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# THE FUTURE OF TRANSFER TAXATION: REPEAL, RESTRUCTURING AND REFINEMENT, OR REPLACEMENT

JOHN E. DONALDSON\*

## I. INTRODUCTION

Taxation of gratuitous transfers is a venerable component of the federal tax system. We have had an estate tax,<sup>1</sup> which includes within its base certain lifetime dispositions testamentary in nature, since 1916. Taxation of gifts<sup>2</sup> has been a significant component since 1932.<sup>3</sup> With a tentative beginning in 1976,<sup>4</sup> aborted retroactively and replaced with a substitute in 1986,<sup>5</sup> the estate and gift tax system is now supplemented with a system for taxing generation-skipping transfers (GST).<sup>6</sup> As a result of reforms enacted in 1976,<sup>7</sup> and later enactments, the system is now largely unified and is, at least in a formal sense, coherent. However, the transfer tax system remains deficient in a number of ways. The adequacy of the system can be measured in terms of whether it accomplishes its objectives. Under this measure, the system, apart from raising comparatively insignificant revenue, is a failure. Its adequacy can also be measured in terms of the traditional tests of a good tax system, which employ standards of efficiency, fairness, and neutrality. Under this measure, the system also fails. Concededly, no tax system can be expected to be perfect. The extent to which imperfections can be reasonably tolerated and accepted is in part a function of the revenues produced by the system. The imperfections within a system are costs which should be borne only if the revenues generated are adequate to warrant the costs. The current system is too costly. It can be improved. However, the improvements possible in relation to revenues likely to be generated from transfer taxation under the existing system, if implemented, are unlikely to make the costs of the system acceptable. The fundamental problem under the present system lies in its focus on the transferor, the donor, or decedent who is transferring accumulated wealth. The tax is imposed on the transferor

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1. I.R.C. §§ 2001-2056A (1988 & Supp. 1993).

2. I.R.C. §§ 2501-2524 (1988 & Supp. 1993).

3. For a history of transfer taxation, see David M. Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L.J. 1, 9-32 (1983).

4. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.).

5. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

6. I.R.C. §§ 2601-2663 (1988 & Supp. 1993).

7. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.).

and is measured by the type and value of wealth transferred, and the extent of imposition is determined by reference to the circumstances of the transferor and by exclusions and exemptions accorded the transferor. Such a system inherently invites manipulation and avoidance by the transferor and penalizes those who are unwary or who fail to pursue avoidance measures. The system's inherent invitation to manipulate and its penalties for failure to do so cause it to be unfair, inefficient, and nonneutral.

Whether accumulated wealth is a proper subject of taxation is a matter over which economists disagree<sup>8</sup> and is essentially a political question. Assuming that wealth transfer or receipt is a proper base for the imposition of tax, the question of how much revenue should be derived from such base is also a political question. However, the question of whether a particular system for taxing accumulated wealth is useful and worthwhile, though not devoid of political significance, is essentially a practical and utilitarian matter. This essay suggests that as a practical and utilitarian matter, the present estate, gift, and generation-skipping tax system should be abandoned.<sup>9</sup> It acknowledges that the present system can be improved. It suggests, however, that the improvements possible are not sufficient to warrant retention of the old system. It suggests that if wealth is to be taxed upon transfer, two models which focus on the transferee rather than the transferor, are likely to offer more acceptable methods of accomplishing that task. One of these models is an accessions tax. The other treats the receipt of gifts and bequests as taxable income to the recipient. This essay first assesses the adequacy of the existing system in relation to its apparent objectives, and then examines the system under the policy measures of fairness, efficiency, and neutrality.<sup>10</sup> It concludes with a consideration of alternative models for taxing the receipt of wealth.

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8. See generally Mark L. Ascher, *Curtailling Inherited Wealth*, 89 MICH. L. REV. 69, 86-121 (1991).

9. The suggestion that estate and gift taxes should be repealed is not novel. See Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215 (1984) (arguing for repeal of estate tax due to minimal revenue and progressivity effects); Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (Sept. 16, 1991) (suggesting lost revenues be made up through income tax changes); Gerald P. Moran, *Estate and Gift Taxation: The Case for Repeal*, 13 TAX NOTES 339 (Aug. 17, 1981) (supporting repeal of estate and gift taxes because of cost, complexity, distortion in private planning, and failure of system to achieve its purposes); Robert B. Smith, *Burying the Estate Tax without Resurrecting its Problems*, 55 TAX NOTES 1799 (June 29, 1992) (faulting Galvin's suggested income tax changes and presenting alternatives). These commentators generally fault the present system for inadequate revenues and lack of fairness, efficiency, and neutrality. Others discuss the inadequacy of the present system in the context of suggested alternatives, including an accessions tax and the inclusion of donative receipts in the income tax base. See sources cited *infra* note 135. Significantly, Australia and Canada have abolished their transfer tax systems. See Willard H. Pedrick, *Oh to Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX LAW. 113 (1981); Carter, *Federal Abandonment of the Estate Tax: The Intergovernmental Fiscal Dimension*, 21 CANADIAN TAX J. 232 (1973).

10. For a discussion of the ideals of fairness, efficiency, and neutrality, see Stanley S. Surrey & Gerald M. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WM. & MARY L. REV. 915 (1968).

## II. GOALS OF THE TRANSFER TAX SYSTEM

Several goals have, from time to time, been ascribed to the transfer tax system. One that has been articulated from time to time, particularly during the 1930s, is the breaking up or reducing of concentrations of wealth.<sup>11</sup> Another is that of producing revenue.<sup>12</sup> More recently, the system has been "justified" for its role or potential in adding an element of progressivity to the overall federal tax system.<sup>13</sup> An examination of the transfer tax system in relation to these perceived goals is in order.

### A. Reducing Concentrations of Wealth

However worthwhile the objective of breaking up or reducing concentrations of wealth may be, commentators generally agree that the transfer tax system has been ineffective in this regard. A study in 1978 concluded that transfer tax revenues were so small in relation to the wealth possessed by the top .5 percent of the population that the system could not have had a significant effect on wealth redistribution.<sup>14</sup> Another commentator writing in 1983 concluded that transfer taxes have done little to reduce concentrations of wealth.<sup>15</sup> Notwithstanding occasional expressions to the contrary,<sup>16</sup> Congress has shown little interest in the role of transfer taxes in breaking up concentrations of wealth. Its actions move in the opposite direction. In the Tax Reform Act of 1976<sup>17</sup> Congress, in enacting the reforms resulting in unification of the estate and gift tax systems and reduction in the number of persons affected, knowingly reduced revenues from transfer taxes. It did so again in the Economic Recovery Tax Act of 1981<sup>18</sup> when it expanded the unified credit,<sup>19</sup> thus exempting gratuitous transfers under \$600,000 from tax, permitted an unlimited marital deduction,<sup>20</sup> and revised the rate structure to phase in a reduction of the maximum rate bracket from seventy percent to fifty percent.<sup>21</sup> Congress did, however, restore a small element of pro-

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11. Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 235-36 (1956).

12. *Id.* at 231.

13. Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983).

14. G. P. Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?*, 117 TR. & EST. 598, 604 (1978) (constituting part one of two-part article).

15. Graetz, *supra* note 13, at 271.

16. S. REP. NO. 144, 97th Cong., 1st Sess. 124 (1981), *reprinted in* 1981 U.S.C.C.A.N. 105, 226 (stating that breaking up concentrations of wealth remains a goal of transfer tax system).

17. Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.).

18. Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

19. I.R.C. §§ 2010, 2505 (Supp. 1993). The credit, as phased in, offsets the tax on the first \$600,000 of donative transfers.

20. I.R.C. §§ 2056, 2523 (Supp. 1993).

21. I.R.C. § 2001 (Supp. 1993).

gressivity to the system in 1988<sup>22</sup> by phasing out the benefit of the graduated structure for estates over \$10,000,000.<sup>23</sup>

It is clear that for political reasons or otherwise, Congress has little interest in using transfer taxes as an instrument to reduce concentrations of wealth. Joseph Peckman of the Brookings Institute was probably correct in his observation that "the public does not appear to accept the desirability of a vigorous estate and gift tax system."<sup>24</sup> Professor Graetz, in likewise concluding that the people "do not seem to like heavy taxes on bequests" pointed to the poor reception given to George McGovern's proposal to heavily tax inheritances above a certain amount and to a California initiative to repeal that state's inheritance tax.<sup>25</sup> He concluded that sixty-four percent of California voters must believe that they will be among the wealthiest five to ten percent of the population at death.<sup>26</sup>

The transfer tax system simply has not made a significant contribution to a goal of breaking up wealth concentration. Although in 1992 transfer taxes produced revenues of approximately \$12 billion from the wealthiest one percent of the population,<sup>27</sup> that amount is relatively minuscule in relation to the objective.<sup>28</sup> Absent a significant change in the political climate, which appears unlikely in the foreseeable future, it is improbable that the system will be called upon to more effectively address perceived problems of wealth concentration.

### B. Production of Revenue

The second, and perhaps the historically more important goal of the transfer tax system, is that of producing revenue.<sup>29</sup> In the mid to late 1930s, the transfer tax system was a major component of the federal tax system, producing more than six percent of total revenues and in one year, 1936, ten percent.<sup>30</sup> Significantly, in 1934 transfer tax receipts were twenty-seven percent of individual income tax receipts.<sup>31</sup> In 1936, the \$379 million produced in transfer taxes amounted to more than fifty-six percent of the \$674 million produced by the individual income tax.<sup>32</sup> Since World War II, however, transfer tax revenues have rarely exceeded two percent of total

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22. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (codified as amended in scattered sections of 26 U.S.C.).

23. I.R.C. 2001(b)(3).

24. J. PECKMAN, *FEDERAL TAX POLICY* 255 (5th ed. 1987).

25. Graetz, *supra* note 13, at 285.

26. *Id.* at 285.

27. COMMERCE DEP'T, *STATISTICAL ABSTRACT OF THE UNITED STATES* 316 (1992) [hereinafter *STATISTICAL ABSTRACT*].

28. Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, *NEW ENG. ECON. REV.*, Nov.-Dec. 1988, at 6.

29. Eisenstein, *supra* note 11, at 231.

30. *Id.* at 239.

31. *Id.* at 240.

32. *Id.*

federal tax collections and as a result of recent changes, have diminished to approximately 1.1 percent.<sup>33</sup> This decline reflects the greater importance of other taxes to the federal fisc. A comparison of the \$12 billion in transfer tax receipts budgeted for fiscal 1992 with the \$479 billion<sup>34</sup> budgeted for individual income tax receipts reveals a ratio of transfer tax revenues to individual income tax revenues of only 2.5 percent. In terms of revenue significance, transfer taxes have evolved from a role of major importance to that of virtually a de minimis component. In 1992, revenues from alcohol and tobacco taxes exceeded those from transfer taxes by more than \$1 billion.<sup>35</sup>

Even if there were greater desire to use the transfer tax system as a source of revenue, it is doubtful whether such taxes could be adapted to become a major revenue source. In fact, no country, including those which have more socialistic political values, derives significant revenues from wealth transfer taxation.<sup>36</sup> A commentator writing in 1983 observed that decedents transfer annually approximately \$120 billion in net assets and that an effective transfer tax rate of twenty percent applied to that base would have produced only \$24 billion, about three times the transfer tax revenues for that year.<sup>37</sup> The actual transfer tax base is much narrower and it would be politically difficult to use a larger base. The political factors that discourage Congress from using transfer taxes to reduce concentrations of wealth also operate to discourage use of transfer taxes as sources of additional revenue.

Although the \$12 billion now produced annually by the transfer tax system is but a minuscule part of total federal revenues, it is a significant amount in the context of a federal fisc operating with inadequate revenues and large deficits. Assuming that these revenue dollars are too important to give up, and the class of wealthy on whom the burden falls should be largely unchanged, it is fair to ask whether the burden can be imposed more fairly and efficiently.

### C. Contributing to Progressivity

A third goal, or role, of transfer taxes advanced by some is that of contributing to the progressivity of the federal tax system.<sup>38</sup> However, that role has a more historic than continuing significance and is a function both of the progressivity of other taxes, particularly the individual income tax, in relation to the amount of transfer tax revenues, and the number of persons

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33. STATISTICAL ABSTRACT, *supra* note 27, at 316.

34. *Id.*

35. *Id.*

36. Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 NAT'L TAX J. 121, 133 (1992).

37. Graetz, *supra* note 13, at 269.

38. *Id.* at 271. See also Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 VA. L. REV. 1183, 1185 (1983) (arguing transfer taxes have "traditionally played, and should continue to play, an important role in contributing to the progressivity of the tax system as a whole").

burdened by the tax. In the mid to late 1930s, when estate tax revenues on occasion were as high as twenty-seven percent to fifty-six percent of individual income tax revenues, the transfer tax contributions to the goal of progressivity were substantial. Analysis of data for the early 1970s led one commentator to conclude that transfer taxes contributed a third as much to progressivity of the tax structure as did rates in excess of the average effective income tax rate.<sup>39</sup> However, the transfer tax contribution to progressivity had dropped to twelve percent by 1980,<sup>40</sup> and would have been down to four percent for 1981 if the 1981 legislation had been fully effective in that year.<sup>41</sup> When transfer taxes affect the top six or seven percent of the population, as they did in the mid-1970s,<sup>42</sup> their contribution to progressivity may have meaningful significance. However, when the affected population drops to approximately one percent,<sup>43</sup> today's level, the role of transfer taxes in contributing to progressivity of the tax system is minuscule.

The existing transfer tax system simply cannot be justified by reference to its contribution to progressivity. Professor Graetz, commenting on the narrowing of the transfer tax base effected by the 1981 legislation, which was predicated on the "myth" that the proper function of the estate tax is to reduce concentrations of wealth in excess of \$600,000, bemoaned that acceptance of the "myth" defeats the contribution of transfer taxes to progressivity.<sup>44</sup> Professor Gutman, also a proponent of the role of transfer taxes in contributing to progressivity, refers to the 1981 legislation narrowing the transfer tax base as "emasculating" transfer taxation as an effective component of the tax system.<sup>45</sup> Absent a congressional resolve to reverse the direction of the 1981 legislation and to expand the scope of transfer taxes by reducing the exemption level and increasing the effective progressivity of the transfer tax rate structure, the existing estate and gift tax system has no meaningful role as a contributor to progressivity. The prospect of such changes is remote and even proponents of the progressivity role of transfer taxation are pessimistic that restoration of such a role is politically possible.<sup>46</sup>

Manifestly, current wealth transfer taxation can not be justified by perceived roles either of breaking up or reducing concentrations of wealth or of contributing to the progressivity of the federal revenue system. If these roles are dismissed, a case can be made for repeal of the estate, gift tax, and generation skipping taxes,<sup>47</sup> notwithstanding that they do produce \$12 billion in revenue. This revenue, comparatively insignificant, comes at

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39. Graetz, *supra* note 13, at 272.

40. *Id.*

41. Gutman, *supra* note 38, at 1195-96.

42. Munell, *supra* note 28.

43. *Id.*

44. Graetz, *supra* note 13, at 271.

45. Gutman, *supra* note 38, at 1271.

46. Graetz, *supra* note 13, at 284-86.

47. *See id.* at 271; sources cited *supra* note 9.

the expense of a "bad" tax system, one that lacks fairness, efficiency, and neutrality.

### III. FAIRNESS, EFFICIENCY, AND NEUTRALITY

Adherence to generally accepted principles of sound tax policy requires that tax systems be fair, efficient, and neutral.<sup>48</sup> The existing transfer tax system severely violates each of these principles.

#### A. Fairness

First, the system is not fair, from considerations of both horizontal equity and vertical equity. Horizontal equity suggests that persons transferring equal wealth within the system be taxed in the same manner. Vertical equity (progressivity) suggests that persons of greater wealth be taxed more heavily on their transfers than persons of lesser wealth. Substantial horizontal inequity has been legislated into the system. For example, qualifying wealth represented by land used in farming and certain other business activities may be valued at "use" value rather than fair market value, permitting reductions in taxable estates of up to \$750,000.<sup>49</sup> Also, while some employment generated post-death payments are within the transfer tax base,<sup>50</sup> others are not.<sup>51</sup> Further, life insurance proceeds, where the decedent has an incident of ownership, are included in the estate tax base. However, proceeds of life insurance, even when attributable to investment made by decedents, are excluded from the base where incidents of ownership are lacking,<sup>52</sup> or if once possessed, have been yielded more than three years prior to death.<sup>53</sup>

More important to considerations of both horizontal and vertical equity is the simple fact that where transfer taxes that would otherwise have been imposed are avoided or postponed without penalty, equity is violated. A major industry, that pursued by estate planning professionals, has evolved to exploit opportunities for avoidance and penalty-free postponement of transfer taxes that would otherwise have been payable. A large number of attorneys, accountants, financial advisors, insurance specialists, and trust officers, having mastered the complexities and intricacies of the transfer tax system, devote all or substantial portions of their professional time in service of the cause of undermining horizontal and vertical equity within the transfer tax system.

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48. Surrey & Brannon, *supra* note 10.

49. I.R.C. § 2032A (Supp. 1993).

50. I.R.C. § 2039 (1988) (including value of annuities in gross estate).

51. For I.R.C. § 2039 to apply to an employment generated post-death benefit, the decedent must have possessed a right to an annuity or other payment. Where the decedent lacks such right, and the right to designate the payee, post-death payments escape estate taxation. *Estate of Fusz v. Commissioner*, 46 T.C. 214 (1966), *acq.*, 1967-2 C.B. 1 & 1967-2 C.B. 2.

52. I.R.C. § 2042 (1988).

53. I.R.C. § 2035 (1988).



A discussion of all of the tax avoidance and postponement devices available to avoid or delay imposition of transfer taxes is beyond the scope of this essay.<sup>54</sup> The literature on estate planning directed to tax avoidance and minimization is extensive.<sup>55</sup> To make the point, however, a mention of several techniques is sufficient. For example, persons having the greatest wealth, and thus benefitting most in circumventing vertical equity, are more readily able than those having less wealth to utilize the gift tax system, with its "tax exclusive"<sup>56</sup> base to reduce the cost of donative transfers. For example, a person who has \$10,000,000 of wealth can, while living, more readily transfer \$600,000 in assets considered likely to appreciate in value, using the unified credit to avoid immediate imposition of tax, than can an one who has only \$1,500,000 in wealth. Also, and for convenience, disregarding the unified credit, persons who would otherwise be in the fifty-percent bracket for both immediate gift tax purposes and for eventual estate tax purposes can choose to make a gift of \$1,000,000, at a gift tax cost of \$500,000 for total transfer related cost (gift plus gift tax) of \$1,500,000. If the "fund" of \$1,500,000 tapped in giving \$1,000,000 to the donee had been retained until death and taxed at the fifty-percent bracket, only \$750,000 would remain after tax to pass to objects of bounty. In this example, the transfer tax saving obtained by using a gift mechanism rather than a testamentary mechanism to pass wealth is \$250,000. Another important device for avoiding imposition of transfer taxes is the utilization of the annual exclusion<sup>57</sup> of \$10,000 (\$20,000 if husband and wife cooperate by using the split-gift election).<sup>58</sup> For example, an individual with three married children and five grandchildren can annually transfer \$10,000 to each child, each child's spouse and each grandchild, totalling \$110,000 per year, eroding the transfer tax base by that amount and avoiding the imposition of as much of \$55,000 (assuming a potential bracket of fifty percent) for each year of such activity. The amounts can be doubled in the case of a married couple. Trust arrangements where beneficiaries, including those with con-

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54. An especially notable study of transfer tax avoidance, drawn in large measure from practices reported by professionals in the field, is George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977). Several of the techniques Professor Cooper discusses, including estate freezing recapitalizations and use of charitable lead trusts, have been curtailed by subsequent legislation.

55. There are a number of journals, monthly and quarterly, devoted to the subject of estate planning. Practising Law Institute annually publishes a significant number of paper back books addressing specialized estate planning issues and topics. The University of Miami sponsors the annual week-long Heckerling Institute on Estate Planning, the proceedings of which are published, and which draws the leading specialists in the field. ALI-ABA and other sponsors offer hundreds of continuing legal education courses on the subject, usually utilizing detailed outlines developing the topics presented.

56. Unlike the estate tax, which is "tax inclusive" in its base and allows no deduction for tax in measuring the tax, the gift tax is "tax exclusive" and gift taxes payable on a transfer are not included in the measure of the tax. Compare I.R.C. § 2001 with § 2501 (Supp. 1993).

57. I.R.C. § 2503 (Supp. 1993) (providing \$10,000 per donor per year exclusion from "taxable gifts").

58. I.R.C. § 2513 (1988).

tingent interests, are given withdrawal powers are available to inflate the number of annual exclusions available.<sup>59</sup>

A more sophisticated technique involves the use of grantor retained income trusts (GRITS) structured as grantor retained annuity trusts (GRATS) or unitrusts (GRUTS) in compliance with applicable limitations.<sup>60</sup> Under this device a wealthy grantor creates a trust for a term likely to be shorter than his remaining life expectancy, retaining a qualifying income interest and giving the remainder to the donee. The remainder is valued for gift tax purposes at its discounted value,<sup>61</sup> which, depending upon the term of the trust and the annual payout specified, can be reduced to almost a de minimis amount. Typically the arrangement is structured to use the available unified credit to offset any gift tax otherwise payable.<sup>62</sup> If the grantor lives out his life expectancy and the remainder thus vests in possession while the grantor is living, the corpus passes to the remainderman with no additional transfer tax exposure.<sup>63</sup> Even if the grantor dies before the end of the trust term, there is no down-side risk. In that event the corpus is included in the gross estate, which would have been the result if the trust had not been created, and the adjustment for lifetime gifts includible in the gross estate assures no adverse treatment.<sup>64</sup>

Even more sophisticated techniques are available within the parameters of the generation-skipping trust provisions. The GST system actually invites the wealthy to structure transfers in a way that avoids the imposition of its tax on aggregate transfers of \$1,000,000 (\$2,000,000 in the case of a married couple)<sup>65</sup> directly or remotely to grandchildren. Effective use of this ploy requires careful navigation through the intricacies of the system and often the use of multiple trust devices, reverse Qualified Terminable Interest Property (QTIP) elections,<sup>66</sup> complex fund flow mechanisms and tax allocation clauses.<sup>67</sup> The system also inflicts severe penalties in the form of otherwise avoidable taxes where multiple-generation trust mechanisms are

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59. *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result in part*, 1992-1 C.B. 1 (allowing annual exclusions for contingent beneficiaries (grandchildren) having lapsing withdrawal rights, and thus considered to possess "present" interests with meaning of I.R.C. § 2503). The treatment of lapsing withdrawal powers as present interests was approved in *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

60. I.R.C. § 2702 (Supp. 1993). Generally, the retained income interest must be in the form of a right to receive a fixed dollar amount or a fixed percentage of corpus valued annually. *Id.*

61. I.R.C. § 2702.

62. A gift of a remainder interest in a trust corpus of several million can be discounted under "time value of money" methods to reduce the value of the remainder to under \$600,000, and the unified credit available under I.R.C. § 2010 may be available to defray the applicable gift tax.

63. I.R.C. § 2036 (Supp. 1993).

64. I.R.C. § 2001(b) (Supp. 1993).

65. I.R.C. § 2631 (1988).

66. I.R.C. § 2652(a)(3) (1988).

67. See generally Edward C. Halbach, Jr., *Living with the Generation-Skipping Transfer Tax*, 22 U. MIAMI INST. EST. PLAN. ¶ 906.2 (1988).

used by the uninformed or ill-advised. For example, the failure, in an appropriate case, to give a child a general power of appointment under a multiple-generation trust arrangement can result in significantly higher taxes at the death of the child, if the child would otherwise have an under-utilized unified credit or would otherwise be in a tax bracket lower than the GST bracket, which is fixed at the highest estate tax bracket.<sup>68</sup>

A corollary to the foregoing observations regarding ease of tax avoidance and its effect on horizontal and vertical equity is the resulting consequence that to a significant extent transfer taxes are "voluntary taxes,"<sup>69</sup> paid largely by wealthy persons who are uninformed or ill-advised, or who simply die before putting their affairs in order—all too frequent occurrences. To the extent that the tax burdens those who bear it only because of the want of effective avoidance planning, it is especially unfair. Married couples who lovingly put substantially all their assets into tenancies by the entirety and other forms of joint and survivor ownership as well as spouses who inadvertently permit the bulk of their assets to be titled in the name of one often forfeit the effective use of an otherwise available unified credit<sup>70</sup> under which up to \$600,000 could be passed tax free to or for the benefit of children on the death of the first to die. In other instances, taxes are needlessly or prematurely imposed simply when more effective use of the marital deduction technique could have avoided or delayed the imposition of tax.<sup>71</sup> Similarly, lack of information or advice regarding opportunities to avoid or minimize taxes through lifetime giving arrangements causes imposition of otherwise avoidable taxes. A tax that is unduly borne by those who lack diligence and are uninformed or ill-advised, and is readily avoided by those who are diligent, well-informed and advised, is inherently an unfair tax.

### B. Efficiency

Second, the transfer tax is inefficient. This is perhaps the system's most serious shortcoming. It requires an inordinate amount of attention at the highest levels of government,<sup>72</sup> especially in relation to the relative insignificance of the revenues generated. Consider, for example, the obvious enormous efforts of the Treasury and Congress recently expended in dealing with valuation issues involved in estate-freezing recapitalizations and related techniques. These resulted first in the enactment<sup>73</sup> of a largely incomprehensible and unacceptable provision, the notorious section 2036(c), second

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68. I.R.C. §§ 2601, 2641 (1988).

69. Cooper, *supra* note 54, *passim*.

70. I.R.C. § 2010.

71. When potentially taxable wealth in an estate exceeds the exemption equivalent (\$600,000) of the unified credit, it is generally desirable to leave the excess amount to the surviving spouse, which delays imposition of tax, if any, until the death of such spouse.

72. Hudson, *supra* note 3, at 32.

73. Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, 101 Stat. 1330 (codified as amended in scattered sections of 26 U.S.C.).

in the attempt to make it workable by later amendment,<sup>74</sup> and then in its ultimate repeal and replacement<sup>75</sup> by Chapter 14 of the Internal Revenue Code.<sup>76</sup> The creativity of estate planning professionals imposes a continuing drain on the attention of policy makers and legislators. The tax is comparatively expensive to administer. The system's complexity, coupled with the creative devices employed in estate planning, requires the Internal Revenue Service (IRS) to employ lawyers as estate tax examiners, who are compensated at a higher level than other IRS compliance personnel. While only a small fraction of individual income tax returns are examined, 12,000 of the 56,000 estate tax returns filed in 1989 were examined.<sup>77</sup>

Efficiency is not properly measured by compliance costs to the government alone. The transfer tax system imposes enormous resource and opportunity costs in taxpayer compliance and avoidance endeavors and in the time and energy of lawyers, accountants, trust officers, and financial planners required to understand and apply the system. The magnitude of human resources involved is partially suggested by the American Bar Association's estimate that over 16,000 lawyers consider trust, probate, and estate law as their area of concentration.<sup>78</sup> Lawyers, in drafting will and trust arrangements, understandably want their documents to stand the test of time. Because of the transfer tax system's focus on the circumstances of the decedent, wills for many are typically drafted not only in relation to existing circumstances and wealth patterns but in relation to possible changes. Lawyers may not cavalierly assume that clients of modest wealth when wills are executed will not have substantial wealth at death. Many clients who will, in fact, not have transfer tax exposure, receive legal services predicated on the possibility that they may face such exposure. Standard "sweetheart" wills leaving everything to a surviving spouse typically include disclaimer clauses with disclaimer amount trust provisions designed to offer the option of a formula-driven "by-pass" trust<sup>79</sup> benefitting the spouse, if later needed to minimize transfer taxes. Standard wills typically include such boiler plate as tax apportionment clauses and tax election clauses, and durable powers of attorney instruments increasingly empower the attorney-in-fact to make gifts to enable "death bed" use of annual exclusions. Given the possibility, although nonlikelihood, that clients will face estate tax exposure, these provisions are prudent, even though in reality generally not necessary. Although the transfer tax system is intended to affect only a very small

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74. Technical and Miscellaneous Revenue Act of 1988, § 3031, 26 U.S.C. § 2036(c) (1988).

75. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

76. I.R.C. §§ 2701-2704 (Supp. 1993).

77. STATISTICAL ABSTRACT, *supra* note 27, at 325.

78. Aaron & Munnell, *supra* note 36, at 138.

79. Such a trust typically is funded in an amount equal to the exemption equivalent (as high as \$600,000) of the unified credit, and benefits the surviving spouse for life, but does not result in inclusion in the taxable estate of the surviving spouse.

portion of the population, such protective drafting causes the system to affect a substantially larger segment, who prudently, but often unnecessarily, receive and pay for complex estate planning services. The system causes dispositive arrangements which could and should be simple to be exceedingly complex. Understandably, testators want to know the meaning of the language used in effecting their dispositive schemes. All too often the tax-driven complexity of language employed is incomprehensible to the testator.

The transfer tax system generates other resource and opportunity costs. Hundreds of law professors devote substantial portions of their careers in exposing thousands of students annually to the challenges and intricacies of transfer taxation<sup>80</sup> and the related subject of estate planning, a major component of which is a study of techniques to avoid or minimize imposition of tax. Similar talent is devoted to the education of accountants, insurance agents, financial planners and others. Considerable resources are devoted to the presentation of continuing education courses for estate planning professionals and to the publication of articles, journals, and books<sup>81</sup> devoted to their needs in understanding and applying the transfer tax system.

There are important consequential costs as well. Prudent fiduciaries are reluctant to distribute and settle decedents' estates before potential estate tax controversies have been settled. The transfer tax system prolongs the administration of estates. Prudent fiduciaries invest conservatively, and prolonged administration delays access to capital by beneficiaries, who may employ it more effectively within the economy. The system also promotes the "trustification"<sup>82</sup> of assets that might otherwise have been transferred outright.

All of the foregoing energy, resources, and opportunity costs are sacrificed on the altar of a tax system that fails to achieve its supposed goals and yields only \$12 billion in revenue. A recent study concluded that resources spent in avoiding transfer taxes are of the same magnitude as the revenue produced.<sup>83</sup> The transfer tax system is manifestly inefficient. The resource and opportunity costs generated in relation to revenues obtained are alone sufficient to make the system unacceptable.

### C. Neutrality

In addition to the standards of fairness and efficiency used to measure the desirability of tax systems is a third, that of neutrality. A good tax

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80. Professor Bittker wrote to the effect that the reason for studying transfer taxes is not their significance for tax purposes, but their "power to stimulate and challenge the student." See Eisenstein, *supra* note 11, at 239 (quoting BITTKER, ESTATE AND GIFT TAXATION—CASES AND MATERIALS v (1951)). One may reasonably ask whether comparable stimulation and challenge from the study of other subject matter may be more productive and useful.

81. See sources cited *supra* note 55.

82. See Dobris, *supra* note 9 at 1223; Edward J. Gac & Sharen K. Brougham, *A Proposal for Restructuring the Taxation of Wealth Transfers: Tax Reform Redux?*, 5 AKRON TAX J. 75, 82 (1988).

83. Aaron & Munnell, *supra* note 36, at 139.

system should be neutral in that it ought to be nonintrusive—it should not alter choices and behavior that would have occurred in the absence of the system. The current tax system is decidedly nonneutral and intrusive. The system encourages lifetime gifts and penalizes the failure to make them. Further, the system virtually compels use of the marital deduction in most cases involving wealthy married couples. In those instances, it thus discourages substantial outright bequests to others. Also, the system discourages heavy use of joint and survivor arrangements that might otherwise be useful and desirable probate avoidance mechanisms. While the transfer tax system discourages substantial bequests to grandchildren and great grandchildren,<sup>84</sup> it encourages limited bequests to, and certain trust arrangements of limited amounts for the benefit of, grandchildren.<sup>85</sup> The system encourages certain trust arrangements for the benefit or charity and discourages all other trust arrangements for charity.<sup>86</sup> Moreover, the system encourages the retention of farm and other land in some cases, and discourages the disposition of that land by surviving family members in those same cases.<sup>87</sup> The system discourages certain employment related post-death benefit arrangements and encourages others.<sup>88</sup> In varying circumstances the transfer tax system may encourage or discourage use of trust arrangements involving general or special powers of appointment.<sup>89</sup> In inducing the making of gifts for minors and others considered unsuitable for the management of property, the system encourages the use of trusts. Given the tendency of most spouses to leave property to each other to the exclusion of children until the death of the surviving spouse, the system encourages the use of “by-pass” trusts. Because life insurance is a form of wealth that is fully realized at the death of the insured, and because life insurance arrangements can be structured to avoid imposition of transfer taxes, even when funded by the insured, the system encourages investment in life insurance products.<sup>90</sup> The transfer tax system discourages the acquisition and retention of life insurance where the insured retains ownership incidents over the policy.<sup>91</sup> Further, the system strongly

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84. I.R.C. § 2601.

85. I.R.C. § 2631.

86. I.R.C. §§ 2055, 2522 (1988).

87. I.R.C. § 2032A.

88. I.R.C. § 2039.

89. This is particularly true in marital dispositions, where the surviving spouse, as to a “by-pass” trust, is often given a special power of appointment that avoids taxation on the spouse’s death, but is given a general power when necessary or appropriate to qualify a trust arrangement for the marital deduction permitted for qualified terminable interests. It is also true in generation-skipping trust arrangements where the exempt portions are typically subject to special powers of appointment and remaining trust vehicles are subject to general powers so as to avoid imposition of generation-skipping tax on the death of the holder-beneficiary. See I.R.C. § 2041 (1988) (defining general (taxable) power of appointment).

90. Unless the proceeds are payable to the estate of the insured, or the insured possesses incidents of ownership over the policy, proceeds of life insurance generally escape taxation at the death of the insured under I.R.C. § 2042.

91. *Id.*

encourages the obtaining of professional estate planning advice. The system discourages and renders difficult the prompt settlement of decedents' estates. On balance, the system contributes heavily to the "trustification" of wealth and thus channels the flow of substantial capital into arrangements where, given the prudence of fiduciaries, capital is conservatively invested. Thus to a substantial degree, the system operates to prevent people from making desired dispositions of their property and encourages undesired dispositions. The transfer tax system forces use of complex dispositive mechanisms when simple arrangements are desired. The system is severely intrusive in affecting human choices, investment decisions, and dispositive arrangements. In penalizing and rewarding different choices and decisions, it restricts investment decisions and donative and testamentary freedom and compromises personal liberty. Consequently, the transfer tax system is decidedly nonneutral.

#### *D. Summary of Deficiencies*

To summarize the foregoing analysis of the current transfer tax system, it fails in contributing meaningfully to breaking up concentrations of wealth or in contributing a meaningful element of progressivity to the federal tax system. The revenue that the transfer tax produces is comparatively insignificant, particularly when examined in terms of the imperfections of the system used to produce it. The system is unfair and grossly inefficient. Rather than being neutral, it is unacceptably intrusive in affecting investment decisions, donative and testamentary choices, forms of ownership, forms of dispositive arrangements, and post-transfer management of capital, and in burdening the probate process and forcing resort to expensive tax avoidance advice. The costs of compliance and related monetary and human resources consumed in the estate planning and related endeavors associated with efforts to comply with the system and avoid or reduce transfer taxes are unacceptably high in relation to revenues produced.

Some of the deficiencies involving horizontal and vertical equity within the system admit of legislative correction. Proposals for improvement are discussed in the next section. However, such limited correction is unlikely to make the system acceptable under standards of efficiency and neutrality. If the transfer tax system was reconfigured to produce substantially increased revenues, its inefficiency and lack of neutrality would become more tolerable, particularly if value is placed on any resulting contribution to progressivity. Such reconfiguration is a political unlikelyhood. Accordingly, Congress should repeal the existing estate and gift tax system.

#### IV. RESTRUCTURE AND REFINEMENT

If however, the choice is one of retaining the present system, Congress may be expected eventually to address a number of proposals to restructure and refine the system. Even if all or most were adopted, the effect on deficiencies noted above would be largely cosmetic. The more important of those which appear to have a reasonable chance of serious consideration are discussed below.

The Treasury Department in its 1984 tax reform study<sup>92</sup> (Treasury proposals), advanced a number of proposals affecting transfer taxation. Thus far, only its proposal regarding repeal and replacement of the 1976 GST system<sup>93</sup> has been considered and acted upon. Among the Treasury's most significant proposals is that of computing gift tax liability on a "tax-inclusive" basis,<sup>94</sup> with the result that gift tax attributable to a transfer be treated as part of the transfer tax base. If implemented, one of the tax incentives for making lifetime gifts would be eliminated but many others would remain. A likely consequence of implementation would be a decline in immediate gift tax revenues and a deferred increase in estate tax collections. The proposal contributes modestly to fairness, but does little to reduce complexity or improve efficiency and increase neutrality. The proposal was examined and rejected by the American Bar Association's Task Force on Transfer Tax Restructuring (Task Force).<sup>95</sup>

A second 1984 Treasury proposal, of which the Task Force generally approves,<sup>96</sup> is a revision of the rules governing completion, for transfer tax purposes, of lifetime gifts in trust where the transferor retains beneficial interests or powers affecting enjoyment by trust beneficiaries.<sup>97</sup> Under the proposal, for example, gifts of property in which the donor retains an income interest would be regarded as incomplete, and would not be taxable until the termination of the income interest. No gift tax would be imposed at time of transfer with respect to the remainder interest. Also, gifts where the transferor retains no beneficial enjoyment would be considered complete notwithstanding a retained power to affect enjoyment by beneficiaries. The proposal, on its face, furthers the cause of simplification by reducing or eliminating the likelihood of a transfer in trust being subject to combined estate and gift tax reporting and compliance rules. However, in reality, it renders the law more complex in that the transition rules needed to protect pre-effective date trust arrangements will require, for another generation, knowledge and understanding of two sets of rather complex bodies of law on when gifts in trust are and are not complete for transfer tax purposes. The proposal does, however, contribute to fairness and may render GRITS, GRATS, and GRUTS<sup>98</sup> obsolete for transfer tax minimization purposes.

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92. 2 TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 373-405 (1984) [hereinafter FAIRNESS, SIMPLICITY]. The proposals were not included in THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY (1985), and except as noted in the text, have not been the subject of further legislation.

93. FAIRNESS, SIMPLICITY, *supra* note 92, at 389-92.

94. *Id.* at 377-78.

95. A.B.A. Section of Taxation Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, 41 TAX LAW. 393, 402-04 (1988) [hereinafter Task Force Report]. The report was prepared at the request of the Treasury Department for suggestions for simplification and improvement of the Federal transfer tax. The Report considered a number of the 1984 Treasury Proposals and also presented some additional recommendations.

96. *Id.* at 404-10.

97. FAIRNESS, SIMPLICITY, *supra* note 92, at 378-83.

98. I.R.C. § 2702.



A third 1984 Treasury proposal addresses valuation issues encountered when a shareholder whose shares may reflect a control "premium" transfers a partial interest in a corporation and the transferor attempts to value the transferred interest by applying a "minority" discount.<sup>99</sup> It seeks to eliminate the valuation "abuse" by requiring, in general, that the transferred interest be assigned "proportional" value from the block of stock owned prior to the transfer. The details of the proposal have not been set forth and its implementation is likely to require complex statutory language. While not flatly rejected, it received a generally hostile evaluation by the Task Force.<sup>100</sup> Implementation of the proposal would make a modest contribution to fairness in preventing erosion of the transfer tax base. It is notable that the minority discount problem arises because our transfer tax system seeks to tax the value of the interest transferred, as opposed to the value of the interest received. Under the alternative models discussed in the next section—those of employing an accessions tax or of including gifts and bequests in the recipient's income—the minority discount problem should not be present because the focus is on value received, not value transferred.

Other 1984 Treasury proposals seek to tighten definitional rules relating to powers of appointment where the holder has a limited power of invasion,<sup>101</sup> modify computations rules for certain credits,<sup>102</sup> deny an estate tax deduction for interest expense,<sup>103</sup> limit deferred payment of estate tax to situations in which there is an actual liquidity problem,<sup>104</sup> and repeal the opportunity for capital gain treatment for certain estate tax related stock redemptions.<sup>105</sup> These proposals are not discussed because they are comparatively unimportant to this essay.

The Task Force, in its evaluation of some of the 1984 Treasury proposals, formulated additional proposals directed to the cause of reducing complexity and adding fairness.<sup>106</sup> One proposal calls for replacing the graduated rate schedule applicable after the exemption level is exceeded with a flat fifty-percent rate.<sup>107</sup> This is intended to advance simplicity by removing the challenge to enhance tax savings in planning for married couples which is present under a graduated rate structure. Implementation of the proposal, while serving the interests of simplicity, reduces the progressivity of the transfer tax scheme and would increase actual tax burdens for varying

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99. FAIRNESS, SIMPLICITY, *supra* note 92, at 386-88.

100. Task Force Report, *supra* note 95, at 421-24.

101. FAIRNESS, SIMPLICITY, *supra* note 92, at 384-85. The proposal would amend I.R.C. § 2041 to generally treat a holder's power to invade as a taxable general power of appointment even where limited by standards.

102. *Id.* at 393-94 and 402-03. The proposals would liberalize the credit under I.R.C. § 2013 for tax on prior transfers for intra-generational dispositions and would simplify computation of the credit under I.R.C. § 2012 for state death taxes.

103. *Id.* at 398-99.

104. *Id.* at 395-97.

105. *Id.* at 404-05.

106. Task Force Report, *supra* note 95, *passim*.

107. *Id.* at 397-98.

numbers of persons, depending upon revision of the exemption level.

A second Task Force proposal calls for replacement of the unified credit exemption device, which amounts to an exemption of \$600,000, with a straight forward exemption.<sup>108</sup> This advances the cause of simplicity because exemptions would be expressed in dollar amounts rather than in credit equivalents. While administrable and more understandable, it is not likely to ease the tax computation process.

A third Task Force proposal, advanced in the cause of fairness, calls for making the exemption portable between spouses.<sup>109</sup> For example, assuming an allowable exemption of \$600,000, if a spouse died with a taxable estate of \$250,000, the surviving spouse would be given the benefit of the unused \$350,000 exemption, and would thus be able to avoid tax on the first \$950,000 of such survivor's taxable estate. This serves the cause of fairness by reducing the transfer tax penalty that accompanies failure to plan for full utilization of allowable exemptions. Implementation of the proposal would require, however, the filing of estate tax returns by spouses who do not have taxable estates in order to permit the computation of unused exemption amounts, and would invite valuations disputes on the death of the surviving spouse regarding the accuracy of valuations and deductions reflected on the nontaxable return of the predeceasing spouse. What is gained in the cause of fairness comes at a cost of greater complexity and increased compliance costs in the administration of the system. The fairness issue associated with a spouse's unused exemption simply does not arise under the accessions tax alternative discussed in the next section.

A fourth Task Force proposal acknowledges the erosion in the tax base associated with lifetime giving techniques focused on the annual exclusion. This proposal calls for retaining the \$10,000 per donee exclusion and for limiting exclusions to an aggregate yearly amount, suggested at \$30,000, but doubled for a married couple.<sup>110</sup> The proposal advances the cause of fairness by reducing, but not eliminating, tax avoidance possible through the use of gift tax exclusions. An aspect of the proposal calls for replacing the easily avoided "present interest" requirement for exclusion with a "vested interest" in the donee standard, a move toward simplicity that should reduce use of the "Crummey" demand power technique.

A fifth Task Force proposal would tighten the estate tax inclusion rule applicable to employment related post-death benefit payments by eliminating the current requirement for inclusion that the decedent must have possessed a right to receive an annuity or other payment.<sup>111</sup> This also serves the interests of fairness by treating all employment generated post-death payments equally.

If the present transfer tax system is to be retained, the proposals discussed above deserve serious consideration. A number serve to reduce

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108. *Id.* at 398.

109. *Id.* at 398-400.

110. *Id.* at 401-02.

111. *Id.* at 411-12.

tax avoidance opportunities and contribute to the fairness and integrity of the system and move the system toward a more coherent scheme for unified treatment of lifetime and testamentary dispositive arrangements. However, some come at the cost of greater complexity, greater inefficiency, and increased compliance costs. None are likely to reduce materially the human and resource costs imposed by the present system. The effects of the proposals on revenue have not been authoritatively projected, in part because many of the details have not been worked out. It is unlikely however, that increased revenues would be at a level that would adequately offset the huge inefficiency costs that have been described in the preceding section. Even if each of the proposals were implemented, a strong case would remain for repeal of the existing transfer tax structure.

An important observation regarding major proposals discussed above is in order. Each of them responds, in some way, to a circumstance associated with the transferor. They involve (1) the gift tax base (tax inclusive or exclusive) of the donor, (2) effect on completeness of gifts when the donor retains interests and powers, (3) value of transferred stock from the perspective of the donor's control "premium," (4) the transferor's transfer tax rate structure, (5) the decedent's unused unified credit or exemption amount, (6) the number and amount of gifts made by the donor, and (7) possession or non-possession by the decedent of rights with respect to employment related post-death benefits.

Under the existing transfer tax structure the entire emphasis is on the transferor, value in the hands of the transferor, actions taken by the transferor, rights possessed or retained by the transferor, and other circumstances of the transferor. The transfer tax system's deficiencies in terms of fairness, efficiency and neutrality are largely explainable by its emphasis on the circumstances of the transferor. That emphasis invites the use of minimization and avoidance techniques and penalizes failure to use such methods. The entire estate planning industry, in service of the cause of avoiding and minimizing transfer taxes, focuses on the circumstances and actions of the transferor. It exploits opportunities within the system to alter and modify the actions and circumstances of the transferor. The huge compliance and avoidance costs in money and resources generated by the transfer tax system derive in large measure from its focus on the acts and circumstances of the transferor.

If wealth transfers are to be taxed under the federal revenue system, models of taxation which have a focus on the circumstances of the transferee rather than on those of the transferor may permit transfer taxation in ways that are fairer, more efficient, and more neutral. Estate planners can readily and effectively exploit a system which focuses on the transferor. A system focused on the circumstances of the transferee is inherently less subject to manipulation and avoidance than one focused on the transferor. Transferees are less apt to arrange their financial position with respect to hoped for receipt of wealth from others not under their control, but transferors, because they must face certain disposition of wealth which they do control, are tempted to manipulate asset arrangements and dispositive schemes. Two

models for taxing gratuitous transfers have been developed by thoughtful commentators, one employing an accessions tax, the other employing inclusion of gifts and bequests in the income tax base. They are discussed in the next section.

## V. TRANSFEREE CENTERED MODELS FOR WEALTH TAXATION

### A. *The Accession Tax Model*

An accessions tax, like the current estate and gift taxes, is an excise tax on gratuitous transfers, but is imposed on the recipient rather than on the transferor. Being imposed on the transferee, the accessions tax is similar to the inheritance taxes in general use in other industrialized countries<sup>112</sup> and to the state inheritance taxes once prevalent here. Unlike most inheritance tax systems, however, the accessions tax is cumulative. Each taxable accession by a transferee, whether from one or several sources, causes a further climb up the rate table. An accessions tax to replace the estate and gift tax system was first proposed in 1945 by Professor Rudick.<sup>113</sup> His proposal was developed further by Professor Andrews in connection with his work as Reporter for American Law Institute Project on Federal Estate and Gift Taxation, completed in 1968.<sup>114</sup> Professor Halbach, focussing heavily on achieving neutrality in a transfer tax system, has recently refined the accessions tax model.<sup>115</sup> Under his version of the model, the accessions tax is entirely centered on the circumstances of the transferee. The transferee would enjoy a modest annual exclusion for direct accessions, but none for accessions from trusts.<sup>116</sup> In addition, the transferee would enjoy a substantial exemption under the rate structure, and potentially taxable accessions from different sources would collectively absorb the exemption, and additional accessions would thereafter be subject to accessions tax.<sup>117</sup> The accessions tax could either be graduated or imposed at a flat rate. However, a flat rate would simplify needed provisions that might otherwise be highly complex.<sup>118</sup> Generally, an accession would occur only upon the receipt of money or property, and thus would not occur merely upon the creation of a nonpossessory interest.<sup>119</sup> Halbach's version anticipates that a donor or testator may be tempted to multiply exclusions and exemptions by making

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112. Aaron & Munnell, *supra* note 36, at 133.

113. Harry J. Rudick, *A Proposal for an Accessions Tax*, 1 TAX L. REV. 25 (1945).

114. William D. Andrews, *Reporter's Study of the Accessions Tax Proposal*, in AMERICAN LAW INSTITUTE, FEDERAL ESTATE AND GIFT TAXATION 446 (1969). For further discussion, see William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967).

115. Edward C. Halbach, Jr., *An Accessions Tax*, 23 REAL PROP. PROB. & TR. J. 211 (1988).

116. *Id.* at 235.

117. *Id.* at 229-35.

118. *Id.* at 247.

119. *Id.* at 222.

transfers to a child and to the spouse of the child, and suggests that a proper solution would lie in attributing to a person any transfer made by the person's close relatives to the person's spouse.<sup>120</sup>

A "deferral problem" inheres in any transfer tax imposed on a transferee at time of possession, rather than upon creation of the interest. Such a tax system invites postponed payment of tax by using trust arrangements to defer distributions. That invitation violates neutrality considerations in favoring dispositive arrangements that would not otherwise have been used and also defers the receipt of revenue which might have been earlier collected had the disposition been outright rather than in trust. Halbach anticipates the problem and suggests a solution in the form of advance payment of "estimated" tax under certain trust arrangements.<sup>121</sup> He also anticipates problems involving use of beneficiary exemptions where interests are held in trust and suggests elective solutions under which the government and the beneficiary can be considered co-beneficiaries during the continuation of the trust arrangement.<sup>122</sup> To this writer, Halbach's solutions, while admittedly requiring complex statutory language, seem fair, effective, and administrable.

Another problem inhering in an accessions tax model is that of "generation-skipping." In the normal order of things one may assume that most wealth at the death of parents would be left to children. An accessions tax invites "scattering" among transferees within the family to take advantage of additional transferee exclusions, and particularly invites transfers to grandchildren, which, in bypassing children, avoid the imposition of taxes that might otherwise have occurred on the death of children. The generation-skipping problem exists under the current system and is the subject of a separate generation-skipping tax. To the extent that generation-skipping is encouraged under any transfer tax system, neutrality is violated. Halbach confronts the generation-skipping problem with a suggestion for a two-step computation of tax liability on transfers to grandchildren, whether outright, or deferred through trust arrangements.<sup>123</sup> Because of the focus on the transferee, rather than on the circumstances and exemptions of the transferor, his approach, while complex, seems less so than the current generation-skipping tax. His approach also seems fair and administrable, and serves well the goal of neutrality.

The accessions tax model as refined by Professor Halbach, being centered on the circumstances of the transferee rather than those of the transferor, offers a number of advantages when contrasted with the present transfer tax system under the policy measures of fairness, efficiency, and neutrality.

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120. *Id.* at 224.

121. *Id.* at 248-70.

122. *Id.* at 248-61.

123. *Id.* at 240-47.

The accessions tax, centered and imposed on transferees, is inherently fairer than the existing tax system in that persons whose total gift and bequest receipts are comparable are comparably taxed.<sup>124</sup> Because under any transfer tax system the tax costs are ultimately borne by successors to the transferred wealth, horizontal and vertical equity is best measured in terms of impact on the recipient successors. Under the accessions tax, they are treated equally. Also, being focussed on the transferees, there are no fairness issues arising from aggressive use of, or failure to use, exemptions of the transferor, in that there are no such exemptions. No one is penalized, for example, for failure to use a by-pass trust or other device oriented toward the existing unified credit.<sup>125</sup> Because of its focus on the accession to property rather than the creation of an interest in property, issues of whether a transfer is complete or whether the transferor has retained impermissible powers or interests simply do not arise.<sup>126</sup> The complex questions of completeness or incompleteness of transfers addressed in the regulations under Code section 2511 and under Code sections 2036, 2037, and 2702 can be ignored under an accessions tax.<sup>127</sup> Similarly, valuation issues involving transfers of partial interests in trust to spouses or to charity largely disappear. Accessions by spouses and by charities would remain exempt from transfer taxation. However no "terminable interest" rule is necessary and complex rules currently applicable to term and remainder interests given to charity are also unnecessary because of the inherent structure of an accessions tax.<sup>128</sup> Questions of tax liability and exemption are presented and resolved at time of possession, not at time of creation of the particular interest. Issues relating to the amount of exclusions or amount of exemptions do not arise until an interest becomes possessory by outright transfer or distribution from a trust, and valuation is relatively easy at such time.<sup>129</sup> The "premium" under the present system associated with equalizing the estates of husband and wife, and the attendant penalty for failure to do so disappears under the accessions tax model.<sup>130</sup> When a child receives accessions of \$2,000,000 upon the combined deaths of both parents, it largely matters not whether the bulk of the accession comes from the first or second parent to die. The applicable rate table is not that of the transferor, but that of the transferee. The combined accessions of a particular individual are essentially taxed as if there is only one accession.

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124. *Id.* at 213.

125. *Id.* at 224.

126. *Id.* at 221-22.

127. Treas. Reg. §§ 25.2511-2 (as amended in 1983) (dealing with cessation of donor's dominion and control); 20.2036-1 (as amended in 1960) (dealing with transfers with retained life estates); 20.2037-1 (1958) (dealing with transfers taking effect at death); 25.2702-0 to -7 (1992) (dealing with transfers of interests in trusts).

128. Halbach, *supra* note 115, at 221-22.

129. *Id.*

130. *Id.* at 223.

In addition to its inherent capacity for greater fairness and neutrality than under the present system, the accessions tax model offers the potential for simpler compliance procedures and mechanisms. The administration of the accessions tax can be coordinated with the current income tax system.<sup>131</sup> Additional reporting would be required, but this can be accomplished through the device of appropriate schedules or supplements to the annual Form 1040. Under the model, transferees are responsible for the reporting of accessions and the payment of any tax due after use of minimum annual exclusions and exhaustion of exemptions.<sup>132</sup>

Because transferees have the reporting and payment duties, and because the tax is measured by the value of accessions when they are paid or become possessory, not by the circumstances and prior behavior and dispositions of the transferor, personal representatives may be relieved of personal liability for payment of transfer tax under the accessions tax model. This feature facilitates use by states of simplified probate practices permitting succession without administration, practices common in European countries that employ transferee centered inheritance taxes in lieu of transferor centered estate taxes.<sup>133</sup>

### B. Income Tax Model

Currently gifts and bequests are excluded from income under the income tax.<sup>134</sup> Consequently, wealth transfers that are not subject to estate, gift, and generation-skipping tax are not part of the federal tax base. A number of commentators have suggested that inclusion of gifts and bequests in taxable income is theoretically sound under an income tax based upon ability to pay.<sup>135</sup> A widely accepted economists' model of the proper income tax base assumes that income consists of accessions to wealth between two points in time, including donative receipts.<sup>136</sup> Canada, in connection with repeal of its estate and gift tax system, considered, but did not implement, a detailed proposal for including gifts and bequests in the income of recipients.<sup>137</sup> The Canadian proposal has generated ongoing interest in this country in including donative receipts in the recipient's taxable income as an alternative to continuation of our current estate and gift tax system.<sup>138</sup>

The proposal to include donative receipts in income as an alternative to the present system of taxing donative transfers has much to commend

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131. *Id.* at 229.

132. *Id.*

133. *Id.*

134. I.R.C. § 102 (1988).

135. See, e.g., Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978) (arguing fairness and simplicity mandate income inclusion in lieu of transfer tax system); Hudson, *supra* note 3, at 59; Munnell, *supra* note 28; Gac & Brougham, *supra* note 82.

136. Dodge, *supra* note 135, at 1182-84 (discussing "Haig-Simons" comprehensive tax base model). See also TREAS. DEP'T, BLUEPRINTS FOR BASIC TAX REFORM 1-3 (1977).

137. Munnell, *supra* note 28, at 21-22.

138. See *supra* note 135 (citing sources).

it. First, it would further refine the income tax in employing a more comprehensive base geared to taxpayer ability to pay. Second, its administration would be comparatively simple in relation to compliance structures currently used in enforcing the existing transferor based transfer tax system. Third, being transferee oriented rather than transferor oriented, it shares with the accessions tax the structural features that better serve the goals of fairness and neutrality. Fourth, because the proposal would utilize only minimal exclusions<sup>139</sup> and would generate revenues based on the income tax posture of the recipient transferee, it has the capacity to generate greater revenues than are derived from the existing transfer tax system.

This last advantage carries with it the political difficulty that a considerably larger number of persons would be burdened by the imposition of taxes measured by donative transfers. Attempts to reduce the political difficulty by the device of using generous exclusions would be a conscious departure from the ability to pay principle. No doubt the life insurance industry would vigorously oppose any attempt to treat life insurance proceeds as includible in the income of beneficiaries. Whether the model of including donative receipts in taxable income should be implemented is fundamentally a political question involving notions of the proper structure of the income tax. It is generally acknowledged that the current income tax system taxes earned income more heavily than income from capital.<sup>140</sup> A substantial amount of gains from capital escapes taxation because of the step-up in basis accorded appreciated assets at the death of the owner.<sup>141</sup> If accumulated capital were taxed as income to the recipient upon donative transfer, much of the perceived abuse in the under-taxation of income from capital would be effectively addressed. Sound income tax policy considerations strongly suggested that the income tax base be expanded to include donative receipts. A major collateral advantage is that implementation of such expansion of the income tax base permits repeal of the estate and gift tax system without revenue loss, and with the potential for significant revenue gain. The proposal to include donative receipts in income deserves sympathetic consideration by Congress.

### *C. Problems in the Income Tax Proposal*

A major problem inherent in the income tax proposal involves the proper treatment of transfers in trust, and the potential for using trust arrangements to postpone distributions and imposition of tax. An approach suggested by Professor Dodge carries with it the advantage of relative simplicity. Under this approach, the current conduit system under Subchapter "J" of the Internal Revenue Code for apportioning income between a trust or estate and its beneficiaries would be repealed, and all distributions, no distinctions being made between distributions of current income, accu-

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139. Dodge, *supra* note 135, at 1192.

140. Graetz, *supra* note 13, at 273.

141. *Id.*



culated income, and corpus, would be taxed as income to the recipient.<sup>142</sup> If deferral by postponement of distributions is considered abusive, a withholding tax could be imposed on the trustees of large trusts, which could be credited against liability by distributees when distributions occur and become taxable.<sup>143</sup> Except for such withholding tax liability in certain cases, trusts would be exempt from tax. Under this approach trusts would have a zero basis for assets held in kind, and thus there would be no depreciation problem with respect to depreciable assets held in trust.<sup>144</sup> Depreciable property would not acquire a basis for allowance of depreciation until distributions occur.

Another approach to the problem posed by use of trusts suggested by commentators is to retain the present structure of Subchapter "J," and to treat trusts as taxpayers. A trust would include initial funding transfers in income and thus pay income tax,<sup>145</sup> presumably at the highest income tax bracket in the case of sizable funding transfers. Concededly, under this proposal, some unfairness could result if the beneficiary who is the equitable owner of the assets held in trust is in a lower bracket. The extent of the fairness problem is in large measure a function of the bracket spread used in the income tax structure. In a regime of few brackets, tightly compacted, the problem is less severe. A possible solution is to permit, in certain cases, the beneficiary to elect to have the corpus, on receipt in trust, to be directly taxed to the beneficiary.<sup>146</sup> Any exclusions that would have been accorded the beneficiary had the beneficiary been a direct transferee could thus be used. Depending upon the extent of bracket spread, income averaging methods could be employed to deal with "bunching" of large amounts within a year.<sup>147</sup>

Liquidity may be a problem if income tax is due upon donative receipt in-kind of nonmarketable or difficult to market assets. Suggestions to deal with liquidity problems include authorization for deferred payment of tax in installments<sup>148</sup> or the assigning of a zero basis to such assets as real estate and closely held business interests.<sup>149</sup>

Another problem of including donative receipts in income is that of distinguishing between transfers pursuant to obligations to support dependents, which presumably should not be taxed, and truly donative payments which should be taxed.<sup>150</sup> However, this problem is not novel to the proposal to include donative receipts in income and arises as well under the current estate and gift tax system, where payments made pursuant to support obligations are not within the transfer tax base. Transfers which enable

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142. Dodge, *supra* note 135, at 1180-81.

143. *Id.* at 1197.

144. *Id.* at 1195.

145. Gac & Brougham, *supra* note 82, at 95.

146. *Id.*

147. *Id.* at 92.

148. *Id.* at 99.

149. Dodge, *supra* note 135, at 1199-1200.

150. *Id.* at 1202-08.

current consumption by dependents should pose no insurmountable problems, nor should those for payment of medical expenses and tuition costs. Transfers of securities and cash which serve to "endow" the transferee would be included in the tax base to the extent in excess of prescribed exclusion amounts.

Generation-skipping, as such, does not present a direct potential for abuse under the proposal to include gifts and bequests in the income tax base, at least in terms of the underlying policy of taxing individuals under the income tax by reference to ability to pay. However, in the normal order of things, accumulated wealth owned free of trust would be transferred at least once each generation, and would thus be included in the enlarged income tax base at least that frequently. Use of trusts benefitting multiple generations thus would result in a potential loss of revenue if accumulated wealth is not taxed at each generation within the income tax base. Whether estate planners would advise, and clients concur in, use of multiple-generation trusts to minimize income tax is unclear, and may be a function of the income tax rate structure. Such an income tax minimizing strategy is implemented at the cost of postponing the receipt and enjoyment of wealth (trust distributions) by the beneficiaries who are the objects of bounty. If, however, use of multi-generational trusts is encouraged under the proposal to include gifts and bequests in income, the goal of neutrality is to that extent undermined. Some sort of generation-skipping levy, such as imposing income tax on trusts with respect to corpus and accumulated income at periodic intervals, perhaps every thirty or thirty-five years, may prove to be needed.<sup>151</sup>

Any consideration of expanding the income tax base by including donative receipts in the income of recipients is likely to be politically controversial. Congress would face difficult choices with respect to the treatment of items such as life insurance proceeds and wrongful death tort recoveries paid to survivors and in establishing exclusion amounts. To achieve neutrality and fairness, careful attention must be paid to problems presented by trust arrangements and to the deferral issues posed by trusts. Whether the political constraints to implementing a fair scheme of including donative receipts in income are surmountable is unclear. However, the technical problems involved in achieving fairness and neutrality appear solvable, although the solutions may require a degree of complexity. In the ongoing process of attempting to improve the income tax, the proposal to include donative receipts in the income tax base deserves careful and sympathetic consideration. In addition to an improved income tax, such consideration could facilitate abolition of the current estate, gift, and generation-skipping taxes.

## VI. CONCLUSION

The current system of transfer taxation should be abolished. In taxing transferors rather than transferees in donative transactions the structure of

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151. Gac & Brougham, *supra* note 82, at 96-97.

the present scheme is fundamentally flawed. The current transfer tax system does not achieve its perceived goals and produces revenues that are grossly inadequate in relation to its unfairness, inefficiency, and lack of neutrality. These revenues are insufficient to compensate for the costs and burdens imposed by the system. Proposed reforms and refinements of the present system, if implemented, are unlikely to make burdens and costs of the system tolerable. Reasonable people differ as to whether wealth transfers should be subject to taxation. If such transfers are properly subject to tax and if such tax should be borne only by the wealthiest segment of the population, Congress should replace the present system with a transferee-based accessions tax with appropriate exclusions and exemptions. The accession tax model offers a structure that is inherently fairer, more efficient, and more neutral than the current system. As an alternative, although politically more difficult to implement, Congress should give careful consideration to the proposal to make the income tax base more comprehensive by including donative transfers within the transferee's gross income. Under either alternative, Congress would rid the Internal Revenue Code of the current outdated and overly complex system while enhancing the realization of the policy goals for the future of transfer taxation