source of the Treasury's proposals was the study conducted under the auspices of the American Law Institute (ALI), with Professor A. James Casner as Reporter.⁹ This study was initiated in 1963, and its recommendations were presented to the annual meeting

6. Mr. Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, in an address delivered at Boston, Massachusetts, on September 30, 1969, indicated that the Nixon Administration would press for more tax reform in 1970 and particularly for the improvement of the estate and gift tax provisions. See Berkowitz, *Estate and Gift Tax Reform—An Overview*, 109 TRUSTS & ESTATES 12 (1970). Similar statements were also made by Mr. K. Martin Worthy, Chief Counsel for the Internal Revenue Service, in an address delivered in Houston, Texas, before the Houston Business and Estate Planning Council and the Houston Estate and Financial Forum on May 12, 1970. See 21 U.S. TAX WEEK 614 (1970).

The Nixon Administration has proposed legislation to the 1970 Congress that would accelerate the payment of gift and estate taxes. The filing of a gift tax return and the payment of the gift tax would be required on a quarterly basis with respect to transfers made after December 31, 1970. Since under present law gift tax returns are filed on a calendar year basis (INT. REV. CODE OF 1954, §§ 2501, 6019), it is currently possible to defer payment of the tax for up to 15½ months after the gift is made. INT. REV. CODE OF 1954, § 6075(b). Payment of an estimated estate tax, consisting of 80% of the estate tax that would be due if the gross estate were valued as of the date of death, would be required within seven months after the decedent's death in cases in which the value of the gross estate exceeds \$150,000. Present law requires the filing of the estate tax return within fifteen months after the decedent's death. INT. REV. CODE OF 1954, § 6075(a). The existing gift and estate tax rates would not be changed (INT. REV. CODE OF 1954, §§ 2001, 2502) by these proposals, and the alternate valuation under INT. REV. CODE OF 1954, § 2032, would still be available for estate tax purposes. The recommended acceleration would result in approximately \$1.5 billion in additional revenue for fiscal year 1971. TAX RECOMMENDATIONS OF THE PRESIDENT, 91ST CONG., 2D SESS. at 1, 9-19 (Comm. Print 1970). Hearings on the above proposals were scheduled to commence September 9, 1970. House Comm. on Ways and Means Release No. 26 (undated).

7. 1969 PROPOSALS, *supra* note 4, pt. 3, at 331-96.

8. A sampling of recent critical articles includes Caplin, *Federal Tax Policy—The Need for Reform*, 56 GEO. L.J. 880 (1968); Draheim, *The Dilemma of Married Couples Under the Gift and Estate Tax Laws: The Need for Reform*, 3 VALPARAISO U. L. REV. 206 (1969); Kurtz, *Federal Estate and Gift Tax Changes: Some Arguments in Favor of the Treasury's Reform Proposals*, 108 TRUSTS & ESTATES 458 (1969); Comment, *A Survey of Generation-Skipping Transfers—The Present Rule and the Possibility of Reform*, 22 SW. L.J. 482 (1968).

9. ALI, *FEDERAL ESTATE & GIFT TAXATION* (Official Draft 1969).

of the American Law Institute in 1968. The purpose of the ALI project was to recommend improvements in present estate and gift tax laws, "not only to surmount their purely technical deficiencies but also to enhance the fairness and the wisdom of the policies that they are shaped to serve."¹⁰ Professor Casner's work has received widespread attention, and the question of the desirability of many of the recommended changes has evoked considerable healthy debate.¹¹ Quite naturally, the Treasury's proposals also have been subjected to much advance criticism and discussion.¹²

The regeneration of professional interest in this long-neglected area is a wholesome sign, and the robust disagreement and controversy will inevitably result in better legislation, regardless of the form that it ultimately takes. This Article will attempt to analyze the reforms that have been suggested, and to assess their impact upon existing estate-planning practices.

I. THE MARITAL DEDUCTION

The Treasury's proposals call for sweeping changes in the marital deduction and gift-splitting provisions of the present Internal Revenue Code (Code).¹³ These changes would be accomplished by (1) replacing the present fifty per cent limitation with an unlimited marital deduction; (2) allowing gift-splitting between spouses in both inter vivos and death transfers on any desired basis; (3) allowing terminable interests to qualify for the deduction; and (4) permitting the spouses to determine by waiver the extent to which the deduction is to be available in their respective estates.¹⁴ According to the Treasury's rationale, these changes will afford substantial tax benefits to small and moderate estates, provide flexibility in transfers between

10. Foreword to ALI, *FEDERAL ESTATE & GIFT TAXATION* at vii (Official Draft 1969).

11. See, e.g., Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 635 (1967); Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515 (1967); McDonald, *Unsatisfied at Any Price: A Summary of the Proposals Presently Under Consideration in the American Law Institute Federal Estate and Gift Tax Project*, 21 TAX. LAW. 329 (1968); ALI *Recommendations on Estate and Gift Taxation*, 3 REAL PROPERTY, PROBATE & TRUST J. 111 (1968); ALI *Federal Estate and Gift Tax Project*, 2 REAL PROPERTY, PROBATE & TRUST J. 463 (1967).

12. See, e.g., Berkowitz, *Estate and Gift Tax Reform—An Overview*, 109 TRUSTS & ESTATES 12 (1970); Brown, *A Case Against an Additional Tax on Generation-Skipping Transfers*, 106 TRUSTS & ESTATES 997 (1967); Dane, *Federal Estate and Gift Tax Reform: Some Arguments Against the Treasury Proposals*, 108 TRUSTS & ESTATES 782 (1969); Marshall & Crumbley, *Reform Proposals for Taxation of Capital Gains: Some Alternate Suggestions*, 108 TRUSTS & ESTATES 871 (1969); Westfall, *Revitalizing the Federal Gift and Estate Tax Reform Proposals*, 108 TRUSTS & ESTATES 664 (1969).

13. Citations are to the INT. REV. CODE of 1954, incorporating all amendments through July 15, 1970.

14. 1969 PROPOSALS, *supra* note 4, pt. 3, at 377-80.

husband and wife, and reduce the complexity of the present marital-deduction rules.¹⁵ While no one would dispute these laudable objectives, there is room for great doubt that the proposed revisions will effectively accomplish the stated goals.

Under present law, the marital deduction is available for both estate and gift tax purposes for transfers of property from one spouse to another. In inter vivos transfers, the deduction is limited to fifty per cent of the value of each gift to the donee spouse;¹⁶ for transfers at death, the deduction is limited to fifty per cent of the adjusted gross estate of the donor spouse.¹⁷ The portion of the gift in excess of the allowable deduction is then subject to the applicable tax. Transfers qualify for the marital deduction only if the donee spouse is given outright ownership or its equivalent—such as the right to receive all income from a trust for life coupled with a general power of appointment over the principal—over the subject matter of the gift or bequest.¹⁸

A. Removal of the Present Maximum Limit on the Estate Tax Marital Deduction

Under the Treasury's proposals, the present fifty per cent limit on the estate tax marital deduction would be removed entirely and replaced by an unlimited marital deduction, thereby making possible completely tax-free transfers of property at death between husband and wife.¹⁹ This proposal, on its face at least, possesses some attractive features. There is merit in the underlying basic notion that transfers between spouses are not appropriate occasions for imposing a tax. When a husband bequeaths property to his wife,²⁰ the property has not moved down a generation; it therefore can be argued from a policy perspective that such a transfer should not be regarded as a taxable event, although a transfer tax would, of course, be imposed upon the wife's death.

Moreover, an unrestricted estate tax marital deduction would eliminate the need for the exceedingly complex and cumbersome formula and fractional-share clauses now utilized by draftsmen in wills to give the surviving spouse an amount equal to the marital

15. 1969 PROPOSALS, *supra* note 4, pt. 3, at 358.

16. INT. REV. CODE of 1954, § 2523.

17. INT. REV. CODE of 1954, § 2056.

18. INT. REV. CODE of 1954, § 2056.

19. 1969 PROPOSALS, *supra* note 4, pt. 3, at 358.

20. For purposes of convenience, it will generally be assumed in this Article that the donor spouse is the husband, and that the donee spouse is the wife. The law is identical, of course, when the roles are reversed. *See* Treas. Reg. § 20.2056(a)-1(a) (1955).

deduction. The present percentage limitation leads to the "exactly half and not one penny more" approach²¹ to estate planning, since overfunding normally results in increased transfer taxes at the death of the donee spouse, and underfunding causes a partial loss of the deduction and hence increased taxes in the donor's estate. As a result, estate planners are excessively preoccupied with the task of describing a quantum exactly equal to the available deduction. This quest for exactitude gives a warped emphasis to estate planning and too frequently results in the indiscriminate use of "boiler plate" clauses and the making of unnatural and unwise dispositive arrangements.²² Removal of the percentage limitation would eliminate the quest for mathematical precision and would free draftsmen to deal with matters of greater human concern. Under this proposal, a husband would have the option of simply leaving the bulk of his estate to his wife without paying any estate or gift tax, and without concern about "overqualifying" the amount of the gift.

The Treasury's proposal is, however, seriously deficient in a number of respects. One of the obvious problems is the loss of revenue to the Government. The principal advantages of the marital deduction to spouses are that it makes lower tax brackets available for each of their estates and that it postpones payment of the estate tax, thereby making the funds that would have been used to pay estate taxes available for use during the lifetime of the surviving spouse. Marital-deduction property passing to a spouse may escape estate taxation altogether if it is used or given away during the surviving spouse's lifetime. Revenue losses of this type are, of course, inherent in any marital-deduction provision, but they would be increased

21. The phrase "exactly half and not one penny more" was used by Professor Polasky in his testimony before the House Ways and Means Committee. See *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4076. Earlier he had used the "not one penny more" phraseology in Polasky, *Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations*, 63 MICH. L. REV. 809, 813 (1965).

There are a variety of techniques by which the amount of the estate tax marital deduction may be expressed. Professor Casner lists the following methods: (a) nonformula pecuniary gift; (b) formula pecuniary gift; (c) nonformula fractional-share gift of the residue; and (d) formula fractional-share gift of the residue. 1 J. CASNER, *ESTATE PLANNING* 791-95 (3d ed. 1961). See also R. COVEY, *THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS* (1966); J. FARR, *AN ESTATE PLANNER'S HANDBOOK* 299-301 (3d ed. 1966); Polasky, *supra*.

22. Mr. Covey asserts that "a majority of lawyers using formula provisions do not have a satisfactory understanding of their operation. In many cases the lawyer has simply gone to a form book and copied a formula provision into the will he is drafting without giving any consideration to how the form will operate upon the client's death." *Preface* to R. COVEY, *supra* note 21, at v. Professor Polasky, in testimony given before the House Ways and Means Committee, characterized the dispositions produced by marital deduction clauses as "a distorted, attenuated pattern of asset disposition which few attorneys, in their wildest flights of fancy, would suggest" *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4073.

significantly if the percentage limitation were removed. By the Treasury's own estimate, the complete exemption of interspousal transfers would result in a thirteen per cent reduction of present estate and gift tax revenues—about 500 million dollars—declining to a ten per cent reduction after a ten-year period.²³

This revenue loss could perhaps be dismissed on the assumption that the deficiency would be made up elsewhere if the proposal otherwise possessed sufficient merit. But there are other objectionable features that combine with the loss-of-revenue factor to render the suggested revision undesirable and unnecessary. The Treasury has painted an overly pessimistic picture of the tax impact of the present marital deduction on smaller estates in which widows are left to support and educate minor children.²⁴ The Treasury fears that because a bequest equal to the present marital deduction might not leave such a widow with adequate funds, a husband might feel compelled to give his entire estate, or substantially more than half of it, outright to her. The overfunding would be taxed in his estate, and a second tax would be imposed on whatever remained of the excess at the widow's death.²⁵

This double taxation would occur in the situation described, but it is submitted that the disposition contained in the Treasury's example is an atypical one that no competent draftsman would advise. The preferred procedure would be to give the wife one half of the adjusted gross estate in a form that qualifies for the marital deduction; the residuary estate would then be placed in a nonmarital family trust containing encroachment powers over the corpus for the support of the widow and children, and with an ultimate gift over to the children or other named beneficiaries at the termination of the trust. The corpus of the nonmarital trust would not be included in the wife's estate at her death. Thus, in its zeal for reform the Treasury has conjured up a problem where none really exists—at least not in carefully planned estates.

The principal fault with the marital deduction, however, is not its rate but rather the fact that it functions in an across-the-board manner without regard to the economic needs of the surviving spouse and dependent members of the family. The deduction applies uniformly, regardless of the size of the estate and without taking into account the decedent's ethical obligation to support his depen-

23. 1969 PROPOSALS, *supra* note 4, pt. 1, at 44. Mr. Robert F. Spindell charged in his testimony that this was a "'sop' . . . to win support for the other radical proposals." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4007.

24. 1969 PROPOSALS, *supra* note 4, pt. 3, at 358.

25. 1969 PROPOSALS, *supra* note 4, pt. 3, at 359.

dents or to maintain his surviving spouse in a comfortable standard of living. An unlimited marital deduction is not needed in larger estates; this is not to say that such a deduction would benefit the larger estate unduly, but simply that it is unnecessary. Because of the progressive rate structure, completely tax-free interspousal transfers would not be fully utilized in estates of considerable size because the initial tax saving achieved in the donor's estate would be more than offset by the tax imposed at the time of the death of the recipient spouse.

In the great majority of cases, the present marital deduction is sufficient to provide the widow with a tax-free amount adequate for her needs. If the unlimited deduction is to be employed at all, it should be applicable only to estates of less than a prescribed value, with the fifty per cent deduction applying to that portion of an estate which exceeds this ceiling.²⁶ This scheme would involve additional complexity, but it would be far better than according an across-the-board one hundred per cent deduction for all estates, because it would distinguish between estates that need the increased deduction and those that do not. However, in view of the difficulties in applying two sets of varying deductions to a single estate, it seems preferable to leave the marital deduction at a uniform rate.

Assuming that a uniform rate is the more feasible mechanism for allowing the marital deduction, it appears that the existing limit is the most desirable. If the present maximum limit were removed there would be an impetus for tax savings at the expense of natural objects of the donor's bounty other than the spouse. A husband, for example, might be tempted to leave all his estate to his wife, perhaps to the detriment of his children by a former marriage. Removal of the percentage limitation would also discriminate even further against the unmarried taxpayer for whom no deduction exists. Although this type of inequity is inherent in the present marital deduction, there is no reason to increase the existing unfairness in the absence of some overriding positive gain.

B. *Removal of the Present Maximum Limit on the Gift Tax Marital Deduction*

Another of the Treasury's proposals, which is consistent with its proposed unlimited marital deduction for death transfers, would remove the present fifty per cent limit on deductions for inter vivos

26. Professor Westfall has proposed a combined unlimited and limited marital deduction, the former applying to adjusted gross estates of \$100,000 or under, and the latter to the excess. Westfall, *supra* note 12, at 996-97.

transfers between husband and wife.²⁷ This recommendation is designed to eliminate present differences in the tax treatment of interspousal gifts made in community property states and those made in common-law jurisdictions, and to reduce the tax incentives for making gifts that result from the gift-splitting advantages that exist under present law.²⁸ The basic notion behind the proposed change is that the presently required tax scrutiny of such transfers dictates an unnatural keeping of records between husband and wife, and that many gifts go unreported without detection because effective enforcement in this area is impossible.²⁹

When property is given inter vivos by one spouse to another, the community property states do in fact enjoy a gift tax advantage under present law. Suppose, for example, that a husband owns property valued at 250,000 dollars and that he wishes to give his wife one half of this amount. In a common-law state, his transfer of a one-half interest in the property to his wife would result in gift tax liability. Ignoring exemptions, his tax would be based on the value of the gift—125,000 dollars—less the fifty per cent marital deduction. Thus, a taxable gift of 62,500 dollars would be involved. In a community property state, however, the wife automatically has a one-half interest in the property of her husband by operation of law; thus, the husband would not have to make a transfer subject to the gift tax in order to accomplish the same result that the husband in the common-law state could achieve only by making a taxable gift.³⁰ The unlimited marital deduction proposed by the Treasury would, of course, eliminate this discrepancy, since a husband in a common-law state could deduct the full amount of any interspousal gift.

27. INT. REV. CODE of 1954, § 2523(a).

28. See 1969 PROPOSALS, *supra* note 4, pt. 3, at 358-59.

29. Mr. Laurens Williams, testifying before the House Ways and Means Committee, pointed to the "enormous amount of non-compliance" and advocated changes in present gift tax laws to make "honest taxpayers out of taxpayers." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4043-44.

30. INT. REV. CODE of 1954, § 2523(f)(1), however, provides that the marital deduction shall not be allowed for transfers of property held as community property at the time of the gift. Thus, in our example, if the husband in the community property state subsequently decided to transfer to his wife his *own* interest in the community property, the transfer would be subject to a gift tax on the full value of the property transferred—\$125,000. The husband in the common-law state, however, could claim the 50% marital deduction if he decided to transfer to his wife the \$125,000 interest he had retained in the property. Thus, his taxable gift would only equal \$62,500. Under these circumstances, the husbands in both the community property and common-law states would have placed title to property valued at \$250,000 in their wives, and would have been taxed on \$125,000 worth of gifts.

Since the writer is opposed to the removal of the percentage limitation for transfers at death, logic would dictate opposition to a similar recommendation for inter vivos transfers. Moreover, one is led to the conclusion that the interspousal-transfer problem is not nearly so important as the Treasury suggests it to be. In the first place, whether an interspousal gift has been made for federal tax purposes depends upon whether or not the transfer or expenditure is in satisfaction of a legal obligation of support imposed by the law of the donor's domicile.³¹ The vast majority of transfers between

31. Broadly speaking, the test for determining whether a transfer is taxable for gift tax purposes is the absence of an adequate or full consideration in money or money's worth. INT. REV. CODE OF 1954, § 2512(b). It is clear that a transfer in discharge of a legal obligation to support a dependent, other than the transferor's spouse, is not a gift if the value of the property transferred is not in excess of the support obligation. C. LOWNDES & R. KRAMER, *FEDERAL ESTATE AND GIFT TAXES* § 32.6 (2d ed. 1962). There is some confusion, however, whether the discharge of a support obligation to a spouse is sufficient consideration to negative a taxable gift. For estate tax purposes, the relinquishment of dower, curtesy, statutory substitutes therefor, or "other marital rights" does not constitute consideration "in money or money's worth," and therefore a transfer in exchange for these rights constitutes a taxable transfer. INT. REV. CODE OF 1954, § 2043(b). In defining transfers for insufficient consideration for gift tax purposes, the regulations have adopted this same position without the aid of any specific statutory provision. Treas. Reg. § 25.2512-8 (1955).

The Treasury, however, has taken the position that the right of a spouse to be supported—unlike the marital rights of dower, curtesy, or their statutory substitutes—is a sufficient consideration to prevent a transfer from being treated as a gift for gift tax purposes. In E.T. 19, 2 CUM. BULL. 166 (1946), the Treasury recognized that marital settlements that involve a relinquishment of support rights cannot be subjected to a gift tax, except to the extent that the value of the property transferred exceeds the value of the support rights released.

Treas. Reg. § 25.2512-8 (1955) does not specifically mention the release of support rights in defining transfers for an insufficient consideration. But after mentioning some marital rights, the regulation specifically includes a transfer in return for the relinquishment of "other marital rights" as not being considered consideration "in money or money's worth." Hence, in relinquishment cases, there is uncertainty whether the wife's right to support is included in "other marital rights" that are not regarded as consideration under the estate and gift tax statutes and regulations. The tax court passed up an opportunity to resolve that uncertainty in *Dwight v. Ellis*, 51 T.C. 182 (1968). That case involved an antenuptial agreement under which a trust was established for the benefit of the wife pursuant to her release of any claim to a widow's allowance, dower, homestead, community estate, or support and alimony. The issue was whether the amount of the trust transfer could be reduced by the value of the support rights that the wife relinquished. The court refused to decide this question on the ground that the attempted relinquishment of support rights was void under local state law.

It appears to be generally assumed that transfers made to a spouse in discharge of the husband's support obligation, which do not involve relinquishment of marital rights, are not taxable gifts. Thus, Professor Bittker, in commenting on E.T. 19, *supra*, stated that "presumably the proposition that one does not incur a gift tax liability by supporting his wife or children in an amicable family setting was thought so obvious as not to require an explicit statement." B. BITTKER, *FEDERAL INCOME, ESTATE & GIFT TAXATION* 1035 (3d ed. 1964). Similarly, Professor Westfall, without citing supporting authority, also has asserted that transfers from husband to wife in discharge of support obligations do not involve taxable gifts. Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 986, 998

husband and wife are probably not "gifts" at all, but rather non-taxable support obligations.³²

Second, it may be suggested that the matter of husband-wife transfers is not sufficiently important to cause excitement. Professor Westfall has aptly pointed out that in 1966 gifts between spouses amounted to less than eight per cent of the aggregate value of gifts reported that year, and that almost one half of these transfers were fully covered by the gift tax marital deduction.³³ Even conceding that a number of gifts were unreported, perhaps the Treasury could better devote its energies to solving problems of greater magnitude.

Failure to remove the present fifty per cent limit, of course, would leave unresolved the discrimination against taxpayers who do not live in community property states. This problem cannot be effectively dealt with except by adopting an unlimited deduction for lifetime gifts. Professor Westfall has nevertheless suggested that "allowing unrestricted deathtime splitting of transfers by both the decedent and the surviving spouse" would be a possible solution.³⁴ But it is difficult to see how deathtime gift-splitting by itself would accomplish much since the limited deduction would still be operative for inter vivos transfers. Perhaps the best answer is to suggest that the inequality is largely theoretical, and that, in reality, few persons are seriously affected by it. It would be preferable to tolerate isolated instances of unequal treatment than to move to the unlimited deduction for all transfers between spouses, both inter vivos and at death.

(1970). This conclusion is consistent with INT. REV. CODE of 1954, § 677(b), which imposes a tax on the grantor of a trust to the extent that income is applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain. The use of trust income, for example, to discharge an obligation of the grantor to support his wife is regarded as the equivalent of the reservation of income by the grantor. *First Natl. Bank v. United States*, 211 F. Supp. 403 (N.D. Ala. 1962) (estate tax case).

32. For example, in *Rasmussen v. Oshkosh Savings & Loan Assn.*, 35 Wis. 2d 605, 151 N.W.2d 730 (1967), the husband had customarily turned over his weekly paycheck to his wife so that she could run the household and pay the bills. Upon the wife's death, the issue arose whether the wife's estate or the husband was entitled to the surplus household funds that had accumulated. The court held that the husband was the owner of the surplus on the ground that "there was a failure to show by clear and convincing evidence that a gift . . . was intended." 35 Wis. 2d at 612-13, 151 N.W. 2d at 734. Apparently the parties had conceded that no gift was made of the sums actually expended in running the household. *See also* *Hooker v. Commissioner*, 174 F.2d 863 (5th Cir. 1949); *Edward B. McLean*, 11 T.C. 543 (1948); *Herbert Jones*, 1 T.C. 1207 (1943). *But cf.* *Meyer's Estate v. Commissioner*, 110 F.2d 367 (2d Cir.), *cert. denied*, 310 U.S. 651 (1940) (estate tax case); *Robert M. McKeown*, 25 T.C. 697 (1956); *Paul Rosenthal*, 17 T.C. 1047 (1951), *revd. on other grounds*, 205 F.2d 505 (2d Cir. 1953).

33. Westfall, *supra* note 31, at 998.

34. *Id.* at 999.

C. *Gift-Splitting*

Under present law, an inter vivos gift made by a taxpayer to any person other than his spouse may be treated for gift tax purposes as if made one half by him and one half by his spouse.³⁵ This device, which enables a donor effectively to double the amount of his annual exclusion and specific exemption, is called "gift-splitting." No gift-splitting is currently permitted for transfers made by a surviving spouse after the death of the decedent spouse.³⁶ The Treasury proposes that a husband and wife be allowed to split gifts made to third persons during their joint lifetimes on any proportional basis consented to by the nondonor spouse; splitting of transfers at death would also be permitted by allowing the surviving spouse or her personal representative to treat the transfer of any portion of the decedent's estate as a transfer by her.³⁷

By extending gift-splitting to transfers made at death, post-mortem planning would be greatly facilitated. The respective estates of the spouses could be equalized for transfer tax purposes through elections made by the surviving spouse or the personal representative of the deceased spouse, regardless of the order of death or the size of the respective estates. In addition, the new rule would eliminate the need for resort to indirect methods to produce the effect of gift-splitting in testamentary transfers.³⁸ It is therefore urged that the Treasury's proposal be adopted.

D. *The Terminable-Interest Rule*

A terminable interest is one that will fail upon the occurrence or nonoccurrence of an event or contingency; and, generally speaking, any such interest that passes from the decedent to his surviving spouse will not qualify for the estate tax marital deduction.³⁹ The practical effect of this rule is to disallow any interspousal bequest that is designed to avoid the imposition of a tax upon the death of the survivor. The surviving spouse, therefore, must be given the

35. INT. REV. CODE of 1954, § 2513.

36. Treas. Reg. § 25.2513-1(b)(1) (1955) provides that consent by the decedent spouse's personal representative "is not effective with respect to gifts made by the surviving spouse during the portion of the calendar year that his spouse was deceased."

37. 1969 PROPOSALS, *supra* note 4, pt. 3, at 380. A particular transfer could be treated as having been made by the husband, by the wife, or by the husband and wife in whatever proportions the parties wish.

38. As Professor Casner has pointed out, the functional equivalent of gift-splitting may be indirectly accomplished in a deathtime transfer—e.g., *H* makes a marital-deduction gift to *W* by will, and *W* in turn gives the property to a beneficiary under *H*'s will. ALI, FEDERAL ESTATE & GIFT TAXATION 37-38 (Official Draft 1969).

39. INT. REV. CODE of 1954, § 2056(b).

equivalent of absolute ownership in order for the gift to qualify for the marital deduction in the decedent spouse's estate. For example, a devise by a husband to his wife of a life estate with a remainder over to their children would not qualify.⁴⁰ But if the wife is given the right to receive all the income along with an unqualified power to appoint the property, the gift to her qualifies for the marital deduction.⁴¹

The availability of the marital deduction turns on (1) whether it is the decedent or his spouse who has the power to name the remaindermen who will take after the wife's life estate; and, if the latter, (2) whether her power is general or special.⁴² Moreover, if the husband's estate contains nonqualified terminable interests, these are deemed to be used first in satisfying a general bequest to the wife, and the amount of the marital deduction is consequently reduced by the value of such interests.⁴³

In order to remedy this technicality-laden situation, the Treasury proposes that the restrictions upon the types of interests that qualify for the marital deduction be liberalized so that any gift or bequest to a spouse of the enjoyment, use, or income from property would be available for the marital deduction if the recipient spouse is willing to treat the subsequent termination of her interest as a taxable transfer by her.⁴⁴ Thus, a husband could make adequate provision for his wife, without losing the benefit of the marital deduction, by creating a testamentary trust that did not give her the power to divert the principal away from his children. For example, assume that *H*'s will sets up a trust, income payable to *W* for life or until she may remarry, remainder to *H*'s children, and with no power in *W* to change the devolution of the property. The income interest given to *W* would qualify for the marital deduction in *H*'s estate under the proposed change. Upon termination of *W*'s interest, either by death or remarriage, she would be deemed to have made a transfer and the property would be taxed at that time. In other words, no transfer tax would be exacted at *H*'s death; the tax would be imposed only at the termination of *W*'s limited interest, and that termination would be taxed as a transfer made by her. The operation

40. Treas. Reg. § 20.2056(b)-1(g), example (1) (1955).

41. INT. REV. CODE of 1954, § 2056(b)(5). The property would be included in the wife's estate for estate tax purposes. INT. REV. CODE of 1954, § 2041.

42. A general power is one that a donee may exercise in favor of herself, her estate, or either. INT. REV. CODE of 1954, § 2056(b)(5).

43. INT. REV. CODE of 1954, § 2056(b)(2). This reduction may be prevented by a provision in the will that only qualified assets shall be used to satisfy gifts to the spouse. Treas. Reg. § 20.2056(b)-2(d) (1955).

44. 1969 PROPOSALS, *supra* note 4, pt. 3, at 358, 360, 377-78.

of the new rule, of course, would have the effect of taxing *W* on the assumed "transfer" of assets not controlled by her, but which in fact pass to the predetermined class of remaindermen under *H*'s will. Since it would be inequitable to subject *W*'s other assets to the payment of taxes on this hypothetical transfer by her, the tax would be collectible only out of the property that was subject to the marital deduction.⁴⁵

The elimination of the terminable-interest rule can only be seen as a positive gain. At best this rule is made up of highly technical requirements that not only produce much litigation but often frustrate good-faith efforts to meet its demands. It would be a great advantage to the donor to be able to obtain the marital deduction without placing the control of the property in the hands of the donee spouse. The area of qualified marital-deduction gifts would be tremendously expanded by the adoption of the new proposal, and wiser estate planning would result.

E. *Waiver of the Marital Deduction*

The Treasury's final recommendation concerning the marital deduction is based on the assumption that "spouses should be given the power to determine the extent to which they wish the marital deduction to apply, and thus the extent to which the transferred property will be subject to tax upon subsequent disposition by the transferee spouse."⁴⁶ The present Code does not expressly authorize the donee spouse to elect immediately to pay, at the time of the transfer to her, the tax on a gift that qualifies for the marital deduction, and thereby to eliminate taxation when she subsequently transfers the property to others. Failure to claim the marital deduction at the time of the donor spouse's death will not reduce the tax on the donee spouse's estate.

The Treasury's proposal, in effect, would permit a waiver of the marital deduction in whole or in part, as the spouses may determine. If the husband's estate has paid the full tax on a marital-deduction gift to his wife, this payment would eliminate the tax on that prop-

45. The amount subject to taxation would be the value of the property at the time the transfer by the donee spouse is deemed to occur. When the transfer occurs at the surviving spouse's death, the tax attributable to such property would be the amount by which the total tax at death exceeds the tax that otherwise would have been payable if the property had not been included in the donee's estate. When the transfer occurs during the donee's life, the tax would be the pro rata portion of the entire tax payable on all transfers during the same period. When the income interest is subject to a power in the trustee to invade the corpus for the benefit of others, any such payments from the corpus would be treated as transfers by the donee spouse at the time such payments are made. See 1969 PROPOSALS, *supra* note 4, pt. 3, at 378.

46. 1969 PROPOSALS, *supra* note 4, pt. 3, at 358.

erty when it subsequently passes to others at her death. Clearly, this waiver rule would give greater flexibility to post-death planning, particularly in situations in which it would be preferable to have the gift taxed at the time of its making rather than at the death of the recipient spouse.

What is overlooked, however, is the fact that the husband may accomplish this result under present law by making a gift to his wife of an interest that does not qualify for the marital deduction. This course of action insures that the gift is taxed in his estate and not in that of his wife. Even if the terminable-interest rule were abolished, a gift not subject to the marital deduction could still be accomplished by giving the wife something less than the current enjoyment, use, or income from the property.⁴⁷

Under the proposal, in order for marital-deduction property to escape taxation at the wife's death it would be necessary to trace the assets in her estate back to property that previously had been taxed in the husband's estate. The burden would be on the widow's personal representative to identify such property as previously taxed marital-deduction property. This tracing would appear to be an insuperable task when the interest is given to her outright; and even in the case of a trust, there possibly would be inordinate delay and litigation. Based on the difficulty of tracing marital-deduction property, and on the present availability of alternatives, it may be concluded that this waiver proposal is ill-adapted to orderly and expeditious estate administration, and that it should not seriously be considered as part of a reform package.

II. THE UNIFIED TRANSFER TAX

Under existing law, inter vivos transfers by gift are subject to the gift tax with its exemptions, exclusions, and rate schedule. A lifetime exemption of 30,000 dollars is provided⁴⁸ in addition to annual exemptions of 3,000 dollars per donee⁴⁹ and special treatment accorded gifts made by husband and wife to third persons.⁵⁰ Transfers at death, however, are taxed under the estate tax, which has a separate structure. Among its distinctive features are the 60,000-dollar specific exemption,⁵¹ the complete exclusion of charitable gifts from taxation at death,⁵² and the estate tax marital deduction.⁵³ Vari-

47. 1969 PROPOSALS, *supra* note 4, pt. 3, at 377-78.

48. INT. REV. CODE of 1954, § 2521.

49. INT. REV. CODE of 1954, § 2503(b).

50. INT. REV. CODE of 1954, § 2513.

51. INT. REV. CODE of 1954, § 2052.

52. INT. REV. CODE of 1954, § 2055.

53. INT. REV. CODE of 1954, § 2056.

ous costs—such as funeral and administration expenses, and claims against the estate—are deductible in arriving at the net estate subject to tax.⁵⁴

This dual tax structure has spawned an elaborate set of rules concerning which tax should apply in a given situation, and there is much uncertainty on the question of “completeness” for gift tax purposes.⁵⁵ In addition, there are situations in which inter vivos transfers subject to gift taxation are also treated as transfers at death subject to estate taxation. Double-transfer taxation may occur when the donor transfers property during his lifetime but retains either an interest in the property or a possibility of recovering the property that is sufficient to make it includible in his estate.⁵⁶ For example, if the donor creates an inter vivos trust and reserves—either singly or in combination—the power to revoke or alter the arrangement⁵⁷ or the right to determine the ultimate devolution of either income or corpus,⁵⁸ or if he retains a life interest⁵⁹ or a reversionary interest that is valued at more than five per cent of the property,⁶⁰ then the value of the property subject to such powers, rights, or interests is includible in his estate. The same result would be reached if the transfer were treated as one made in contemplation of death, even though none of the above powers were present.⁶¹ When a transfer falls into this area of double taxation, the situation is partially alleviated by the allowance of a credit for the gift tax paid against the estate tax assessed.⁶² Also, the double scheme may lead to estate tax savings through the use of deliberate deathbed gifts, since only the net amount of such gifts is brought back into the estate and subjected to the estate tax. The estate tax levy would thus be reduced because the amount of the previously paid gift tax would not be present in the estate and hence would escape estate taxation.

The present law favors inter vivos gifts over death transfers. By taking advantage of the liberal exclusions from gift taxation, it is possible for a donor to make significant gifts during his lifetime with-

54. INT. REV. CODE of 1954, § 2053.

55. For discussions of the issue of completeness, see *Burnet v. Guggenheim*, 288 U.S. 280 (1933), and *Holtz's Estate v. Commissioner*, 38 T.C. 37 (1962).

56. The overlap between gift and estate taxes is treated in C. LOWNDES & R. KRAMER, *supra* note 31, at §§ 28.2-13.

57. INT. REV. CODE of 1954, § 2038.

58. INT. REV. CODE of 1954, § 2038.

59. INT. REV. CODE of 1954, § 2036.

60. INT. REV. CODE of 1954, § 2037.

61. Any transfer in contemplation of death, if made within three years of death, is included in the donor's estate and subjected to tax as if the gift had not been made. INT. REV. CODE of 1954, § 2035.

62. INT. REV. CODE of 1954, § 2012.

out the imposition of any gift tax at all. Even when some gift tax is payable, the rates are twenty-five per cent lower than estate tax rates.⁶³ Moreover, because the donor pays the gift tax out of his own funds after the transfer, the amount of the gift tax itself is not included in the tax base. In contrast, the estate tax is imposed on the value of the estate, which includes the amount used to pay the tax.

The total value of lifetime gifts is disregarded in determining the estate tax rate applicable to property transferred at death. Thus, a donor, by a combination of inter vivos gifts and transfers of property at death, may make optimal use of both sets of exemptions and receive the lowest possible rates in the respective rate schedules for the two taxes. A husband, for example, who during his life gave to his children 200,000 dollars of his 500,000-dollar taxable estate would have removed this amount from his estate and hence from the thirty-two per cent estate tax bracket; the gift tax on the amounts transferred inter vivos would have been computed at rates ranging from zero to 22½ per cent—the exact rate depending on the amount of other gifts, the annual exclusion, the lifetime exemptions, and the availability of gift-splitting with his wife. Moreover, any amount paid as gift tax would no longer be in the estate and therefore would not be includible in the estate tax base. The estate tax would then be computed after all deductions and exemptions had been taken into account.

The Treasury Department proposes to eliminate the distinction in tax treatment between lifetime and deathtime transfers by making the total tax burden the same, whether gifts are made inter vivos, at death, or by a combination of these two methods.⁶⁴ Estate and gift taxes would be combined into a unified transfer tax, subject to a single 60,000-dollar exemption plus a complete exemption for transfers between spouses. A single rate schedule would be applicable to the transfer, regardless of when it is made. The base of the unified tax would include the amount of tax paid on lifetime gifts in order to conform to the present method of taxing transfers at death.⁶⁵

The over-all 60,000-dollar exemption could be used against inter vivos or death transfers at the option of the donor. To the extent that this exemption is not used up during the taxpayer's lifetime, it would be applied against transfers at death. Retention of the 3,000-dollar

63. INT. REV. CODE of 1954, §§ 2001 (estate tax rates); 2502 (gift tax rates).

64. 1969 PROPOSALS, *supra* note 4, pt. 3, at 355.

65. This procedure is referred to as "grossing-up"—*i.e.*, including the amount of the tax in the amount of the gift upon which the tax is computed. The Treasury promises a simplified table to compute the grossed-up transfer. 1969 PROPOSALS, *supra* note 4, pt. 3, at 355.

annual exclusion per donee would continue to provide at least some incentive for making lifetime gifts. A transfer tax return would be filed for each calendar year in which gifts were made to any single donee in excess of the annual exclusion. Upon the death of the donor, a return would be filed if the total amount of transfers at death, when added to the sum of all lifetime gifts, amounted to more than 60,000 dollars. In other words, the tax rate applicable to transfers at death would be based upon the aggregate of previous lifetime transfers.

The additional revenues derived from the unified transfer tax⁶⁶ would permit a reduction of about twenty per cent from the present estate tax rates, presumably to be accomplished over a ten-year period.⁶⁷ The present credit allowed for state death taxes⁶⁸ would not be changed, but the credit for tax on prior transfers would, of course, be eliminated.

The integration of estate and gift taxes would undeniably accomplish the Treasury's stated objective of reducing the "inequitable and unwarranted preferences for lifetime gifts, as opposed to transfers at death."⁶⁹ The time of making the transfer would be immaterial because the unified-tax rate schedule would be applicable to all transfers, whether they be inter vivos or testamentary. The proposal would also do away with the problem of gifts made in contemplation of death⁷⁰ and the litigation that such transfers have engendered concerning the motives of the deceased donor.⁷¹ It

66. The increased revenue yield stems from the fact that the single \$60,000 exemption is less than the total \$90,000 combined gift tax and estate tax exemptions allowed under INT. REV. CODE of 1954, §§ 2052, 2521. The projected increase is estimated at 7%. ALI, *FEDERAL ESTATE & GIFT TAXATION* 78 (Official Draft 1969).

67. The top estate tax bracket, now 77% (INT. REV. CODE of 1954, § 2001), would be reduced to around 65%. Other tax brackets would be reduced about 20%, except for the lowest bracket of 3%. In general, the progression in the lower brackets of the present estate and gift tax rates would be reduced, and the progression in the upper brackets would be increased. 1969 PROPOSALS, *supra* note 4, pt. 3, at 355-56.

68. INT. REV. CODE of 1954, § 2011.

69. 1969 PROPOSALS, *supra* note 4, pt. 3, at 351.

70. The present contemplation-of-death rule would, however, still be applied to transfers of ownership of an insurance policy within three years prior to the insured's death. 1969 PROPOSALS, *supra* note 4, pt. 3, at 362.

71. According to the leading case of *United States v. Wells*, 283 U.S. 102 (1931), the ultimate test for determining whether a transfer is in contemplation of death is the mental attitude of the donor—*i.e.*, whether the thought of death was the dominant motive prompting the transfer or whether the gift was primarily actuated by motives associated with life. These criteria are incorporated in Treas. Reg. § 20.2035-1(c) (1955). The donor's advanced age or ill health (*Estate of Mabel Lloyd Ridgely v. United States*, 67-2 U.S. Tax Cas. ¶ 12,481 (Ct. Cl. 1967), in which a gift of a summer cottage was made by an eighty-eight-year-old donor in ill health for the past five years); the purpose of reducing estate taxes (*Fatler v. Usry*, 269 F. Supp. 582 (E.D. La. 1967), in which gifts were made on the advice of an attorney to save estate taxes, although the donees were not in need of funds and there was no prior gift pattern); the size of the

would also eliminate, of course, the overlap between estate and gift taxes and the computation of the gift tax credit under existing law.⁷²

No one can seriously fault the proposal in terms of its accomplishment of these needed changes. Since persons who transfer equal amounts of wealth would pay equal taxes, a potential donor would be free to decide, apart from tax consequences, whether to give away property during his lifetime or to hold it until death. It would appear, however, that the major defects in the present dual system could be cured by means short of substituting a completely new and different tax structure. Present statutes could be amended to remove most of the undesirable features. If it is desired to reduce the tax incentives for inter vivos gifts, the gift tax rate structure could be revised to eliminate the differential, and mutually exclusive lines could be drawn between complete and incomplete gifts for purposes of both taxes.⁷³ A "grossing-up" provision could be adopted to include the gift tax as well as the gift itself in the amount of the transfer. It would be simpler to accomplish this grossing-up at the time the gift is made instead of at death as the Treasury proposes. A delayed grossing-up at death, by adding to the taxable estate the amount of

gift in relation to the donor's estate (*Estate of Robert W. Hite*, 49 T.C. 580 (1968), in which the court considered the fact that the gifts were quite large in relation to what the donor retained, along with other factors such as age, ill health, and the absence of a long-established policy of giving); and the purpose of utilizing the transfer as a will substitute (*Yeazel v. Coyle*, 68-1 U.S. Tax Cas. ¶ 12,524 (N.D. Ill. 1968), in which the fact that the donor was a trustee of a gift of stock in trust, with the duration of the trust set well beyond his life expectancy, indicated a motive to make a gift as part of a testamentary plan) are factors that tend to indicate that the gift was made in contemplation of death.

On the other hand, a purpose of reducing income taxes (*Carlson v. United States*, 61-1 U.S. Tax Cas. ¶ 12,016 (D. Minn. 1960), in which the dominant purpose of a gift made by a donor after suffering a serious heart attack was held to involve income tax considerations); a pattern of similar gifts in the past (*Estate of Errett Ross Crum*, 28 CCH Tax Ct. Mem. 946 (1969), in which a seventy-seven-year-old donor had a fixed-gift plan of affording limited business and financial assistance to donees); or the fact that the gift was made for a particular purpose ordinarily connected with life (*Estate of John Baxter v. United States*, 68-2 U.S. Tax Cas. ¶ 12,546 (E.D. Ark. 1968), in which the donor desired to reward his sons who had assumed managerial responsibilities and to provide for special current financial needs), tend to show that a transfer was not made in contemplation of death.

The artificiality and unpredictability of these nebulous criteria has led one study to assert that "the idea of weighing motives as though they were blocks of ice borders on the fantastic." C. LOWNDES & R. KRAMER, *supra* note 31, at 68. A collection of contemplation-of-death cases decided during the last decade is contained in 1 A. CASNER, ESTATE PLANNING 303-08 (Supp. 1970).

72. The credit provisions of existing law would be retained in the case of property now held by a surviving spouse and taxed to the decedent spouse's estate. The maximum period of extension for such credit would be limited to ten years. 1969 PROPOSALS, *supra* note 4, pt. 3, at 371.

73. Professor Casner urges the adoption of a hard-to-complete-gift rule if the dual system is retained. See ALL, FEDERAL ESTATE & GIFT TAXATION 42-43 (Official Draft 1969).

tax paid on lifetime gifts, would result in administrative headaches and possibly could give rise to problems concerning the apportionment of the tax between inter vivos and testamentary donees. The "simplified tables" promised by the Treasury⁷⁴ to accomplish grossing-up would be anything but simple if previous experience affords a basis for judgment.

In addition, the unified-tax proposal would place on the executor the onerous burden of determining the extent to which the decedent had made taxable transfers during his lifetime. To avoid possible personal liability, the executor would be required to show lack of knowledge of tax liability, to make written request to the Internal Revenue Service for copies of the decedent's transfer tax returns, and to show that he has examined such returns.⁷⁵ Moreover, it is unrealistic to assume that the ordinary taxpayer would keep the detailed records of lifetime gifts that would be required by the integrated system.

Another problem would be the transitional period during which the new rules would govern transfers made after their enactment and the old dual system would apply to gifts previously made.⁷⁶ The confusion of shifting to an untried system would be magnified if during a lengthy interim period the old system continued to be operative.

Although the Treasury proposes that the new unified rate schedule be lowered because a higher revenue yield will automatically result from the institution of an integrated system, there is no assurance that Congress would reduce the rates or maintain any rate reduction in the face of intense current-revenue needs. Indeed, Professor Westfall urges that transfer taxes should be utilized to produce more revenue, and he therefore opposes removal of the present higher-bracket rates.⁷⁷ But despite the theoretical soundness of this scheme, Professor Westfall seems to ignore the need for public acceptance of such a proposal. Historically, estate and gift taxes have not been regarded principally as revenue-raising devices but rather as measures for social control that prevent the undue accumulation of wealth by breaking up great family fortunes.⁷⁸ Professor Casner

74. See note 65 *supra*.

75. 1969 PROPOSALS, *supra* note 4, pt. 3, at 372. The personal representative, after forty months have elapsed from the time of the decedent's death, may not be held personally liable for death transfer tax deficiencies of which he had no actual knowledge. *Id.* at 371-72.

76. See note 72 *supra*.

77. Westfall, *supra* note 31, at 990.

78. An elaboration of the theory and philosophy of federal estate and gift taxation

flatly states that "support for the unified transfer tax rests solidly on the assumption that the amount of revenue collected from this source is to be approximately the same whether we retain a dual system or shift to a unified transfer tax."⁷⁹ The likelihood that higher revenue collections actually may result gives proper cause for alarm.⁸⁰

The unified transfer tax is keyed to the unlimited estate tax marital-deduction proposal discussed earlier.⁸¹ It would not work well with the present fifty per cent marital deduction because a donor who makes substantial lifetime gifts to his children, for instance, would build up the tax rate on his death transfers to the point that the surviving spouse might not receive an adequate amount after taxes.⁸² The writer's opposition to the unlimited marital deduction provides another reason for opposition to the integrated transfer tax.

Under the proposed system, the present credit for state death taxes under section 2011 of the Code would not be changed.⁸³ Since the credit would be allowed only on property transferred at death and therefore would exclude lifetime transfers, state death taxes would in many cases greatly exceed the allowable credit. Discrepancies between federal and state law may result in the same transfer being treated as an inter vivos gift under the former and as a death transfer under the latter. There also would be problems in calculating the state death tax credit—*i. e.*, whether the credit should be computed on the rates applicable to the value of the property transferred at death or on the rates actually applied to the death transfer.⁸⁴ The two rates would not be the same because the federal government's death tax rates would be determined in light of lifetime transfers as well as death transfers.

It may also be objected that the integrated transfer tax would discourage inter vivos gifts. The desirability of an incentive for life-

is contained in B. BITTKER, *FEDERAL INCOME ESTATE & GIFT TAXATION* 987-1001 (3d ed. 1964).

79. ALLI, *FEDERAL ESTATE & GIFT TAX PROJECT 62* (Proposed Draft April 30, 1968) (statement omitted from the official draft). The American Law Institute took no position on the choice between a dual or a unified tax system. ALLI, *FEDERAL ESTATE & GIFT TAXATION 63* (Official Draft 1969).

80. See *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3994 (testimony of Mr. George Craven).

81. See text accompanying notes 19-26 *supra*.

82. As pointed out by Professor Casner, "[t]he 100% marital deduction for death-time transfers is almost essential where a unified tax is involved." ALLI, *FEDERAL ESTATE & GIFT TAXATION 35* (Official Draft 1969).

83. 1969 PROPOSALS, *supra* note 4, pt. 3, at 368.

84. *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3993-94 (testimony of Mr. George Craven).

time giving is open to debate,⁸⁵ but in practical effect the gifts that would most often be deterred by the removal of the existing incentive would be those transferred from parents to their children and grandchildren.⁸⁶ The writer believes that it is socially desirable to encourage benefactions of this type, although it is conceded that the proposed changes would not seriously affect the economy or investment policy.

It appears, therefore, that the troublesome areas in the Treasury's proposal overbalance its positive advantages. Any benefits that might accrue would not be worth their cost in terms of the resulting administrative confusion and of the awesome complexity of shifting to a drastically different and untried system. The dual tax structure is viable and the major reforms needed can be effected within its present framework.⁸⁷

III. TAXATION OF CAPITAL GAINS AT DEATH

A major criticism of our estate tax laws has always been that they place a premium on passing wealth to the next generation in the form of appreciated property.⁸⁸ Property passing at death receives a "stepped-up" basis in the hands of the beneficiary equal to its fair market value at the time of the decedent's death,⁸⁹ or one year thereafter.⁹⁰ This new basis is not dependent upon the payment of any income tax by the decedent, his estate, or the ultimate beneficiaries.⁹¹ The Treasury Department estimates that this stepped-up basis re-

85. Widely varying views on the policy aspects are reported in *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3982 (testimony of Mr. Jerome Kurtz), 3992 (testimony of Mr. George Craven), 4005 (testimony of Mr. Robert F. Spindell), 4036 (testimony of Mr. James B. Lewis), 4081 (testimony of Professor Alan N. Polasky).

86. In fairness it should be pointed out that incentives still would exist because of the annual exclusions and the gift-splitting opportunities. Income tax incentives for establishing short-term trusts (INT. REV. CODE of 1954, § 673) and present-interest trusts for minors (INT. REV. CODE of 1954, § 2503(c)) would be unaffected by the proposed change.

87. Professor Polasky, although a proponent of the unified tax, nevertheless admitted that "it is still possible to accomplish significant reforms through a patching of the existing dual transfer tax provisions." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4082 (testimony of Professor Alan N. Polasky).

88. See, e.g., Hanrahan, *A Proposal for Constructive Realization of Gains and Losses on Transfers of Property by Gift and at Death*, 15 KAN. L. REV. 133 (1966); Heckerling, *The Death of the "Stepped-Up" Basis at Death*, 37 S. CAL. L. REV. 247 (1964); Note, *Taxation of Capital Gains at Death*, 38 GEO. WASH. L. REV. 138 (1969).

89. INT. REV. CODE of 1954, § 1014(a).

90. The executor may elect to choose the fair market value at date of death or one year thereafter. INT. REV. CODE of 1954, § 2032(a).

91. Compare the stepped-up basis given property passing at death with the treatment afforded inter vivos gifts, in which the donee takes the donor's basis, thus postponing rather than forgiving the appreciation accruing before the date of the gift. INT. REV. CODE of 1954, § 1015.

sults in the annual escape from taxation of about 15 billion dollars of capital gains.⁹² In addition to the revenue loss and the matter of unequal treatment of taxpayers with equal ability to pay, there is also concern over the adverse economic "lock-in" effect produced by the incentive to hold appreciated assets until death.⁹³ The Treasury asserts that "[t]his freezing of investment positions deprives the economy of the fruits of an unencumbered flow of capital toward areas of enterprise promising larger rewards."⁹⁴

The immunity of unrealized capital gains from taxation operates to the prejudice of the taxpayer whose estate has been accumulated from salary or other income that has been taxed as it is earned or accrued, as opposed to the person whose estate has been enriched principally through the appreciation of assets held until death. Moreover, this opportunity for tax avoidance is directly proportionate to the wealth of the taxpayer and the resulting lack of economic compulsion to dispose of capital assets. Assume, for example, that *A* and *B* each purchase 100,000 dollars worth of stock that subsequently appreciates in value to 200,000 dollars. If *A* is forced by economic circumstances to sell the stock, he must, of course, pay a tax on the 100,000 dollars of capital gain,⁹⁵ whereas *B*—who can afford to hold the shares until his death because he possesses independent resources—and his legatee will pay no income tax at all on that gain.⁹⁶

In an effort to alleviate this disparate tax treatment, the Treasury proposes that appreciated capital assets held at death be treated as if the decedent had sold such property just prior to death, with the gain being taxed in the final income tax return filed by his executor.⁹⁷ All appreciation would be accorded long-term capital gains treatment regardless of the holding period.⁹⁸ The tax levied on the appreciation of capital assets would be allowed as a deduction in

92. 1969 PROPOSALS, *supra* note 4, pt. 3, at 331.

93. Beazer, *Expected Income Changes and the Lock-In Effect of the Capital Gains Tax*, 19 NATL. TAX J. 308 (1966); Holt & Shelton, *The Lock-In Effect of the Capital Gains Tax*, 15 NATL. TAX J. 337 (1962).

94. 1969 PROPOSALS, *supra* note 4, pt. 3, at 334. Faced with the reward of total forgiveness of the tax on appreciation at death, it is reasonable to assume that older taxpayers in particular would be deterred from selling their appreciated assets.

95. INT. REV. CODE of 1954, § 1202.

96. In the example, however, the amount of income tax that *A* paid as a result of the capital gain realized would not be included in his estate at death. On the other hand, the full appreciated fair market value of *B*'s stock would be included in his estate. If *B*'s estate has a high marginal rate, a substantial portion—up to 77%—of the amount which he did not pay in income tax on the capital gains would be consumed by the estate tax. Thus, the inequity involved, though not insignificant, is not as great as it appears at first blush.

97. 1969 PROPOSALS, *supra* note 4, pt. 3, at 334-35.

98. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335-36, 340.

favor of the estate, and thus would not be included in the decedent's estate for transfer tax purposes.⁹⁹ The property would then assume a stepped-up basis equal to its fair market value at the date of death,¹⁰⁰ as it does under the present Code.¹⁰¹ Gains would be offset against unrealized losses before computing the tax, and net unrealized losses could be carried back against ordinary income for the three taxable years prior to the decedent's death.¹⁰² Moreover, if the property decreased in value after the decedent's death, the transferee could claim a capital loss when he later disposed of it.¹⁰³ Appreciation on personal household items, except for items exceeding 1,000 dollars in value, would be excluded from taxable income.¹⁰⁴

A number of liberalizing provisions have been included in the proposal in an effort to make the new tax scheme work more fairly and to relieve the hardship caused by the bunching of taxes at death. The most important of these relief measures is the exemption from taxation of appreciation that has occurred prior to the enactment of the new law.¹⁰⁵ In effect a special new basis would be created, based on fair market value at the time the new law takes effect, and the new tax would be levied only on future appreciation. Thus, a person dying within one year after enactment of the new proposal would be taxed only on gains that accrued during that year.

The proposal would also establish a minimum basis of 60,000 dollars for all taxpayers;¹⁰⁶ as a result, there would be no income tax at all on the appreciation if the total value of assets transferred at death were less than this amount. The appreciation on all property with a total fair market value of less than 60,000 dollars would be exempt, and only the gain on property having a total basis in excess of 60,000 dollars would be taxed.¹⁰⁷

In addition, no tax would be imposed on the appreciation of

99. 1969 PROPOSALS, *supra* note 4, pt. 3, at 360. This deduction would reduce the decedent's taxable estate by the same amount it would have been reduced if the capital gains tax had been paid after an inter vivos sale. See note 96 *supra*.

100. 1969 PROPOSALS, *supra* note 4, pt. 3, at 334-45.

101. INT. REV. CODE of 1954, § 1014(a).

102. 1969 PROPOSALS, *supra* note 4, pt. 3, at 336, 341.

103. 1969 PROPOSALS, *supra* note 4, pt. 3, at 333.

104. 1969 PROPOSALS, *supra* note 4, pt. 3, at 337, 342-43. This exception would be meaningless in most cases since most household items, with the exception of antiques and oriental rugs, experience a rapid deterioration in value.

105. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335, 340, 351.

106. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335.

107. For example, if a decedent died owning assets with a cost basis of \$30,000 and a fair market value at the date of death of \$60,000, there would be no capital gains tax on the \$30,000 appreciation. If the assets had a fair market value of \$80,000 at the time of death, the taxable capital gain on the \$50,000 appreciation would be \$20,000.

assets given by one spouse to the other, regardless of the amount of the gift or the increase in value. The transferee spouse, however, would not receive a new basis, but would carry over the basis of the decedent.¹⁰⁸ Similarly, the gain on assets transferred to charities would be exempted from tax, and the decedent's basis would be carried over to the transferee.¹⁰⁹ Present rules for payment of taxes due at death would be liberalized, and these new rules would apply to capital gains taxes as well as to transfer taxes.¹¹⁰

These innovations in capital gains treatment are the most important and most controversial recommendations in the reform package. Taxing these presently untaxed capital gains would produce an estimated 2 billion dollars in revenue each year.¹¹¹ The Treasury's position is that this increased revenue would merely offset the revenue loss stemming from the reduction in rates under the unified transfer tax and from the unlimited marital-deduction reforms.¹¹² Since, as noted above, the writer opposes the unified transfer tax¹¹³ and the removal of the percentage limitation on the marital deduction,¹¹⁴ he believes that there should be no revenue loss and hence that an offsetting tax on unrealized capital gains would be unnecessary.

Apart from the revenue question, however, there are independently valid reasons that make the Treasury's proposal untenable. It should be pointed out that the present recommendation is basically a revival of an earlier proposal to tax capital gains at death made in President Kennedy's tax message to Congress in 1963.¹¹⁵ The

108. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335, 337.

109. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335, 337.

110. The present Code allows ten-year installment payments of the estate tax when 35% of the estate consists of an interest in a closely held business, or when the payment of the tax would create "undue hardship." INT. REV. CODE of 1954, §§ 6161, 6166. These sections would be expanded to permit installment payment of the gains tax. Also, stock redemption without payment of the tax would be available (*see* INT. REV. CODE of 1954, § 303). 1969 PROPOSALS, *supra* note 4, pt. 3, at 347, 404, 406-08.

111. Berkowitz, *Estate and Gift Tax Reform—An Overview*, 109 TRUSTS & ESTATES 12 (1970). *See also* Eilbott, *Revenue Gain from Taxation of Decedent's Unrealized Capital Gains*, 22 NATL. TAX J. 506 (1969).

112. The Treasury asserts that "on the average the total taxes paid on death under these proposals will be substantially the same as is paid for estate taxes under present law." 1969 PROPOSALS, *supra* note 4, pt. 3, at 336.

One critic fears that a subsequent Congress will enact rate increases and that "taxpayers may be lulled into a false sense of security by the assertions of the proponents that the effect of the proposal, taken as a unit, will result in no overall tax increase." Dane, *Federal Estate and Gift Tax Reform: Some Arguments Against the Treasury Proposals*, 108 TRUSTS & ESTATES 782, 843 (1969). *See also* text accompanying notes 77-80 *supra*.

113. *See* notes 48-87 *supra* and accompanying text.

114. *See* notes 19-34 *supra* and accompanying text.

115. *Hearings on the President's 1963 Tax Message Before the House Comm. on*

proposal was rejected at that time,¹¹⁶ and significantly was not included in the American Law Institute study prepared by Professor Casner.¹¹⁷

The principal objection to a tax on the appreciation of unsold property at death is that it would create a deterrent to wealth accumulation by imposing an onerous burden on the decedent's estate, particularly when a closely held family business or other non-marketable asset is involved.¹¹⁸ Such a tax could necessitate the dissolution of many independent businesses, thus precluding their transfer as going concerns from one generation to another. Planning for estate liquidity to meet the augmented tax burden at death would take on greatly increased proportions,¹¹⁹ especially in the case of an owner who, because of age or physical condition, can obtain additional life insurance only at greatly increased cost or not at all. An owner approaching retirement would be forced to sell his business and convert it into more liquid assets, and this practice would result in increased mergers and concentration of economic power in the hands of large companies. Because the capital gains tax would in many instances be larger than the transfer tax, the greatest difficulties would fall on estates least able to raise cash without a forced sale of assets.

Furthermore, the executor would be burdened with the difficult task of attempting to ascertain the decedent's cost or other basis for various items of property that were acquired many years before death. Presumably, if this basis could not be determined, the entire value of the property in excess of the 60,000-dollar exemption would be considered capital gain.

The Treasury's proposed forgiveness of the new tax on appreciation in interspousal transfers, with a carry-over of the decedent's basis,¹²⁰ would be of little help in solving the problem of transferring

Ways and Means, 88th Cong., 1st Sess. 24, 128-37 (1963). A comparison of the similarities and differences between the 1963 proposal and the Treasury's current recommendation is contained in Note, *Taxation of Capital Gains at Death*, 38 GEO. WASH. L. REV. 138, 141-47 (1969).

116. See Heckerling, *supra* note 88.

117. ALI, *FEDERAL ESTATE & GIFT TAXATION* (Official Draft 1969).

118. For an elaboration of these objections, see *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3970-75 (testimony of Mr. Samuel F. Foosoner), 4002-04 (testimony of Mr. Robert F. Spindell), 4086-87 (testimony of Mr. John C. Davis, III), 4096-97 (testimony of Mr. Henry Bison, Jr.).

119. See Anthoine, *Tax Reduction and Reform: A Lawyer's View*, 63 COLUM. L. REV. 808, 815-16 (1963); Koudelis, *Some Observations on the Proposed Capital Gains Reforms*, 37 TEMP. L.Q. 289, 316 (1964); Wormser, *The Case Against a Capital Gains Tax at Death*, 51 A.B.A.J. 851 (1965).

120. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335, 337.

a closely held enterprise from one generation to the next. Since most surviving widows would not be capable of managing a business, an interspousal disposition generally would not be wise. Assuming, however, that the husband did leave his business to his wife, the entire gain computed with reference to the husband's basis would be taxed when she later sold the enterprise or died owning it. In other words, the tax is not forgiven in interspousal transfers, but is merely postponed until a later time—when it could be greater and more burdensome to pay.

The Treasury's recommendation that allows payment of the tax in installments over a ten-year period¹²¹ has a beguiling ring of liberality that is more illusory than real. Upon the death of the owner of a small business, there is generally a period of adjustment carrying with it lower profit margins while the new management acquires needed experience. If there has been significant appreciation of the capital assets of the business, it is unrealistic to assume that the new owners would be able to pay the tax in installments, plus interest on the unpaid balance, along with current business and personal income taxes.¹²² The chances are great that there would be inadequate collateral to secure the payment of the increased tax burden, and thus the government would secure a lien on the assets of the business.¹²³ Such a lien would undoubtedly paralyze financial operations by destroying the company's borrowing capacity.¹²⁴

In addition, the Treasury's proposal would require that the District Director be given

ninety days notice of sales of corporate assets of a value greater than \$1000 (other than sales in the ordinary course of business), to notice of the declaration of a dividend, and to notice of any other action calculated to have a substantial effect upon the liquidation value of a firm, including changes in the salaries of officers or directors. Failure to furnish such notice will constitute a default, which will authorize the District Director to enforce his security interests.¹²⁵

One critic concluded, in testimony before the House Ways and

121. See note 110 *supra*.

122. Mr. John C. Davis, III, Chairman of the Board, National Association of Wholesalers, depicted the dire consequences that might conceivably ensue over a projected twenty-six-year period to an average wholesale firm if the Treasury's proposals were adopted. See *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4087-89 (testimony of Mr. John C. Davis, III).

123. 1969 PROPOSALS, *supra* note 4, pt. 3, at 405.

124. One critic has termed the adequate-collateral requirement as "[t]he final nail in the coffin of the small business." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4090 (testimony of Mr. John C. Davis, III).

125. 1969 PROPOSALS, *supra* note 4, pt. 3, at 405.

Means Committee, that "it is a certainty that the District Director will be either running or liquidating every small business within his district if this proposal is enacted."¹²⁶ It would be intolerable to have government officials in effect sitting on a company's board of directors with a de facto veto power over management decisions concerning expenditures for capital improvements or additions to inventory.

Another of the Treasury's proposals would allow earnings of the business accumulated after death to be used for stock redemption of the decedent's holdings for the purpose of paying the unappreciated capital gains tax without payment of an accumulated-earnings tax.¹²⁷ This proposal would, of course, afford a partial measure of relief for a business that is able to accumulate sufficient post-death earnings to make the redemption. However, for the many companies not in this favorable economic condition following the decedent's death and therefore unable to use the stock redemption advantage, this proposal would be unavailing and of no practical consequence.

Since assumed gain in the form of appreciation of capital assets may never be realized by the legatee, the Treasury's proposals in effect would impose a tax on property solely because of its ownership. Doubts have been expressed whether, in the absence of a sale or exchange, unrealized appreciation can properly be considered income within the meaning of the sixteenth amendment to the Constitution.¹²⁸ But even though such a tax might be unwise when viewed from a policy perspective,¹²⁹ there probably is little chance for a successful attack on its constitutionality. Cases decided by the Supreme Court since *Eisner v. Macomber*¹³⁰ indicate that there is no constitutional limitation on the power of Congress to determine that

126. *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4090 (testimony of Mr. John C. Davis, III).

127. 1969 PROPOSALS, *supra* note 4, pt. 3, at 407. Section 906 of the Tax Reform Act of 1969, P.L. No. 91-172, 83 Stat. 715, amended INT. REV. CODE of 1954, § 537, to provide that an accumulation of earnings by a corporation to fund a redemption made in order to pay death taxes is not subject to the accumulated-earnings tax.

128. A challenge to the constitutionality of an income tax on unrealized appreciation would be based on *Eisner v. Macomber*, 252 U.S. 189 (1920), in which the Court held in substance that a gain derived from capital must be severed and realized by the taxpayer before it can be considered income. See generally Del Cotto, *The Trust Annuity as Income: The Constitutional Problem of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231 (1968); Roehner & Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953).

129. The principal policy objections center around the undesirable economic effect of the proposed tax in discouraging the transmission at death of a successful income-taxpaying company, thus "undermining the very stability of American business enterprise." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3971 (testimony of Mr. Samuel J. Foosaner).

130. 252 U.S. 189 (1920). See note 128 *supra*.

the devolution of appreciated assets at death constitutes an appropriate taxable event.¹³¹

Despite the apparent constitutionality of taxing unrealized capital appreciation at death, the many defects in the Treasury's proposals, which were pointed out above,¹³² strongly militate against their enactment. It is obvious, however, that something should be done to remedy the inequities produced by the immunity from taxation that such gains enjoy. The fact that assets are held until death rather than sold during the owner's lifetime should not change the tax impact on the property owner. On the other hand, no solution should be adopted that forces the sale or liquidation of a business at the death of the owner.¹³³ The Treasury's recommendation, although constitutional, creates more problems than it solves, and its drastic impact would doom countless estate plans to hopeless obsolescence. Thus, while there is a great need for remedial action, the Treasury's proposals do not provide the answer.

As a compromise solution, it is suggested that recipients assume a "carry-over" basis for all property passing at death so that the assets retain the same basis that they had in the hands of the decedent. By thus treating deathtime transfers in the same manner that inter vivos gifts are presently dealt with under the Code,¹³⁴ the "stepped-up" basis would be eliminated. The Treasury, it will be remembered, has recommended that this be done for interspousal transfers, with the recipient spouse carrying over the decedent's basis.¹³⁵ There is no reason why the same treatment should not be accorded to all transfers at death. The appreciation would, of course, ultimately be taxed when the property is later sold, but the effect would be less drastic than a capital gains tax at the time of death. The donees would benefit if they are in a lower income bracket than the decedent was when he died. In any event, the bunching of taxes at death would be eliminated, and the resulting burden on the business owner or farmer would be eased.

In fairness, however, it must be conceded that a carry-over basis would allow an indefinite postponement of the tax, and could give

131. The Supreme Court has refused, in a number of cases decided since 1940, to adhere to the definition of "gain" that was set out in *Eisner v. Macomber*. See, e.g., *United States v. Davis*, 370 U.S. 65 (1962); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Bruun*, 309 U.S. 461 (1940); *Helvering v. Eubank*, 311 U.S. 122 (1940).

132. See text accompanying notes 113-27 *supra*.

133. While the existing estate tax burden is already great enough to force some businesses into liquidation, the proposed unappreciated capital gains tax would greatly lengthen the fatality list.

134. INT. REV. CODE of 1954, § 1015(a).

135. 1969 PROPOSALS, *supra* note 4, pt. 3, at 335, 337.

rise to considerable difficulty in determining the decedent's basis in property held by him for a great many years. There would be less incentive for the donee to sell appreciated property, since his taxable gain would be computed on the decedent's basis. Thus, the existing "lock-in" problem would be extended for an indefinite period beyond the death of the original owner.¹³⁶ Moreover, it may be confidently anticipated that the ingenuity of tax planners would be exerted to discover a tax-free method of converting one asset into another.

Despite these deficiencies, the carry-over approach would be a clear improvement over both the present system and the Treasury's proposal, and equally important, its enactment would appear to be politically feasible. It also would be superior to the various other alternatives that have been suggested as solutions to the problem.¹³⁷

IV. GENERATION-SKIPPING TRANSFERS

A person with considerable wealth normally will desire to make gifts or bequests to his wife that qualify for the marital deduction, and gifts to his children and grandchildren that "skip generations" for tax purposes. Typically, these dispositions take the form of a marital-deduction trust and a residuary trust, the income from the latter being applied to the benefit of the family group for life, with a special power of appointment in the life beneficiaries exercisable in favor of the testator's grandchildren or issue.

The present tax structure creates an artificial incentive for the use of long-term generation-skipping trusts. The movement of property through successive holders of limited interests is not regarded as a transfer unless the income beneficiary is given the equivalent of outright ownership.¹³⁸ Thus, if the beneficiary has only a life estate

136. It should also be emphasized that any postponement of the tax would amount in substance to an interest-free loan to the taxpayer. Hanrahan, *A Proposal for Constructive Realization of Gains and Losses on Transfers of Property by Gift and at Death*, 15 KAN. L. REV. 133, 149 (1966).

137. One suggested alternative is the taxation of capital gains each year as ordinary income, whether realized or not. This solution would abolish the distinction in tax treatment between capital gains and ordinary income, and only the appreciation accruing in the year of death would be included in the decedent's final income tax return. See, e.g., Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 623-25 (1967). Another possible alternative is the "roll-over approach," which would defer until death the tax on net realized gains to the extent they are reinvested in other property held for the production of income. See Marshall & Crumley, *Reform Proposals for Taxation of Capital Gains: Some Alternate Suggestions*, 108 TRUST & ESTATES 871, 874-75 (1969). The difficulty with these approaches lies in the impossible administrative burdens produced by their inordinate complexity.

138. An interest that terminates at the death of the decedent is not owned by him at his death, unless he himself was the transferor. INT. REV. CODE of 1954, § 2036.

or other limited interest, no portion of the property is includible in his estate when he dies. By the use of special powers of appointment, the donor may leave the income beneficiary—for example, his daughter—in almost complete control of the property and at the same time avoid having the property regarded as in her taxable estate when she dies.¹³⁹ For example, if a father leaves property in trust, income to his son *A* for life, and then in trust for such of *A*'s children as *A* may by will appoint, the property is passed on to the second generation without additional transfer tax at *A*'s death. This succession of life income interests with limited powers of appointment can be carried on tax free as long as the Rule Against Perpetuities is not violated.¹⁴⁰

The Treasury has come up with a proposed substitute tax on such transfers,¹⁴¹ the objective of which is to "obtain a transfer tax with respect to each generation regardless of whether that generation receives the property or is skipped in favor of a succeeding generation."¹⁴² The substitute tax would be imposed on any arrangement, whether outright or in trust, that accomplishes the avoidance of a transfer tax for one generation or more.¹⁴³ The amount of the generation-skipping transfer would be taxed at sixty per cent of the marginal rate applicable to the donor—taking into account all gifts made by him, both inter vivos and at death. The purpose of this rate, of course, is to approximate the tax that would have been paid on the net gift by the skipped generation. For instance, if property

139. A power that is not exercisable in favor of the holder, his estate, his creditors, or creditors of his estate is not a general power of appointment. INT. REV. CODE OF 1954, § 2041(b)(1).

140. For example, assume that the donor establishes a trust, income to his son *A* for life, then to such of *B*'s issue as *B* may by will appoint. The principal will not be includible in either *A*'s estate or *B*'s estate. Assume that *B* exercises the power by appointing the property to be held further in trust, income to *B*'s children for life, with a remainder gift of the principal to *B*'s grandchildren then living, in equal shares. The appointive assets will not be included in the estates of *B*'s children; no estate tax would be imposed on the trust corpus until the death of *B*'s grandchildren. It should be emphasized that the appointment in favor of *B*'s grandchildren would not violate the Rule Against Perpetuities if all of *B*'s children had been born at the time of the creation of the trust and *B* had no further children. Under the "second-look" doctrine, *B*'s children could be used as the measuring lives and the contingent remainder to the grandchildren would have to vest, if at all, at the death of the last surviving child. See L. SIMES & A. SMITH, *THE LAW OF FUTURE INTERESTS* §§ 1274-75 (2d ed. 1956); 6 *AMERICAN LAW OF PROPERTY* §§ 24.34-35 (A. Casner ed. 1952).

141. 1969 PROPOSALS, *supra* note 4, pt. 3, at 388-401.

142. 1969 PROPOSALS, *supra* note 4, pt. 3, at 389. It is estimated that the generation-skipping tax would generate an added 12% in revenue. ALI, *FEDERAL ESTATE & GIFT TAXATION* 412 (Official Draft 1969).

143. Any transfer to a person more than one degree in relationship below the donor, or in case of a nonrelative, if the donee is more than twenty-five years younger than the donor, would be considered a generation-skipping transfer subject to the substitute tax. 1969 PROPOSALS, *supra* note 4, pt. 3, at 393.

is bequeathed to the testator's grandchildren in such a manner that it is not included in a child's estate, the substitute tax would theoretically compensate for the normal transfer tax that is avoided by the intervening generation.

The recommendation would allow a member of the skipped generation to elect to treat the transfer as if it had passed to him, and was later transferred by him to the next generation. The transfer tax payable on this hypothetical retransfer would constitute the substitute tax.¹⁴⁴ In effect, a generation-skipping transfer would be treated as two transfers involving two taxable events.¹⁴⁵

However well conceived in theory these proposals may be, the recommended tax on generation-skipping transfers would add an enormous complexity to the already complex structure of the estate tax law. The amount of the substitute tax would be added back to the base of the generation-skipping transfer on which it is computed. In other words, a gift subject to the substitute tax would be "grossed-up" at sixty per cent of the transferor's marginal rate and the tax would be imposed on that amount; the remaining amount would constitute the net gift.¹⁴⁶

The Treasury's own example of how this new tax would work may be used to demonstrate the confusion and apprehension that would be produced in estate planning and estate administration.¹⁴⁷ The example involves a transferor in the marginal forty per cent transfer tax bracket who makes a gift of 50,000 dollars to his grandchild. We are told by the Treasury that the total transfer tax on this simple gift is computed "by increasing the net gift by 60 per cent of the actual amount (\$30,000) grossed-up for the substitute tax at 60 per cent of [the grandfather's] marginal rate or 24 per cent (\$9473.68)."¹⁴⁸ This would result in a "regular transfer tax of \$43,859.65 (40 per cent multiplied by the amount of property transferred—\$50,000 gift plus \$59,649.12 tax) and an immediate generation-skipping tax of \$15,789.47 (40 per cent times \$39,473.68)."¹⁴⁹ The substitute tax would be imposed on 65,789.47 dollars, which

144. 1969 PROPOSALS, *supra* note 4, pt. 3, at 393-95.

145. Theoretically, the elective tax would be imposed on the generation-skipping transfer as though the property had in fact moved through each generation. The donor would be taxed on the assumed transfer to the parent of the recipient, and the parent would pay the elective tax on the constructive transfer from himself to the recipient. If, however, the donor provided funds for payment of the elective tax, those funds would constitute a bequest to the parent. 1969 PROPOSALS, *supra* note 4, pt. 3, at 394.

146. This is similar to the Treasury's proposal for a gross-up of all inter vivos transfers under a unified-transfer-tax system. See note 65 *supra*.

147. 1969 PROPOSALS, *supra* note 4, pt. 3, at 397-98.

148. *Id.*

149. *Id.*

constitutes the grossed-up amount required to produce the 50,000-dollar gift after deducting the tax.¹⁵⁰

In addition to the difficult problems of apportionment, the impact of the proposed increased tax burden may be so severe that generation-skipping dispositions will be virtually eliminated, or at least drastically curtailed.¹⁵¹ This result would be unfortunate because there are valid nontax reasons for the use of long-term trusts with limited powers of appointment in estate planning regardless of their generation-skipping advantages.¹⁵² The intricacy of tax computation would, moreover, be magnified in the case of discretionary trusts for the benefit of a family group composed of two or more generations, with the trustee being given broad powers to pay out income and make allocations of principal among the beneficiaries.

It would take years of interpretation by the courts, aided by statutory amendments and administrative regulations, to make the proposed plan even minimally comprehensible.¹⁵³ In the meantime there would be a period of bewilderment and uncertainty.¹⁵⁴ The Treasury's recommendations go far beyond those contained in the American Law Institute study, which would impose an additional tax only on transfers that skipped more than one generation. That tax would be payable either at the time of the original transfer or at the time of actual distribution to beneficiaries more than one

150. *Id.*

151. The suggested tax on generation-skipping transfers has been characterized as "the most ingenious, yet the most devastating and most unworkable of all the Casner proposals." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4005 (testimony of Mr. Robert F. Spindell). It "would make the estate and gift tax system so top heavy that it would fall of its own weight." *Id.* at 4006.

152. The most important advantage is the avoidance of overly rigid estate planning. For example, a rigid bequest might provide that at the death of the life tenant the property shall pass to the surviving children in equal shares, with the issue of a deceased child sharing per stirpes regardless of their ages or individual needs. By the use of special powers of appointment, however, flexibility can be achieved and maximum protection can be afforded the family group during the minority of children or grandchildren. Provision for the surviving spouse and issue of a deceased child can be made according to their respective needs and competence to handle the funds. See J. FARR, AN ESTATE PLANNER'S HANDBOOK 150, 161-63 (3d ed. 1966).

153. In addition to clarifying, if possible, the grossing-up technique and the method for determining the applicable rate of the substitute tax, rules would have to be formulated to determine what constitutes the equivalent of ownership and which recipients other than relatives are to be regarded as generation-skipping transferees. *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3997-98 (testimony of Mr. George Craven). Professor Westfall has pointed out that gifts to cousins of the donor would not constitute generation-skipping under the Treasury's proposal. Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 986, 1010 n.127 (1970).

154. See Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 635, 636 (1967); Comment, *A Survey of Generation-Skipping Transfers—The Present Rule and the Possibility of Reform*, 22 SW. L.J. 482, 490-91 (1968).

degree below the donor.¹⁵⁵ Professor Casner, in the ALI study, expressly rejected the Treasury's present proposal, which bases the rate of the additional tax on an assumed transfer by the skipped generation to the recipient, "because of the complications that developed in dealing with all the ramifications of the problem."¹⁵⁶

Advocates of the additional tax point out that generation skipping is available only to persons of substantial means who can afford to tie up wealth in long-term trusts,¹⁵⁷ and that therefore a more equitable system is needed for imposing the tax at reasonable intervals in order to prevent an erosion of the tax base.¹⁵⁸ The force of these arguments is diminished, however, by the facts that the revenue loss is comparatively small¹⁵⁹ and that the penalty tax would discourage the wise use of trusts to accomplish normal nontax estate-planning objectives.¹⁶⁰ In the absence of greater abuse and misuse of long-term dispositive arrangements,¹⁶¹ property should be allowed to remain in trust during the permissible period of the Rule Against Perpetuities without tax consequences.¹⁶² Although the Rule may be a clumsy and imperfect mechanism for determining taxable

155. ALI, *FEDERAL ESTATE & GIFT TAXATION* 26-31 (Official Draft 1969). Resolution 2B was adopted by the American Law Institute at its annual meeting in May 1968—which the writer attended—by a vote of 116-59. The effect of this resolution would be to permit the first generation to be skipped, but a tax would be levied on all subsequent transfers, except for outright gifts. *Id.* at 31.

156. ALI, *FEDERAL ESTATE & GIFT TAXATION* 30 (Official Draft 1969).

157. The point has been made that most trusts created by donors with estates exceeding \$2,000,000 are designed to skip at least one or two generations. *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4036 (testimony of Mr. John B. Lewis).

158. Since the property, after being taxed in the donor's estate, may escape further taxation for eighty to one hundred years, the progressive rates of the estate and gift taxes are subverted and their revenue-producing ability is impaired. *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3982-83, 4036 (testimony of Mr. John B. Lewis).

159. Statistics indicate that of the net estates in excess of \$300,000 filing estate tax returns in 1957 and 1959, totaling \$7.676 billion in disposable assets, only \$793,000,000 (a little over 10%) were placed in trusts with plans that skipped one or more generations. *See* Alexander, *supra* note 154, at 673-74.

160. *See* Brown, *A Case Against an Additional Tax on Generation-Skipping Transfers*, 106 *TRUSTS & ESTATES* 997, 998 (1967); Comment, *supra* note 154, at 490; *Tax Reform Hearings*, *supra* note 5, pt. 11, at 3997.

161. In this connection it should be noted that § 331 of the Tax Reform Act of 1969, P.L. No. 91-172, 83 Stat. 592—incorporated into INT. REV. CODE of 1954, §§ 665-69—has restricted the benefits to be derived from long-term accumulation trusts by providing for an unlimited throw-back rule.

162. Professor Leach asserts that "our present estate and inheritance tax system depends upon the wealth of the community going through the wringer every so often, and in the main it depends upon the Rule Against Perpetuities and its relatives to prevent the intervals from being too long." Leach, *Perpetuities Legislation: Hail Pennsylvania!*, 108 U. PA. L. REV. 1124, 1141 (1960). Professor Leach also states that "much has been written about the iniquity and folly of tying up property in trusts. But a careful examination of these complaints will usually disclose that they are arguments, not for fewer trusts, but for better trusts." W. LEACH & J. LOGAN, *CASES & TEXT ON FUTURE INTERESTS & ESTATE PLANNING* 238 (1961).

events, it does in fact reduce the time period during which generation-skipping transfers may exist.¹⁶³ Thus, on balance, the Rule Against Perpetuities is a more desirable means of limiting tax-free intervals than the Treasury's highly complex proposal or any of the various alternatives that have been seriously considered.

Each of these other alternatives has complexities and problems of its own. For example, the English system, which regards the termination of a life interest as a taxable event,¹⁶⁴ results in overtaxation since it subjects the entire corpus to taxation at the life tenant's death.¹⁶⁵ Moreover, it leaves unanswered problems and opportunities for tax avoidance through the use of discretionary trusts.¹⁶⁶ An accessions tax also would impose a levy upon the termination of limited interests, and would represent an attempt to provide a procedure for the taxation of discretionary trusts.¹⁶⁷ Professor Casner and his

163. Apparently, some advocates of the additional tax on generation-skipping transfers do not clearly perceive the operation of the Rule Against Perpetuities in policing the period during which the property may be tax exempt as it passes through successive generations. For example, one proponent of reform, in testimony given before the House Ways and Means Committee, attempted to illustrate the need for change by giving an example of a testamentary trust in which the income was to be distributed to the testator's children and grandchildren, and at the death of the survivor of them the trust principal was to be distributed to the surviving great-grandchildren. It was concluded that "[p]roperty so placed in trust will not be subjected to estate tax again until the great-grandchildren die perhaps 80 or 100 years in the future." *Tax Reform Hearings*, *supra* note 5, pt. 11, at 4036 (testimony of Mr. John B. Lewis). The fact is, however, that if children are alive at the time of the testator's death, the contingent-remainder gift to the great-grandchildren would be void *ab initio* under the Rule. The testator's children would be the measuring lives and it is possible that an interest in a great-grandchild might vest more than twenty-one years after the death of the survivor of the children. See 6 AMERICAN LAW OF PROPERTY §§ 24.21, 24.26 (A. Casner ed. 1952); R. LYNN, *THE MODERN RULE AGAINST PERPETUITIES* 89-95 (1966); 1 A. SCOTT, *THE LAW OF TRUSTS* § 62.10 (3d ed. 1967); L. SIMES & A. SMITH, *supra* note 140, at §§ 1228, 1265; Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638, 642-46 (1938); Leach, *The Rule Against Perpetuities and Gifts to Classes*, 51 HARV. L. REV. 1329 (1938).

164. Finance Act of 1894, 57 & 58 Vict. 53, c. 30, §§ 1, 2, *as amended*, Finance Act of 1969, c. 32, § 36. See also G. JANTSCHER, *TRUSTS & ESTATE TAXATION* 163 (1967).

165. England is the only country that has a generation-skipping tax. It would be hard to find a worse example. It is common knowledge in the business and political worlds that the staggering inheritance tax rates in England have brought about such a critical shortage of capital that it is unable to modernize its plants and compete effectively with other Western European countries.

And, without doubt, the assessment of an estate tax on every generation has contributed to this end.

Tax Reform Hearings, *supra* note 5, pt. 11, at 4006 (testimony of Mr. Robert F. Spindell).

166. See Westfall, *supra* note 153, at 1011; Comment, *supra* note 154, at 491.

167. See ALI, *FEDERAL ESTATE & GIFT TAX PROJECT* 118 (Study Draft No. 1, 1965); Andrews, *Reporter's Study of Accessions Tax System*, in ALI, *FEDERAL ESTATE & GIFT TAXATION* 446-589 (Official Draft 1969). The amount of the tax would be based on wealth received by the donee from various sources, rather than on the donor's privilege of transferring wealth.

consultants in the American Law Institute project, however, concluded "that a change-over to an accessions tax system is not a feasible alternative at this time"¹⁶⁸—a conclusion that was doubtless influenced by the drastic nature of the change and the complicated administrative problems that it would produce. Another possible solution would lie in changing the present law so that certain powers, now tax exempt, would be included in the estate of the holder.¹⁶⁹ This solution, however, would tend toward the creation of unwisely rigid future interests, and would eliminate needed flexibility in draftsmanship.¹⁷⁰

Professor Westfall has recently proposed a forty per cent "parental deduction" for transfers to children and grandchildren, with an increase in estate tax rates to make up for the revenue loss.¹⁷¹ This plan would give the transferor roughly the same benefit now available in transfers that skip a single generation, and would be analogous to the existing gift tax marital deduction.¹⁷² The Treasury's proposed substitute tax, on the other hand, would apply to multiple generation-skipping and to transfers to nonrelatives. It is difficult to see how this hybrid solution would operate any more effectively than the other suggestions, or how its administration would be any less burdensome. Therefore, until a better and more workable alternative to the existing system is found, there should be no change.

V. CONCLUSION

Few would quarrel with the basic policy goals of removing taxpayer inequities and eliminating the techniques for tax avoidance that are available only to the wealthy. Our estate and gift tax laws need to be simplified, and the tax burden should be distributed in an even-handed fashion. The public deserves a tax structure that is as fair and efficient as possible.

When the Treasury's package of proposed reforms is viewed in perspective, however, it must be concluded that the Treasury has failed to sustain the burden of establishing the need for or workability of its recommendations. Although most of the proposals ap-

168. ALI, *FEDERAL ESTATE & GIFT TAX PROJECT 6* (Proposed Draft April 30, 1968).

169. See Comment, *supra* note 154, at 493.

170. "To regulate events in 1980 the judgment of a mediocre mind on the spot is incomparably preferable to the guess in 1960 of the greatest man who ever lived." W. LEACH & J. LOGAN, *supra* note 162, at 241-42.

171. Westfall, *supra* note 153, at 1012-13. The transfer would be taxed at 60% as it moved from father to child, and again at 60% when the wealth passed from child to grandchild.

172. INT. REV. CODE of 1954, § 2523.

pear to be designed to produce good results, they do not stand up well under critical examination—there is a tremendous gap between promise and performance in most instances. The only reforms that meet the test of analytical scrutiny are the elimination of the terminable-interest rule for the marital deduction and the allowance of gift-splitting between spouses on any desired proportional basis for both inter vivos and testamentary transfers.

Changes are needed that are more feasible and less onerous and complex. Until these are forthcoming, it is preferable to live with the existing law, despite its defects.