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THE ESTATE AND GIFT TAX REVISIONS OF THE TAX REFORM ACT OF 1976

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The Federal estate tax was adopted in 1916,¹ amidst echoes of a presidential call for

a progressive tax on all fortunes beyond a certain amount either given in life or devised or bequeathed upon death to any individual — a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual.²

Since its enactment, the estate tax has been continually revised and restructured in an effort to make it a more effective means of wealth redistribution and revenue gain.³

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¹ Int. Rev. Code of 1916, ch. 483, §§ 200-12, 39 Stat. 756, 777. This was the origin of the modern estate tax. However, a stamp tax was levied on receipts through inheritance in 1797. Act of July 6, 1797, ch. 11, § 1, 1 Stat. 527. In 1862, Congress levied an inheritance tax to support the Civil War effort. Act of July 1, 1862, ch. 119, § 110, 12 Stat. 432, 479. The ill-fated income tax act of 1894 even included in "income" amounts received by inheritance. Tariff of 1894, ch. 349, § 28, 28 Stat. 509, 553. The Spanish-American War was also funded through an estate tax. Act of June 13, 1898, ch. 448, § 29, 30 Stat. 448, 464. This last tax was significant in that the United States Supreme Court specifically upheld its validity, giving sanction to the modern estate tax which would be enacted 18 years later. *Knowlton v. Moore*, 178 U.S. 41 (1900).

² Speech by President Theodore Roosevelt, April, 1906, quoted in R. PAUL, *TAXATION IN THE UNITED STATES* 88 (1954).

³ Briefly, the estate tax was adopted in 1916 and suffered only minor revisions between 1916 and 1932. In 1932, the gift tax was added to prevent the *inter vivos* disposition of assets in evasion of the estate tax. Between 1932 and 1941, the rates

Prior to the recent revision, the estate and gift taxes were separate, complementary taxes, both graduated and both designed to raise revenues and prevent the perpetuation of large estates. The estate tax was imposed on the fair market value of all property or interests in property possessed by the decedent on the date of his or her death,⁴ reduced by certain credits, exemptions and deductions. Foremost among these were the specific exemption of \$60,000 worth of property⁵ and the marital deduction for certain properties passing to a surviving spouse.⁶ The gift tax, enacted in 1932, was an effort to curtail avoidance of estate taxes through *inter vivos* dispositions.⁷ While the gift tax was intended to complement the estate tax, its rates were set at three-quarters of the estate tax rates.⁸

The current effort towards estate and gift tax reform began in the House Committee on Ways and Means in 1969.⁹ Four years later, the effort was begun anew,¹⁰ resulting in consideration of an estate and gift tax reform bill in 1976 by the House of Representatives.¹¹ This

were changed but no structural modifications took place. In 1942, the current format was adopted, with the specific exemption of \$60,000 and the rudimentary beginnings of the marital deduction, designed to equalize the treatment of estates in community property and common law states. See Int. Rev. Code of 1916, ch. 483, §§ 200-12, 39 Stat. 756, 777; Int. Rev. Code of 1917, ch. 154, §§ 300-01, 39 Stat. 1000, 1002; War Revenue Act of 1917, ch. 63, §§ 900-01, 40 Stat. 300, 324; Int. Rev. Code of 1918, ch. 18, §§ 400-10, 40 Stat. 1057, 1095 (1919); Int. Rev. Code of 1921, ch. 136, §§ 400-11, 42 Stat. 227, 277; Int. Rev. Code of 1924, ch. 234, §§ 300-24, 43 Stat. 253, 303; Int. Rev. Code of 1926, ch. 27, §§ 300-25, 44 Stat. 9, 69; Int. Rev. Code of 1932, ch. 209, §§ 401-03, 47 Stat. 169, 243; Int. Rev. Code of 1934, ch. 277, §§ 401-06, 48 Stat. 680, 752; Int. Rev. Code of 1935, ch. 829, §§ 201-03, 49 Stat. 1014, 1021; Int. Rev. Code of 1941, ch. 412, §§ 401-02, 55 Stat. 687, 704; Int. Rev. Code of 1942, ch. 619, §§ 401-58, 56 Stat. 798, 941.

⁴ I.R.C. §§ 2031, 2033 [hereinafter cited as Code]. The past tense is applicable to this statement because, under the Tax Reform Act of 1976, some properties are included in the gross estate at other than their fair market values. See discussion of tax relief for small businesses and family farms, text accompanying notes 122-174 *infra*.

⁵ Int. Rev. Code of 1954, ch. 736, § 2052, 68A Stat. 389 (repealed 1976).

⁶ I.R.C. § 2056 (originally enacted as Int. Rev. Code of 1954, ch. 736, § 2056, 68A Stat. 392).

⁷ S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932).

⁸ Int. Rev. Code of 1954, ch. 736, § 2502, 68A Stat. 403 (current version at I.R.C. § 2502).

⁹ *Hearings on Tax Reform Before the House Committee on Ways and Means*, 91st Cong., 1st Sess., 3970-4185 (1969).

¹⁰ *Panel Discussions on General Tax Reform Before the House Committee on Ways and Means*, 93d Cong., 1st Sess., Panel 10 (1973) [hereinafter cited as *1973 Panel Discussions*].

¹¹ H.R. 14844, 94th Cong., 2d Sess. (1976) [hereinafter cited as *H.R. 14844*]; H. R. REP. No. 1380, 94th Cong., 2d Sess. (1976) [hereinafter cited as *House Report*].

bill eventually became the basis for the estate and gift tax title of the Tax Reform Act of 1976,¹² passed by Congress on September 16, 1976,¹³ and signed into law on October 4, 1976. The estate and gift tax revision of the Tax Reform Act of 1976 is a new set of ground rules for estate planners and tax practitioners, as well as for taxpayers. Each provision must be examined in order to develop a clear understanding of the new structure.

Unification of the Estate and Gift Tax Rate Schedules and the Unified Transfer Tax Credit

Historically, the estate tax has been imposed on transfers at death and the gift tax on transfers during life, and each has had its own rate schedules and exemptions. The estate tax rates ranged from 3 percent on taxable estates of up to \$5,000 to 77 percent on taxable estates over \$10 million.¹⁴ The estate tax exemption was set at \$60,000.¹⁵ The gift

¹² Pub. L. 94-455, 90 Stat. 1525 (1976) [hereinafter cited as *Act*].

¹³ H.R. 10612, 94th Cong., 2d Sess. (1976), was first reported out of the House Committee on Ways and Means without an estate and gift tax provision. H. R. REP. No. 658, 94th Cong., 1st Sess. (1975). After its consideration of the bill, the Senate Finance Committee reported it to the floor of the Senate with a title dealing with estate and gift tax reform. S. REP. No. 938, Pt. II, 94th Cong., 2d Sess. 13-23 (1976) [hereinafter cited as *Senate Report*]. The Conference Committee on H.R. 10612 compared the Senate Finance Committee package with the separate bill reported out of the House Ways and Means Committee, H.R. 14844, and adopted the House version with only minor changes. H. R. REP. No. 1515, 94th Cong., 2d Sess. 552-625 (1976) [hereinafter cited as *Conference Report*]. Congress passed the bill on September 16, 1976. The House passed it by a vote of 383 yeas to 26 nays, and the Senate passed it by a vote of 84 yeas to 2 nays. 122 CONG. REC. H. 10225, S. 16029 (1976).

¹⁴ Int. Rev. Code of 1954, ch. 736, § 2001, 68A Stat. 373 (current version at I.R.C. § 2001).

¹⁵ See note 5 *supra*. The exemption was set at \$50,000 in the original estate tax of 1916. Int. Rev. Code of 1916, ch. 483, § 203, 39 Stat. 778. In 1926, the exemption was increased to \$100,000, and an 80 percent credit was provided for state death taxes paid on the same property. Int. Rev. Code of 1926, ch. 27, §§ 301(b), 303(a), 44 Stat. 70, 73. In 1932, an additional estate tax was levied on top of the old tax, with a credit set at \$50,000. This was done to limit the use of the 80 percent state death tax credit to the taxes imposed under the 1926 rate schedules. Int. Rev. Code of 1932, ch. 209, § 401, 47 Stat. 243. In 1942, however, the exemption on the additional tax was set at \$60,000. Int. Rev. Code of 1942, ch. 619, § 414, 56 Stat. 951. In 1954, with the codification of the current Internal Revenue Code, the two sets of estate tax rates were unified into one rate schedule, and the exemption of \$60,000 was retained. Int. Rev. Code of 1954, ch. 736, §§ 2001, 2052, 68A Stat. 373-74, 389. The apparent rationale for the exemption from 1916 to the present was to assure the application of the estate tax to only larger estates, although this has not been clearly defined in legislative documents. See C. LOWNDES, R. KRAMER & J. MCCORD, *FEDERAL ESTATE AND GIFT TAXES* 9 (3d ed. 1974) and Surrey & Kurtz, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1366-68 (1970).

tax rates ranged from 2 1/4 percent on taxable gifts up to \$5,000 to 57 3/4 percent on taxable gifts above \$10 million.¹⁶ The first \$3,000 worth of gifts to each donee annually was exempted from tax,¹⁷ as was an additional lifetime \$30,000 worth of gifts.¹⁸ In addition to the separation of the two rate schedules and exemptions, the division was bolstered by disregard of lifetime transfers when computing the estate tax. Thus, an individual could make a large number of both *inter vivos* gifts and utilize the progressive nature of both rate schedules if he or she had sufficient wealth to afford this practice.¹⁹ A third aspect of the independence of the estate and gift taxes was the exclusion of an amount paid in gift taxes from the estate of the donor when the property was included in the gross estate. This problem could arise if the gift was found to be incomplete because the donor retained beneficial control over the enjoyment of the property, or because it was found to be in contemplation of death.²⁰

The independence of the two taxes was perceived as creating difficulties in administration and inequity in application, resulting in a proposal for the unification of both the rate schedules and exemptions by the Department of the Treasury in 1969.²¹ The Secretary of the Treasury recommended to the House Committee on Ways and Means that the rate schedules be integrated into one single schedule, with rates ranging from 3 percent on taxable transfers up to \$5,000 to 65 percent on taxable transfers about \$10 million.²² He also recommended the creation of an "overall exemption" of \$60,000 to replace both the lifetime gift tax exemption and estate tax exemption.²³ The

¹⁶ See note 8 *supra*.

¹⁷ I.R.C. § 2503(b). As this was a "per donee" exclusion, there was no limitation on the total amount of gifts which could be made without tax. If a donor made 100 gifts of \$3,000 to 100 different donees in the same taxable year, the entire \$300,000 in transfers would be exempt from tax.

¹⁸ Int. Rev. Code of 1954, ch. 736, § 2521, 68A Stat. 410 (repealed 1976).

¹⁹ Several exceptions to the general disregard of *inter vivos* gifts in computing the estate tax were gifts in contemplation of death, transfers with a retained life estate, transfers taking effect upon the decedent's death, and revocable transfers. Int. Rev. Code of 1954, ch. 736, §§ 2035-2038, 68A Stat. 381-84 (current version at I.R.C. §§ 2035-2038). In these cases, the value of an *inter vivos* gift is brought back into the gross estate for imposition of an estate tax.

²⁰ While the gift tax paid is allowed as a credit against the estate tax, the savings arise because when the property transferred in gift is returned to the gross estate, it is returned net of the gift tax paid, thereby reducing the total taxed transfer.

²¹ HOUSE COMMITTEE ON WAYS AND MEANS AND THE SENATE COMMITTEE ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS OF THE U.S. TREASURY DEPARTMENT 354-55 (Comm. Print 1969) [hereinafter cited as *Treasury Proposals*].

²² *Id.* at 31, 356.

²³ *Id.* at 357.

proposed rate schedule would have been applied against the total, grossed-up value of all lifetime and testamentary transfers.²⁴ In this fashion, the incentive to make lifetime gifts to avoid estate taxes would be reduced.²⁵ Furthermore, gifts with retained beneficial enjoyment would not be taxable until the beneficial enjoyment had been surrendered or, at the grantor's election, at the initial transfer.²⁶

The Treasury proposals had a marked influence upon the Congress when it considered estate and gift tax revision in later years. Also leaving a significant mark on the legislative thoughts on estate and gift tax unification was the American Law Institute's findings and recommendations.²⁷

In spite of extensive study of the relative merits of unification and dual tax structure, the Institute could make no recommendations as to the need for unification.²⁸ It did, however, make recommendations to be considered in case unification was adopted. First, the Institute suggested that the tax base would not be the grossed-up total of all gifts made during the life of the grantor, but rather, the estate tax portion of the unified tax would apply independently of the gift tax portion.²⁹ The only grossing-up would occur as to gifts made within two years of the death of the donor, which would be included in measurement of the rates applied to the estate.³⁰ Second, the Institute felt that it was important that no property be included in both the *inter vivos* and testamentary transfers.³¹ As such, it proposed a series of rules to assure that all gifts were treated as either *inter vivos* or testamentary.³² The Institute also recommended the creation of a unified tax exemption of \$100,000 in order to permit smaller estates to avoid high tax burdens.³³ This was also intended to reflect the

²⁴ *Id.* at 355. For example, if G made taxable gifts of \$50,000 in 1980, \$100,000 in 1981, and died with a taxable estate of \$250,000 in 1982, the first gift (assuming no prior taxable transfers) would be taxed at the rates applicable to transfers up to \$50,000. The second gift would be taxed at the rates for transfers between \$50,000 and \$150,000. The estate would be taxed at the rate for transfers between \$150,000 and \$400,000.

²⁵ *Id.*

²⁶ *Id.* at 364-65.

²⁷ AMERICAN LAW INSTITUTE, FEDERAL ESTATE AND GIFT TAXATION; RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE AND REPORTER'S STUDIES (1968) [hereinafter cited as *ALI Proposals*].

²⁸ *Id.* at 3-4.

²⁹ *Id.* at 9, 45.

³⁰ *Id.*

³¹ *Id.* at 45-46. As such, the line between completed and uncompleted gifts was to be made more definite. This was recommended for either unified or dual tax systems.

³² *Id.* at 46-47.

³³ *Id.* at 9, 49-50.

impact of inflation on the current exemption levels set in 1942.³⁴

The new unified estate and gift tax schedules and the unified transfer tax credit adopted in the Tax Reform Act of 1976 show the impact of both the Treasury and Institute proposals. The basic schedule adopted is progressive, with rates ranging from 18 percent on taxable transfers up to \$10,000 to 70 percent on taxable transfers above \$5 million.³⁵ The new unified transfer tax is based on the total, grossed-up lifetime and deathtime transfers of the taxpayer.³⁶ Whether an *inter vivos* transfer has been made will still be determined under pre-1976 rules, but any transfer included in the lifetime tax base will not be included again upon death.³⁷ This will insure against double taxation of the same transfer, as might occur with incompleted gifts.³⁸ Gifts in contemplation of death will still be included in the estate of the decedent,³⁹ although the rules for such inclusion have been changed.

Formerly, where a gift was made within three years of the date of the decedent's death, a rebuttable presumption existed that it was transferred in contemplation of death, and its value was included in the gross estate absent evidence by the estate that the transfer was not in contemplation of death.⁴⁰ The new law removes the presumption, simply including in the estate of a decedent the value of all gifts made within three years of the date of a decedent's death.⁴¹ In addition, the new rules bring the property transferred in contemplation of death back into the estate without first reducing them by the gift taxes paid.⁴² This is in contrast with the prior law which brought gifts in contemplation of death into the estate net of gift taxes paid.

³⁴ *Id.* at 49-50. In 1942, when the pre-1976 exemption levels were established, only one percent of all estates were brought within the ambit of the estate tax. By 1975, however, seven percent of all estates were being subject to tax. *House Report, supra* note 11, at 5.

³⁵ I.R.C. § 2001(c) (*added by Act, supra* note 12, § 2001(a)(1)). This schedule only applies to residents and citizens. Another schedule is used for nonresident alien decedents or donors with rates between 6 percent on taxable transfers up to \$100,000 to 30 percent on taxable transfers in excess of \$2 million. I.R.C. § 2101, (*added by Act, supra* note 12, § 2101(c)(1)(D)).

³⁶ I.R.C. § 2001(b) (*added by Act, supra* note 12, § 2001(a)(1)).

³⁷ *House Report, supra* note 11, at 12.

³⁸ This would appear to be a response to the ALI Proposals discussed earlier. See text accompanying notes 27-34 *supra*.

³⁹ I.R.C. § 2035 (*amended by Act, supra* note 12, § 2001(a)(5)).

⁴⁰ I.R.C. § 2035(a), (b) (*amended by Act, supra* note 12, § 2001(a)(5)).

⁴¹ *Id.*

⁴² I.R.C. § 2035(c) (*amended by Act, supra* note 12, § 2001(a)(5)).

In the case of a husband and wife who make a joint gift to take advantage of the gift-splitting provisions of the law,⁴³ the tax paid by the surviving spouse will be allowed as an offset to the transfer tax of the deceased spouse if the gift is brought into the estate because it is incomplete.⁴⁴ This is designed to neutralize the treatment of the surviving spouse as the donor of one-half of the gift.⁴⁵

Gifts made before December 31, 1976, are taken into account for the determination of the transfer tax rate, as part of the grossed-up total of all lifetime gifts.⁴⁶ The new rules for gifts in contemplation of death also apply to transfers made after December 31, 1976.⁴⁷

In addition to unification of the estate and gift tax schedules, the Tax Reform Act of 1976 also unified the lifetime gift tax exemption and the estate tax exemption into a single tax credit.⁴⁸ When fully phased-in, in 1981, the credit will be \$47,000. Until then, it will begin at \$30,000 for estates and gifts in 1977 and increase to \$34,000 in 1978, \$38,000 in 1979, and \$42,500 in 1980.⁴⁹ The taxable estate of a decedent dying in 1982, after full phase-in of the unified transfer tax credit, will not have to file an estate tax return if it has sufficient credit to cover its tax liability.⁵⁰

For gifts made after September 8, 1976, and before December 31, 1976, a taxpayer will still be able to utilize any portion of his or her lifetime gift tax exemption remaining. However, any portion of the gift tax exemption utilized before the end of 1976 will reduce the remaining unified tax credit for 1977 by 20 percent of the exemption utilized.⁵¹ For example, if a taxpayer had his or her entire \$30,000 lifetime gift tax exemption intact and made a taxable gift which utilized the entire exemption, \$6,000 of the \$30,000 unified credit for 1977 would not be available. That individual's credit for 1977 would only be \$24,000.

⁴³ I.R.C. § 2513.

⁴⁴ I.R.C. § 2001(d) (amended by Act, *supra* note 12, § 2001(a)(1)).

⁴⁵ House Report, *supra* note 11, at 13. However, there is no restoration of any portion of the unified transfer tax credit used with respect to the gift brought back into the estate. This presents the inequitable result of the reduction of the unified transfer tax credit of the donor's spouse coupled with the inclusion of the gift in the donor's gross estate, without concomittant increase in the spouse's credit.

⁴⁶ Act, *supra* note 12, § 2001(d)(2).

⁴⁷ *Id.*

⁴⁸ I.R.C. § 2010 (added by Act, *supra* note 12, § 2001(a)(2)); I.R.C. § 2505 (added by Act, *supra* note 12, § 2001(b)(2)).

⁴⁹ *Id.*

⁵⁰ I.R.C. § 6018(a) (amended by Act, *supra* note 12, § 2001(c)(1)(J)).

⁵¹ I.R.C. § 2505(c) (added by Act, *supra* note 12, § 2001(b)(2)).

The unification adopted by the Congress will remove most of the tax incentives for lifetime giving. A taxpayer will still have his or her annual \$3,000 per donee exemption to utilize, and the gift taxes paid on all gifts made over three years prior to date of death are, themselves, removed from the gross estate, but the major incentives for such *inter vivos* dispositions have traditionally been the added \$30,000 exemption and the lower rates on gift taxes. This, in turn, should produce a greater equity in the estate and gift tax field.⁵²

The use of *inter vivos* trusts should also decrease because of the unification of the estate and gift tax schedules and creation of the unified credit. In the past, these trusts have been convenient mechanisms for removing assets from an individual's estate without entirely disposing of control over the assets. However, with the unification of the gift and estate tax, removal of an asset from one's estate will take on minor significance. Indeed, the use of trusts for purely nontax purposes may become the common situation rather than the rarity that appears to have transpired until 1976.

While the gift in contemplation of death rules have been simplified, some criticism may be levied here against the reasoning which led to their continuation at all. Since the estate and gift tax rates are now the same and the transfer tax imposed at the date of death will take into consideration the value of all *inter vivos* gifts, the incentive for making gifts in contemplation of death in order to evade the estate tax is reduced. It seems reasonable to assume that had Congress not removed the presumption from the gift in contemplation of death provisions, making them absolute, it would have been very difficult for the Government ever to establish that a gift had been made in contemplation of death because of the greatly diminished tax-avoidance incentive. With very few exceptions, only a negligible tax would be avoided. However, the impact of the new gift in contemplation of death provision on a taxpayer who makes a gift for legitimate reasons within three years of death will be minimal. Therefore, Congress may be faulted for retaining the provision, but the significance of the fault is minimal in relation to what appears to be a sound, equitable change in the structure of the estate and gift tax laws.

⁵² Two commentators pointed out the gross inequities they perceived to arise from the favoritism granted lifetime gifts by the estate and gift tax laws in effect before the revision. "[T]he present estate and gift tax system introduce[s] serious elements of unfairness to smaller estates . . . and to those families unable to take advantage of the three factors described above. The 1957-1959 data indicate that decedents with large estates (over \$1,000,000) had transferred 10% of assets during life; those with small estates (under \$300,000) had transferred less than 2% of assets." Surrey & Kurtz, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1373 (1970).

Marital Deduction and Fractional Interests

The marital deduction, enacted in 1948 in an effort to equalize the estate tax treatment of decedents in common law and community property states,⁵³ has become the basic tool of estate planning. The modification of the deduction under the Tax Reform Act of 1976 should result in a reduced burden of the tax on small- and moderate-sized estates, without reducing its value to larger estates.

An estate is granted a deduction for the value of any property passing to a surviving spouse, either under a will or by intestacy.⁵⁴ Until 1976, however, the deduction was limited to the lesser of the property passing to the surviving spouse or one-half of the adjusted gross estate.⁵⁵ The adjusted gross estate is the gross estate, less funeral and estate administration expenses, losses and state death taxes paid by the estate.⁵⁶

In order for property passing to the surviving spouse to qualify for the marital deduction, it must be equivalent to absolute ownership. Terminable interests and legal life estates, where not coupled with a non-limited power of appointment, are not qualifying property for purposes of the marital deduction.⁵⁷

In addition to the marital deduction for testamentary interspousal transfers, another deduction is available against the gift tax for interspousal *inter vivos* transfers. Prior to the 1976 revision, the gift tax marital deduction was equal to the lesser of the entire gift, after the allowable annual exclusion, or one-half of the gift, before deducting the annual exclusion.⁵⁸

Similarly, terminable interests given one spouse by another spouse will not qualify for the marital deduction. This includes inter-

⁵³ Act of April 2, 1948, ch. 168, § 361, 62 Stat. 117. (I.R.C. § 2056) (*amended* 1976). § 361, 62 Stat. 117. (I.R.C. § 2056) (*amended* 1976). The Senate Finance Committee noted that the purpose of the new marital deduction was to correct a disparity of treatment between common law and community property states and, with respect to the estate tax, "provide more nearly equal results . . ." S. REP. NO. 1013, Pt. I, 80th Cong., 2d Sess. 21 (1948). As has been noted by some, however, "[a]bsolute parity is, of course, impossible to achieve due to the essential differences in the two systems." Young, *Proposed Revisions of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 82 n.58 (1970).

⁵⁴ I.R.C. § 2056(a) (*amended* 1976).

⁵⁵ I.R.C. § 2056(c)(1) (*amended* 1976).

⁵⁶ I.R.C. § 2056(c)(2) (*amended* 1976).

⁵⁷ I.R.C. § 2056(b) (*amended* 1976).

⁵⁸ I.R.C. § 2523. For example, if H gives W property valued at \$25,000 in 1975, the gift tax marital deduction will be the lesser of the full value of the gift after the annual exclusion (\$25,000 - \$3,000, or \$22,000), or one-half of the gift itself (\$12,500). The marital deduction would be \$12,500, and the taxable gift would be \$12,500.

ests that terminate or fail after the passage of time or upon some stated contingency, such as life estates, annuities, and estates for years.⁵⁹

The Department of the Treasury and the American Law Institute proposed nearly identical marital deduction revisions. Both suggested the use of an unlimited marital deduction for *inter vivos* and testamentary interspousal transfers.⁶⁰ Both also expanded the base of the marital deduction, including terminable interests in which the surviving spouse or transferee spouse received beneficial enjoyment of the property. Under both proposals, the tax would normally be imposed when the beneficial enjoyment terminated, but could be imposed at the time of transfer by election of the transferee spouse.⁶¹ With respect to the gift tax marital deduction, both suggested that the spouses be able to determine the relative proportions in which they would like a jointly-made gift deemed made, rather than mandatorily deeming it made equally.⁶²

The flexibility offered by the two estate and gift tax marital deduction proposals was touted as a strong point favoring their adoption. Where a surviving spouse expected to consume the greatest portion of an estate, either directly or by *inter vivos* gifts within his or her annual and lifetime exclusions, the election could be made to have no part of a terminable interest taxed on the transfer, but rather, upon termination. In most cases, this could result in significantly reduced estate taxes. In those instances where a surviving spouse expected to increase the estate, terminable interests could be used and taxed on transfer, removing the assets from the estate of the surviving spouse.⁶³ Another contention made by the two proposing bodies was that this would relieve the burden of the estate tax on the surviving spouses, who would receive the estate undiminished by taxes.

The proposals had an impact on the considerations for estate and gift tax revision, but an unlimited marital deduction was not adopted. Rather, a hybrid deduction, possessing features of the unlimited marital deduction and the limited deduction, was accepted

⁵⁹ I.R.C. § 2523(b)(amended 1976).

⁶⁰ *ALI Proposals*, *supra* note 27, at 7-8, 32-33, 37-39; *Treasury Proposals*, *supra* note 21, at 119, 357-60.

⁶¹ *ALI Proposals*, *supra* note 27, at 7-8, 34-35; *Treasury Proposals*, *supra* note 21, at 379.

⁶² *ALI Proposals*, *supra* note 27, at 7-8, 37-39; *Treasury Proposals*, *supra* note 21, at 380.

⁶³ *Treasury Proposals*, *supra* note 21, at 349-60.

by the House Committee on Ways and Means⁶⁴ and incorporated into the Tax Reform Act of 1976.⁶⁵

The new marital deduction for testamentary transfers sets an alternative limitation on the estate tax deduction for property passing to a surviving spouse. The deduction is limited to the greater of one-half of the adjusted gross estate or \$250,000.⁶⁶ Furthermore, the gift tax marital deduction is unlimited for the first \$100,000 of gifts, but with the second \$100,000 of gifts fully taxed, and one-half of all gifts above the \$200,000 mark granted a deduction.⁶⁷ To the extent the marital deduction for *inter vivos* transfers exceeds one-half of the value of the gift, that is, for part of the deduction for gifts under \$200,000, the estate tax marital deduction is subject to a dollar-for-dollar reduction.⁶⁸

The new estate tax marital deduction applies to estates of decedents dying after December 31, 1976.⁶⁹ It was not intended that some estates which had already been planned with formula marital deduction clauses be forced to leave more than intended to the surviving spouse.⁷⁰ For a decedent dying after December 31, 1976, but before January 1, 1979, leaving a will written before January 1, 1977, and not amended prior to date of death, containing a formula marital deduction clause, the old rules shall apply if the statutory law of the state does not construe the clause as being subject to the revised federal marital deduction limitations.⁷¹ The gift tax marital deduction limitations imposed by the new law will apply to all gifts made after December 31, 1976.⁷²

⁶⁴ House Report, *supra* note 11, at 17-18.

⁶⁵ Act, *supra* note 12, § 2002(a)(1).

⁶⁶ I.R.C. § 2056(c)(1) (amended by Act, *supra* note 12, § 2002(a)(1)).

⁶⁷ I.R.C. § 2523(a)(2) (amended by Act, *supra* note 12, § 2002(b)).

⁶⁸ I.R.C. § 2056(c)(1)(B)(i) (amended by Act, *supra* note 12, § 2002(a)(1)).

⁶⁹ Act, *supra* note 12, § 2002(d)(1).

⁷⁰ House Report, *supra* note 11, at 18.

⁷¹ Act, *supra* note 12, § 2002(d)(1)(B). For decedents whose wills do not use a marital deduction formula clause, but leave one-half of their adjusted gross estates to the surviving spouse and, because of the desire to maximize the marital deduction, leave one-half of all assets either to the surviving spouse by terminable interest or to others, action should be taken before date of death to amend the will. For example, if a decedent intended to leave as much property to his or her surviving spouse as was possible, utilizing maximum tax advantage, and if the adjusted gross estate was \$250,000, it is possible that without amendment the surviving spouse would take either half the adjusted gross estate by conditional gift or that it would go to another person. With amendment, he or she would be able to take the entire estate without imposition of tax.

⁷² Act, *supra* note 12, § 2002(d)(2).

A problem related to that of the marital deduction is the fractional interest question. Under the estate tax law, the entire value of the property owned jointly by a husband and wife is included in the estate of the first spouse to die. If the surviving spouse can show that he or she contributed part of the consideration, in money or money's worth of goods or services, towards acquisition of the asset, the property will be excluded from the decedent's estate to the extent of the relative contributions.⁷³

Under the gift tax law, the creation of a joint tenancy by a spouse who has contributed the entire consideration towards acquisition of the asset, constitutes a taxable gift if two conditions are met. First, there must be a right of survivorship and, second, the right must not be destructible, other than by mutual consent of the parties.⁷⁴ That is to say, if the grantor can take the joint interest back, no gift has actually been made.

If the property is placed in a joint tenancy with right of survivorship, or a tenancy by the entirety, and if the gift is deemed taxable, the amount of the gift is determined by comparing the total value of the contribution made by the donor with the actuarially-determined value of the donor's percentage interest in the property as a joint owner.⁷⁵

One exception to the fractional interest rule occurs in gifts of real property by one spouse to another. Where a joint tenancy with right of survivorship is created by one spouse to another. Where a joint tenancy with right of survivorship is created by one spouse, with the spouse as joint tenant, and if the property is real estate, the donor may elect whether the property shall be treated as transferred by gift.⁷⁶ If the donor takes no affirmative action, the transfer is treated

⁷³ I.R.C. § 2040 (amended 1976).

⁷⁴ I.R.C. § 2515 (amended 1976); Treas. Reg. § 25.2515-2(b) (1958).

⁷⁵ Treas. Regs. §§ 25.2511-1(h)(5)(1958), 25.2515-2(b)(1) (1958). For example, "H creates a tenancy by the entirety between himself and his wife, W, in certain common stocks having a total fair market value of \$50,000. At the time of the creation H is 44 years of age and W is 36 years of age. Under local law, H and W are each entitled to one half of the income from the stocks held by the entirety. Since H is older than W and has a shorter life expectancy, the value of his interest in the property is less than W's because W has a greater possibility of surviving H and obtaining all of the property outright. Table IX of the I.R.S. Publication No. 11, 'Actuarial Values for Estate and Gift Tax,' shows that H's percentage interest in the stocks is .42577 and, consequently, the value of the gift to W is .57423 times \$50,000 or \$28,711.50." Egan, Andrews, Colson, Graven & Kahn, *PROBLEMS OF FEDERAL TAXATION OF ESTATES—GIFTS—TRUSTS*, 127-28 (1st ed. 1966) [hereinafter cited as *Problems of Federal Taxation*].

⁷⁶ I.R.C. § 2515 (amended 1976). The rationale for electing to have the transaction taxed as a gift relates to the treatment of termination of the tenancy. If the considera-

as not being a gift, and not subject to gift tax.⁷⁷

The distinct treatments of the fractional interest situation for estate and gift tax purposes raised serious problems with interspousal tenancies. The gift tax could flow from the creation of a joint tenancy, since that is determined by applicable local law. The property subject to a gift tax, however, could also be subject to an estate tax because that levy looked only to the relative contributions.⁷⁸ With respect to this problem, only minor mitigation occurred by the credit given for gift taxes paid on the prior levy.⁷⁹

The American Law Institute addressed the fractional interest question in their 1968 proposals, suggesting that the value of what is received by a donee of a joint interest should be the value of the fractional interest, regardless of applicable state law. Furthermore, the Institute suggested that the amount of the joint interest transferred at the death of a joint owner be the fractional interest owned at the date of death or the alternate valuation date, except where the initial creation of the tenancy was subject to no gift tax.⁸⁰ The rationale of the Institute was that, if the transaction was treated as a taxable gift, it would raise the rates at which the property would be included and taxed in the gross estate.⁸¹

The Tax Reform Act of 1976 remedied this problem by providing that one-half of the value of a qualified joint interest is included in the gross estate of the first-deceding spouse, regardless of relative contributions. However, a qualified joint interest must have been created by the decedent and his or her spouse, or either alone. In the case of personal property, the gift must have been completed. In the case of real estate, the donor must not have elected to have the transfer treated as not being subject to gift tax. Finally, the decedent and his or her spouse must have been joint tenants.⁸²

The impact of the new marital deduction and fractional interest rules will be most felt by smaller and moderate estates. When cou-

tion for property held as tenants by the entirety was a gift for tax purposes, termination results in a gift to one tenant to the extent that he or she receives an amount with greater value than that of his or her proportionate interest. If the transfer was not treated as a gift, on the other hand, termination creates a gift equal to the proceeds received by the noncontributing spouse. Treas. Regs. § 25.2515-3. If the property is expected to appreciate, it would be better to have the initial transfer taxed as a gift.

⁷⁷ I.R.C. § 2515(c) (amended 1976).

⁷⁸ House Report, *supra* note 11, at 19.

⁷⁹ *Id.*

⁸⁰ ALI Proposals, *supra* note 27, at 14-15.

⁸¹ *Id.* at 13-14.

⁸² I.R.C. §§ 2515, 2040, (amended by Act, *supra* note 12, § 2002(b)).

pled with the new, unified transfer tax credit, the marital deduction limitations will permit a decedent dying in 1982 and leaving a surviving spouse, to pass up to \$425,000 worth of assets without imposition of an estate tax. That is to say, by utilizing the \$250,000 marital deduction, an adjusted gross estate of \$425,000 may be reduced to a taxable estate of only \$175,000. The \$47,000 unified transfer tax credit will eliminate any liability on an estate of \$175,000. If *inter vivos* interspousal transfers of \$100,000 have been made, a total of \$475,000 can be transferred without tax since the \$100,000 gift tax marital deduction will only result in a \$50,000 reduction in the estate tax marital deduction. In fact, no return would have to be filed on an adjusted gross estate of \$425,000, which maximized its marital deduction and had not exhausted any of its transfer tax credit.⁸³

The new marital deduction limitations will have limited effect on larger estates. The retention of the alternative limitation of one-half of the adjusted gross estate will continue to permit estate planning for estates in excess of the tax-free marks, and the standard formula marital deduction clauses will continue to be valid tools for these estates.⁸⁴

The policy behind the new marital deduction limitation should also be examined. First, it will clearly serve to reduce the percentage of all estates which are subject to estate tax. This will assist in returning the estate tax to its basis in preventing perpetuation of very large estates, and its inapplicability to small or moderate estates.⁸⁵

Another argument which has been raised with respect to the liberalization of the marital deduction limits, is that some family members are frequently shortchanged in order to maximize the marital deduction. When the marital deduction is given a flat base, the potential for distortion of natural giving patterns would be increased, the argument continues.⁸⁶ However, as one commentator has reasoned, in small and medium estates, it is most common for the bulk of the estate to pass to the surviving spouse in any event, minimizing

⁸³ I.R.C. § 6018(a), (amended by Act, *supra* note 12, § 2001(c)(1)(J)).

⁸⁴ Standard estate planning with the marital deduction is an attempt to equalize the two estates and to preclude any portion of the estate from being included in both the taxable estates of the first and second deceasing spouses, resulting in double taxation of the same assets.

⁸⁵ Blum & Pedrick, *The Reform School Approach to Estate and Gift Tax Revision*, 51 TAXES 81, 84 (1973). As the expert contends, with tongue placed firmly in cheek, "our existing estate and gift tax system . . . encourages people to have large families. . . . The marital deduction, in both the gift and estate tax, is an inducement to marriage—and you know what happens in marriage. And the tax favoritism bestowed on skip generation trusts surely invites the wealthy to become grandparents and great-grandparents over and over again." *Id.* at 85-86.

⁸⁶ See, e.g., Seidman, *Status of Federal Estate and Gift Tax Legislative Proposals*, 51 TAXES 197, 198 (1973); Young, *Proposed Revisions of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 83 (1970).

the potential for significant distortion in giving patterns.⁸⁷

The fractional interest rules should alleviate a severe inequity in the estate and gift tax laws, resulting in occasions of double taxation of the same transfers. Together with the new marital deduction limitations, the portions of the estate and gift tax revisions of the Tax Reform Act of 1976 directed at interspousal transfers would appear to be one of the soundest legislative tax reforms in a long time. It promotes equity, relieves the burden on small and moderate estates, and does not appear to impose a significant additional burden on anyone. Perhaps the only consideration which should be raised is that the terminable interest problem, which was attacked in the Treasury and American Law Institute proposals, was not attacked in the estate and gift tax revision which became law. While this is an area which could clearly stand reform, its absence should not diminish a significant and seemingly wise change in the marital deduction and fractional interest rules.

Basis of Inherited Properties

Of all the provisions of the estate and gift tax revision of the Tax Reform Act of 1976, surely none will have as great an impact on tax and estate planning as the imposition of a carryover basis on inherited properties. The law formulated by Congress to cure what many perceived as "the most serious defect in our federal tax structure today"⁸⁸ is, in many respects, an entirely workable solution to a problem of intense complexity.

Under prior law, the basis of property acquired from a decedent, either by testate or intestate succession, was its fair market value on the date of decedent's death, or the alternate valuation date.⁸⁹ Consequently, no tax was imposed on appreciation in value attributable to the holding period of a decedent.⁹⁰

In its 1969 proposals, the Department of the Treasury suggested imposition of a combined carryover basis and tax on unrealized ap-

⁸⁷ Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1395 (1970).

⁸⁸ *Id.* at 1381.

⁸⁹ I.R.C. § 1014 (*amended* 1976). This is also the valuation placed upon the asset for estate tax purposes. I.R.C. § 2031 (*amended* 1976). As such, it was felt by some that the failure to tax appreciation at date of death was a reasonable concomitant to the estate taxation of the asset.

⁹⁰ While an estate tax was imposed, the point made is that no income tax was imposed. Furthermore, if the decedent acquired the asset in a nonrecognition transaction, such as a like kind exchange, the unrealized appreciation could be attributable to the holding periods of numerous taxpayers, not merely the decedent.

preciation of assets held by a decedent on the date of his or her death. The tax portion, equivalent to that which would have been imposed had the decedent sold the asset immediately prior to the date of his or her death, would have been reported on the last income tax return of the decedent, and would have served as a deduction against the gross estate.⁹¹ For property subject to the tax, beneficiaries would receive a fair market value basis, as under the pre-1976 law.⁹²

Property passing to a charity or surviving spouse and \$60,000 of other assets, as well as household goods, were exempt from the tax on unrealized appreciation. A carryover basis attached to assets passing to a beneficiary without the imposition of a tax on unrealized appreciation.⁹³

The principal argument against the Treasury's proposal was that it was too "complicated and cumbersome."⁹⁴ In its consideration of the treatment of unrealized appreciation on the date of decedent's death, this factor appears to have been of some concern to the Conference Committee, which adopted a provision altogether workable, in light of the complexities of the tax law involved.

The Tax Reform Act of 1976 requires individuals acquiring assets by inheritance after December 31, 1976, to take a basis carried over from the decedent.⁹⁵ The carryover basis provision could impose significant problems on beneficiaries of decedents now living who might have kept few records of their basis in an asset, or might not know what their basis ever was. Consequently, all assets in the hands of individuals which are also held by those individuals on the dates of their deaths, after December 31, 1976, take as their basis their fair market value on December 31, 1976.⁹⁶

Rather than requiring all individuals to have their assets immediately appraised for their values on December 31, 1976, the law has adopted a mandatory method of computing the fair market value of an asset held on that date.

To determine the fair market value of an asset held on December 31, 1976, the relative number of days during which the asset was held

⁹¹ *Treasury Proposals*, *supra* note 21, at 334-36.

⁹² *Id.* at 336.

⁹³ *Id.* at 336-37.

⁹⁴ Young, *Proposed Revision of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 93 (1970).

⁹⁵ I.R.C. § 1014(d), (amended by Act, *supra* note 12, § 2005(a)(1)).

⁹⁶ I.R.C. § 1023, (added by Act, *supra* note 12, § 2005(a)(2)). This also applies to properties acquired by a decedent after January 1, 1977, which has a basis computed with reference to the basis of the transferred property, held on January 1, 1977. *Conference Report*, *supra* note 13, at 612 or 1355.

before and after that date must be compared, giving rise to a fraction. This fraction is then used to reduce the appreciation over the life of the asset, under an assumption of even appreciation in value, and the appreciation attributable to the pre-1977 valuation changes of the property is determined and added to the basis.⁹⁷

For example, if D held an asset at the date of his death, December 31, 1986, and he had acquired the asset on December 31, 1966, one-half of the appreciation in value of the asset would be added to D's cost basis⁹⁸ to determine the fair market value of the asset on December 31, 1976. If D had paid \$50,000 and the asset is worth \$550,000 in 1986, the basis carried over to the beneficiaries would be \$300,000 (\$500,000 in appreciation, times 1/2 [the number of days after December 31, 1976 are only one-half of the number of days of total holding] plus D's cost basis of \$50,000 equals \$300,000).

The fresh start applies to all property held by a decedent on December 31, 1976, but marketable securities are to be valued for their fresh start on the basis of normal valuation methods, rather than by the ratio of post-December 31, 1976, holding period to total holding period.⁹⁹ For family farms and small businesses, if the alternative valuation is elected,¹⁰⁰ it is to be used for the fresh start alternative valuation, but the alternate valuation date cannot be used.¹⁰¹

The law provides a number of exceptions and special rules for different types of property to facilitate the administration of the carryover basis requirement. First, the executor or administrator of the estate may elect to exclude from carryover \$10,000 in personal effects and household goods.¹⁰² Where household goods and personal effects

⁹⁷ I.R.C. § 1023(h), (added by Act, *supra* note 12, § 2005(a)(2)).

⁹⁸ I.R.C. § 1023(h)(2)(C), (added by Act, *supra* note 12, § 2005(a)(2)). The cost basis is the decedent's adjusted basis immediately prior to death, increased by all adjustments for depreciation, depletion or amortization over decedent's holding period, multiplied by the fraction representing the ratio of the holding period after December 31, 1976, to the total holding period, and also all depreciation or depletion or amortization adjustments after January 1, 1977.

⁹⁹ I.R.C. § 1023(h)(1), (added by Act, *supra* note 12, § 2005(a)(2)). Stock and securities are marketable if they are listed on a national, regional, city or foreign exchange, or are regularly traded over-the-counter. *Conference Report, supra* note 13, at 613 or 1356.

¹⁰⁰ I.R.C. § 1023(h)(2)(A)(ii), (added by Act, *supra* note 12, § 2005(a)(2)). The special valuation methods for family farms and small businesses are contained in new Code § 2032A, discussed *infra*.

¹⁰¹ I.R.C. § 1023(h)(2)(A)(ii), (added by Act, *supra* note 12, § 2005(a)(2)). However, the alternate valuation would probably not be elected for appreciated assets in any event, since it would only act to increase the denominator of the fraction used in setting the fresh start basis, thereby decreasing the carryover basis.

¹⁰² I.R.C. § 1023(b)(3), (added by Act, *supra* note 12, § 2005(a)(2)). Personal

are not subjected to the election, or are not covered by the \$10,000 limitation on the election, for purposes of determining a loss on subsequent disposition by the beneficiary, they will be valued at their fair market value on date of death.¹⁰³ In addition, life insurance on the decedent's life¹⁰⁴ and certain items taxed as income on the decedent's last return are not subject to the carryover rule.¹⁰⁵

In addition to the exemptions and fresh start rules, there are adjustments made to the carryover basis for federal and state death taxes attributable to the property, a flat \$60,000 basis, and state death taxes paid by the distributee.¹⁰⁶ The \$60,000 basis adjustment is allocated to all properties in relation to their adjusted bases, adjusted for purposes of the carryover rules.¹⁰⁷ It cannot, however, be used to increase the basis of an asset beyond its fair market value.¹⁰⁸

Certain questions regarding the carryover basis are to be answered by the Department of the Treasury in its regulations. These include how to reflect capital improvements in the fresh start computations of basis, and when to deem a substantial improvement a separate piece of property for basis purposes.¹⁰⁹ It is also intended that the Treasury set forth allocations of basis rules when the property is treated, in part, as taxable income under other sections of the Code, such as those dealing with income in respect of a decedent.¹¹⁰

If a pecuniary bequest is satisfied with appreciated property, otherwise subject to a carryover basis, gain will be recognized to the estate. This gain, however, is limited to the extent to which the fair market value at the time of the transfer in satisfaction of the bequest, considered an exchange for income tax purposes, exceeds the estate tax valuation of the asset.¹¹¹ A similar rule applies to trust disposi-

and household goods include clothes, furniture, sporting goods, jewelry, stamp and coin collections, silverware, china, crystal, cooking utensils, books, televisions, cars, radios, and similar items. *House Report*, *supra* note 11, at 38.

¹⁰³ I.R.C. § 1023(a)(2), (*added by Act*, *supra* note 12, § 2005(a)(2)). This is similar to the treatment currently afforded property acquired by gift. Code § 1015(a).

¹⁰⁴ I.R.C. § 1023(b)(2)(B), (*added by Act*, *supra* note 12, § 2005(a)(2)).

¹⁰⁵ I.R.C. § 1023(b)(2), (*added by Act*, *supra* note 12, § 2005(a)(2)). The properties excluded include income in respect of a decedent, joint and survivor annuities under which the survivor is taxable, and payments from a deferred compensation plan which are taxable to the distributee, property included in the gross estate as a gift in contemplation of death, revocable transfer or power of appointment, and certain stock options.

¹⁰⁶ I.R.C. § 1023(c), (*added by Act*, *supra* note 12, § 2005(a)(2)).

¹⁰⁷ I.R.C. § 1023(d), (*added by Act*, *supra* note 12 § 2005(a)(2)).

¹⁰⁸ I.R.C. § 1023(f)(1), (*added by Act*, *supra* note 12, § 2005(a)(2)).

¹⁰⁹ *Conference Report*, *supra* note 13, at 612-13 or 1355-56.

¹¹⁰ *Id.* at 613 or 1356.

¹¹¹ I.R.C. § 1040(a), (*added by Act*, *supra* note 12, § 2005(b)).

tions because of the death of the decedent.¹¹² The basis received by the beneficiary of such a specific bequest or transfer is the carryover basis increased by any recognized gain.

Each executor is required to furnish the Secretary of the Treasury, or his delegate, such information with respect to the carryover basis of property at date of death as is required in future regulations.¹¹³ He is also required to furnish the beneficiary of the property a statement in writing noting the adjusted basis of the asset.¹¹⁴ Failure to furnish the Secretary of the Treasury such information as may be required is punishable by a penalty of \$100 for each day of failure due to reasonable cause and not willful neglect, subject to a total limitation of \$5,000.¹¹⁵ Failure to furnish a beneficiary the statements required, if due to reasonable cause and not willful neglect, is punishable by a \$50 fine for each failure, subject to an overall limitation of \$2,500.¹¹⁶ The carryover basis provisions apply to all gifts after December 31, 1976, and to all estates of decedents dying after December 31, 1976.¹¹⁷

As enacted, the carryover basis provisions will have a significant impact on estate planning and tax planning. Many individuals have been holding assets with the expectation of an eventual stepped-up basis at their death. These persons will either have to dispose of the asset currently, realizing and recognizing taxable gain, or hold the asset for disposition at death, leaving the gain to be recognized by their beneficiaries. Among the factors which might weigh in this decision would be whether the current holder of the asset had a significant capital loss carryover to be utilized, and the relative marginal tax rates of the two individuals. Also considered would be the estate tax and the gift tax, both of which would be imposed on the property. This last factor should not play too heavy a part in the decision-making process, however, since the new estate and gift tax revisions unify and equalize these two impositions.

Another result of the carryover basis change is the neutralization of the estate and gift tax in *inter vivos* giving patterns. The unification of the two taxes and of the two tax exemptions into a unified transfer tax credit, and the changes in the marital deduction, have acted to discourage *inter vivos* giving, in the sense such discouragement occurs when an incentive is removed. However, the impact of

¹¹² I.R.C. § 1040(b), (added by Act, *supra* note 12, § 2005(b)).

¹¹³ I.R.C. § 6039A(a), (added by Act, *supra* note 12, § 2005(d)(1)).

¹¹⁴ I.R.C. § 6039A(b), (added by Act, *supra* note 12, § 2005(d)(1)).

¹¹⁵ I.R.C. § 6694(a), (added by Act, *supra* note 12, § 2005(d)(2)).

¹¹⁶ I.R.C. § 6694(b), (added by Act, *supra* note 12, § 2005(d)(2)).

¹¹⁷ Act, *supra* note 12, § 2005(f)(1), (2).

the carryover basis change is to encourage *inter vivos* disposition of assets which are expected to appreciate, since they could be subject to a lower transfer tax and the eventual capital gains would be split between the beneficiary and the transferor. Consequently, the total incentives and disincentives for giving found in the new tax law will tend to offset each other. This should make the estate and gift tax law, and, to the extent the carryover basis is a factor, the income tax law, far more tax-neutral with regard to lifetime giving than the former estate and gift laws.

One frequent complaint about a carryover basis approach is that it will result in beneficiaries being locked into keeping the assets they receive, for fear of a large capital gains tax on the disposition of these assets. This argument, however, holds little validity, inasmuch as the actual evidence shows that the stepped-up basis at date of death caused an entirely significant lock-in of assets as well. A study by the Brookings Institution showed that three-fourths of the gains on stocks are unrealized during the lifetime of the investor, being locked-in by the stepped-up basis at the date of death.¹¹⁸ One commentator has referred to this as creating an almost "complete immobility of the investments of older persons."¹¹⁹ Consequently, the argument that a carryover basis will result in a lock-in of assets appears incomplete at best and specious at worst.

While it is not really certain whether or not the problem of untaxed appreciation at the date of death is or was the "most serious defect in our federal tax structure,"¹²⁰ it is clear that the change from a fair market value basis, either stepped-up or stepped-down,¹²¹ to a carryover basis will constitute a significant factor in tax planning and estate planning. It may free many older persons to make wiser investments of their capital, not bound by the wait for a stepped-up basis at date of death. Coupled with the generally well thought out format of the carryover basis provision, this appears to be a workable and reasonable solution to what was clearly a difficult problem of tax policy.

¹¹⁸ DAVID, *ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION* 99 (1968).

¹¹⁹ Young, *Proposed Revisions of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 90 (1970).

¹²⁰ See note 88 *supra*.

¹²¹ The fair market value basis will raise the basis (stepped-up) if the property has appreciated between the date of acquisition and date of death, and lower the basis of property (stepped-down) which has depreciated in value between the date of acquisition and date of death.

Liberalization of Payment Rules, Redemption of Stock to Pay Death Taxes and Asset Valuation

During recent consideration of estate and gift tax reform, a number of organizations and individuals requested that the Congress consider legislative measures to reduce the burden these taxes imposed on family farms and small businesses.¹²² Traditionally, these enterprises have had difficulties meeting estate tax liabilities upon the death of a principal owner because of their low liquidity. This has resulted in the involuntary disposition of many such farms and businesses, although the family and surviving spouse might have desired to continue operations. In response, Congress has taken three actions in the Tax Reform Act of 1976: reduction of some of the valuation problems which plagued small businesses and family farms, alteration of the rules governing redemptions of stock to pay death taxes, and liberalization of the deferred payment provisions of the estate tax law.

Farms and small businesses are normally composed of many assets, the largest of which is usually their real estate. When the principal owner of the business or farm dies, the real estate is included, along with other assets in his or her gross estate at its fair market value on the date of death, or alternate valuation date.¹²³ Among the various factors which enters into the determination of fair market value of the property is its "highest and best" use.

In some cases, the use of property for a farm or closely held business is at its highest and best use. However, particularly where farm land is located close to urban or commercial centers, or where a small business is located in an urban or commercial center, the property would be worth considerably more if it were converted to other uses. In these instances, the land is valued as if it were converted to one of these "higher or better" uses, raising the estate tax liability to a point

¹²² See, e.g., *Treasury Proposals*, *supra* note 21, at 118; *1973 Panel Discussions*, *supra* note 10, at 74; *Hearings on Federal Estate and Gift Taxes Before the House Committee on Ways and Means, 94th Cong., 2d Sess. Pt. II*, at 857-58, 860-920, 963-1002 (1976); *Hearings on Revision of Federal Estate Tax Before the Senate Finance Committee, 94th Cong., 2d Sess.*, at 1-28, 36-85, 111-117 (1976).

¹²³ I.R.C. § 2031. The fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts." *Treas. Reg. § 20.2031-1(b)* (1958).

where these estates which traditionally lack liquidity may be forced to discontinue business operations and sell off the assets of the farm or small business.

This problem was perceived by the Department of the Treasury when it prepared and presented its 1969 proposals. The Department suggested a two-step approach to alleviating the burdens imposed on family farms and small businesses. First, it would increase the marital deduction, permitting totally taxfree interspousal testamentary dispositions. Second, it would liberalize the rules governing both redemptions to pay death taxes and extensions of time for payment of estate taxes.^{123.1}

The Treasury noted four rules governing the payment of estate taxes by family farms and small businesses. First, the time for payment of estate taxes could be extended for up to ten years in the case of undue hardship.¹²⁴ Second, the time for payment was automatically extended for up to ten years if the estate contained a farm or closely held business interest, the value of which exceeded either 35 percent of the gross estate or 50 percent of the taxable estate.¹²⁵ Third, stock held by an estate could be redeemed to pay death taxes, funeral or administration expenses, with favorable capital gains treatment, if the stock constituted either 35 percent of the gross estate or 50 percent of the taxable estate.¹²⁶ Fourth, the interest rate on unpaid estate taxes, deferred under one of the aforementioned extension pro-

^{123.1} *Treasury Proposals*, *supra* note 21, at 118. The Department noted that:

Estates which contain farms or closely held businesses sometimes encounter difficulty in finding the cash needed to pay the Federal taxes which become due shortly after death. This can result in different disposition patterns than would have been selected had sufficient cash been available to pay the Federal tax on the transfer at death. These problems can be alleviated by permitting tax free interspousal transfers and by easing rules for payment of taxes for estates consisting largely of farms or closely held businesses.

Id. The reflection by the Treasury in the alteration of natural disposition patterns evidences the general belief of that department that the estate tax laws, as other tax laws, should be neutral factors in disposition determinations. This was also shown in the decision of the Treasury to tax appreciation at date of death, eliminating the perceived lock-in caused older taxpayers by the presumed stepped-up basis at date of death. See text accompanying notes 118-119 *supra*.

¹²⁴ Int. Rev. Code of 1954, ch. 62, § 6161(a)(2), 68A Stat. 762, as amended by Technical Amendments Act of 1958, P.L. 85-866, § 206(c), 72 Stat. 1684. The regulations note that undue hardship requires a showing of significant financial losses if payment is immediately required. Mere inconvenience is not sufficient. Treas. Reg. § 1.6161-1(b) (1960).

¹²⁵ Technical Amendments Act of 1958, P.L. 85-866, § 206(a), 72 Stat. 1681.

¹²⁶ Int. Rev. Code of 1954, ch. 1, § 303, 68A Stat. 88.

visions, was imposed at the then-rate of only four percent, contrasted with the general rate of six percent on unpaid taxes.¹²⁷ The Department proposed significant revision in each of the four provisions, but primarily in the first three.

The extension of time for payment of estate taxes in situations of undue hardship would have been amended to apply to the capital gains tax imposed on unrealized appreciation in assets held by a decedent on the date of his or her death.¹²⁸ This tax, it may be recalled, was the Department of the Treasury's answer to the problem of unrealized appreciation on date of death, and would have been the equivalent of the income tax imposed had the decedent sold the asset immediately prior to death.¹²⁹

The rules governing extension of time to pay estate taxes for family farms and small businesses would have been significantly altered under the suggested reforms. First, the requirement that the farm or business comprise more than either 35 percent of the gross estate or 50 percent of the taxable estate would have been reduced. The new rule would require only that the business or farm exceed 25 percent of the taxable estate.¹³⁰ In addition, the definition of a "closely held business," which, for purposes of the extension, required that either the decedent have a 20 percent interest or the enterprise have no more than 10 shareholders or partners, would have been reduced to a single requirement that there be no more than 15 partners or shareholders, with no percentage ownership required.¹³¹ This extension liberalization would also have applied to the capital gains tax imposed on unrealized appreciation at date of death.¹³² Further liberalization was evident in that the District Director would not have been able to require a bond of double the tax liability as a condition to granting an extension where other satisfactory security was furnished.¹³³

¹²⁷ Int. Rev. Code of 1954, ch. 67, § 6601(b), 68A Stat. 817 as amended by Technical Amendments Act of 1958, P.L. 85-866, § 66(c), 72 Stat. 1658.

¹²⁸ *Treasury Proposals*, *supra* note 21, at 407.

¹²⁹ See text accompanying notes 88-121 *supra*.

¹³⁰ *Treasury Proposals*, *supra* note 21, at 404. This would apparently have benefited all family farm or closely held business estates of at least 25 percent farm or business assets, but it would have especially benefited those estates with greater proportions of exemptions and deductions, which are often the smallest estates.

¹³¹ *Id.* This would permit extensions of time for payment of estate taxes where the business was more diffuse in ownership, or when one individual controlled the business himself or herself.

¹³² *Id.* at 405.

¹³³ *Id.* at 406. The executor would be relieved of personal liability during the extension as well.

The Treasury proposals also provided substantial revisions of the law regarding redemptions of stock to pay death taxes, following the changes in the rules governing extensions of time for payment of estate taxes. First, the estate could qualify for capital gains treatment on the redemption of its closely held business stock if the stock represented at least 25 percent of the taxable estate, rather than requiring either more than 35 percent of the gross estate or 50 percent of the taxable estate.¹³⁴ In addition, the definition of closely held stock would follow the definition used in granting extensions of time for payment of estate taxes.¹³⁵ A suggestion would also have permitted the Secretary of the Treasury to set the interest rates for both overdue income and estate taxes according to the fluctuations of the money market.¹³⁶

The Congressional action taken on the subject of family farms and small businesses in the estate and gift tax area clearly reflects the impact of the 1969 Treasury Proposals, although these proposals were not altogether adopted. Rather, the provisions adopted were, with only minor changes, those suggested by the House Committee on Ways and Means, which included revision of the rules for extending time for payment of estate taxes and for redeeming stock to pay death taxes, and relaxation of the valuation methods used on family farms and small businesses.

The new extension of payment rules provide for three extensions, rather than the two extensions found in the prior law. First, upon a showing of "reasonable cause," and not the stricter, "undue hardship" standard, an extension of up to ten years may be granted by the Secretary or his delegate.¹³⁷ Second, the present provision permitting automatic ten-year extensions of the time for paying estate taxes where the family farm or small business comprises at least 35 percent of the gross estate or 50 percent of the taxable estate is retained for future use.¹³⁸ However, if the family farm or small business comprises 65 percent of the adjusted gross estate, a fifteen-year extension is automatically available.¹³⁹

The fifteen-year extension permits a total deferral of any pay-

¹³⁴ *Id.* at 406-07.

¹³⁵ *Id.*

¹³⁶ *Id.* at 409.

¹³⁷ I.R.C. § 6161A(a)(2), (*added by Act, supra* note 12, § 2004(c)). The term "reasonable cause" is to be interpreted as it is for the one-year extension provisions. *Conference Report, supra* note 13, at 611 or 1354.

¹³⁸ *Id.*

¹³⁹ I.R.C. § 6166, (*amended by Act, supra* note 12, § 2004(a)).

ments for five years, along with ten equal payments thereafter.¹⁴⁰ If the estate is composed of a family farm, the percentage requirements may be met by including in the value of the farm the residential buildings housing either the owners or lessees of the farm, or their employees whose occupation is tending the farm.¹⁴¹ If the estate is composed of a small business, the interest will qualify if decedent held at least 20 percent of the stock or partnership interests, or if there were no more than 15 shareholders or partners.¹⁴² The valuations used for either a family farm or small business will be those set for estate tax purposes.¹⁴³

The interest charged on deferred tax payments has also been changed. In 1976 the interest rate on extended estate tax payments was increased to seven percent, and the special lower rate for extensions was removed in 1975.¹⁴⁴ The Tax Reform Act of 1976 reduces the interest rate on unpaid estate taxes extended for the fifteen-year period to four percent, while ordinary estate tax liabilities accrue at the seven percent rate.¹⁴⁵

To facilitate administration of estates, the new law also provides a special lien procedure for payment of deferred estate taxes. The lien attaches in favor of the Government on any property in the estate on which tax payments are deferred for either ten or fifteen years. The lien attaches to the extent of the deferred tax liability and interest, and no greater lien can be used.¹⁴⁶ The property must also be expected to survive the duration of the lien.¹⁴⁷

In addition to the new rules for extension of time to pay estate tax liabilities, the Tax Reform Act of 1976 also changes the rules for redeeming stock at capital gains rates in order to pay death taxes. Instead of the requirement that stock must comprise at least 35 percent of the gross estate or 50 percent of the taxable estate, the new law now requires only that the stock comprise at least 50 percent of the adjusted gross estate.¹⁴⁸ Furthermore, where the estate elects to

¹⁴⁰ I.R.C. § 6166(a), (*amended by Act, supra* note 12, § 2004(a)).

¹⁴¹ I.R.C. § 6166(a)(1), (*amended by Act, supra* note 12, § 2004(a)).

¹⁴² I.R.C. § 6166(b), (*amended by Act, supra* note 12, § 2004(a)).

¹⁴³ I.R.C. § 6166(b)(4), (*amended by Act, supra* note 12, § 2004(a)). This takes into account the new alternate valuation methods for family farms and small businesses.

¹⁴⁴ Pub. L. No. 93-695, 93d Cong., 2d Sess. (1975).

¹⁴⁵ I.R.C. § 6601(j), (*added by Act, supra* note 12, § 2004(b)).

¹⁴⁶ I.R.C. § 6324A(b)(2), (*added by Act, supra* note 12, § 2004(d)(1)). This prevents imposition of the double bond or a lien equivalent, which may be imposed under current law.

¹⁴⁷ I.R.C. § 5324A(b)(1)(A), (*added by Act, supra* note 12, § 2004(d)(1)).

¹⁴⁸ I.R.C. § 303(b)(2), (*amended by Act, supra* note 12, § 2004(e)(2)). The House Committee on Ways and Means had proposed that the stock be required to comprise

defer tax payment, it need not make the election to have stock redeemed until the final payment of tax is due.¹⁴⁹ However, if the redemption is made at any time after four years and ninety days past the date of decedent's death, the only portion of the gain on the redemption which receives capital gains treatment is the lesser of the unpaid death taxes and administration expenses, or the expenses paid within one year of the distribution.¹⁵⁰

To assure that the redemption is to be used to pay death taxes or estate expenses, the new amendments only permit capital gains treatment on a redemption to the extent an interest of a shareholder is reduced, either directly or indirectly, through a binding obligation to contribute towards the payment of debts, expenses or taxes of the estate.¹⁵¹

These changes are intended to assist estates with liquidity problems and high estate tax liabilities. They permit deferral of tax payments and facilitate the raising of capital through stock redemptions in order to pay the tax liabilities. However, none of the aforementioned provisions actually assists the estate in reducing its tax liability. This is accomplished by the new, alternative valuation provisions of the Tax Reform Act of 1976.

Under the new provisions, an alternate valuation may be elected for real estate devoted to farming or to a closely held business, and included in the gross estate of a decedent. The alternative valuation essentially includes the property in the estate at its value as a farm or closely held business, rather than its highest and best use.

In order to elect the alternate valuation method, the estate must meet six requirements. First, the decedent must have been either a United States citizen or a resident alien.¹⁵² Second, the value of the farm or closely held business assets, including both realty and personalty, included in the estate must amount to at least one-half of the gross estate.¹⁵³ Third, the value of the farm or closely held business

at least 65 percent of the adjusted gross estate, but the Conference Committee reduced this to 50 percent. *House Report*, *supra* note 11, at 35; *Conference Report*, *supra* note 13, at 621.

¹⁴⁹ I.R.C. § 303(b)(1), (*amended by Act*, *supra* note 12, § 2004(e)(1)).

¹⁵⁰ I.R.C. § 303(b)(4), (*amended by Act*, *supra* note 12, § 2004(e)(3)).

¹⁵¹ I.R.C. § 303(b)(3), (*amended by Act*, *supra* note 12, § 2004(e)(3)). Prior to this amendment, the estate could have its stock redeemed even though another person, prior to the decedent's death, had received the stock in transfer from the decedent. As long as the stock was returned to the gross estate, because it was transferred in contemplation of death, for example, the individual could receive capital gains treatment on the redemption.

¹⁵² I.R.C. § 2032A(a)(1)(A), (*added by Act*, *supra* note 12, § 2003(a)).

¹⁵³ I.R.C. § 2032A(b)(1)(A), (*added by Act*, *supra* note 12, § 2003(a)). This is the

real estate must constitute at least one-fourth of the adjusted gross estate.¹⁵⁴ Fourth, the property must pass to a qualified heir.¹⁵⁵ Fifth, the property must have been owned by the decedent or his or her family for at least 5 of the last 8 years, and used as a farm or closely held business for this period.¹⁵⁶ Finally, there must have been material participation by the decedent or a member of his family in the business or farm for 5 of the last 8 years of its operation.¹⁵⁷ If all of these requirements are met, the executor may elect to value the farm or closely held business real estate under either of two special methods.

If the qualified real estate is a family farm,¹⁵⁸ the value may be determined by dividing the excess of the average annual gross cash rental for comparable land¹⁵⁹ over the annual state and local real estate taxes by the average annual effective interest rate for the new Federal Land Bank loans.¹⁶⁰ The computation figures are based on the five most recent calendar years preceding the date of decedent's death.¹⁶¹

If there is no comparable property upon which to value a family farm, or if the executor so elects, or if the property is used as a closely

only requirement which looks at both the realty and personalty of the farm or business. All others look only to the real estate, perhaps because only the real estate may receive the alternate valuation.

¹⁵⁴ I.R.C. § 2032A(b)(1)(B), (*added by Act, supra* note 12, § 2003(a)).

¹⁵⁵ I.R.C. § 2032A(b)(1)(A)(ii), (*added by Act, supra* note 12, § 2003(a)). A "qualified heir" includes any member of the decedent's family who acquired the property from the decedent. To constitute a "member of the family" of the decedent, for purposes of the special valuation provisions, the beneficiary must be one of the decedent's ancestors or lineal descendants, a lineal descendent of one of the decedent's grandparents, decedent's spouse, and the spouse of another descendant of the decedent. An adopted child will be considered in the same relationship as if the child had been born of the decedent. I.R.C. § 2032A(e)(1), (2), (*added by Act, supra* note 12, § 2003(a)). *Cf.* I.R.C. § 2611, (*added by Act, supra* note 12, § 2006(a)).

¹⁵⁶ I.R.C. § 2032A(b)(2), (*added by Act, supra* note 12, § 2003(a)).

¹⁵⁷ I.R.C. § 2032A(b)(1)(C)(ii), (*added by Act, supra* note 12, § 2003(a)). The determination of "material participation" will be made in a manner similar to that in which "material participation" for self-employment taxes is determined under present law. I.R.C. § 1402(a)(1). *See House Report, supra* note 11, at 23 n.1.

¹⁵⁸ Qualified real property includes property located in the United States and used as a farm, including a stock, dairy, poultry, fruit, furbearing animal, or truck farms, or as a small business. I.R.C. § 2032A(e)(3), (4), (5) (*added by Act, supra* note 12, § 2003(a)).

¹⁵⁹ I.R.C. § 2032A(e)(7)(A), (*added by Act, supra* note 12, § 2003(a)).

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

held business and not as a farm, the value may be determined under a multiple factor method.¹⁶² Under the multiple factor method, the real estate is valued by the executor using normal appraisal methods, but considering five major factors, including the capitalization of the income the property can reasonably be expected to yield as a family farm or closely held business, capitalization of the fair rental value of the land for farming or as a closely held business, the state's assessment of the land for tax purposes (assuming the state assesses at current use, rather than best or highest use), the comparable sales of other properties of the same use and in the same geographical area if far enough removed from a metropolitan center to assure accurate valuation, and any other reasonable valuation factors.¹⁶³

In order to use the special valuation methods, the property must be used as a family farm or closely held business for 15 years following the decedent's death, or until the qualifying heir dies.¹⁶⁴ If the property is converted to another use,¹⁶⁵ or sold to a nonfamily member, the estate tax benefits obtained through the special valuation method are recaptured.¹⁶⁶ The recaptured amount will be the lesser of the tax saved by use of the special valuation method, or the difference between the fair market value at disposition and the special valuation of the asset at date of death.¹⁶⁷ If the recapture event occurs within ten years of the decedent's death, the entire tax savings will be recaptured. If, however, the event takes place between the tenth and fifteenth years, the recapture is phased-out on a monthly pro rata basis.¹⁶⁸

A special lien is given the Government on all farm or closely held

¹⁶² I.R.C. § 2032A(e)(7), (*added by Act, supra* note 12, § 2003(a)).

¹⁶³ I.R.C. § 2032A(e)(8), (*added by Act, supra* note 12, § 2003(a)).

¹⁶⁴ I.R.C. § 2032A(c)(1), (*added by Act, supra* note 12, § 2003(a)). If the property passed jointly to two or more qualifying heirs, however, the death of one does not relieve the other of his or her liability for the portion of the tax savings attributable to his or her property. *House Report, supra* note 11, at 26.

¹⁶⁵ I.R.C. § 2032A(c)(7), (*added by Act, supra* note 12, § 2003(a)), notes that a discontinuation is deemed to occur when the qualified property ceases to be used for the purpose at which it was valued or there is no material participation by a qualified heir during at least 3 of any 8 years after the decedent's death.

¹⁶⁶ I.R.C. § 2032A(c)(1), (*added by Act, supra* note 12, § 2003(a)). An involuntary conversion of the property is not, of course, a disposition such as would invoke recapture. There may, however, be partial dispositions invoking partial recaptures. *House Report, supra* note 11, at 25-26.

¹⁶⁷ I.R.C. § 2032A(c)(2), (*added by Act, supra* note 12, § 2003(a)). If the disposition is by a sale or exchange between unrelated and disinterested parties, the sales price is the fair market value. *Id.*

¹⁶⁸ I.R.C. § 2032A(c)(3), (*added by Act, supra* note 12, § 2003(a)).

business property which is afforded the special valuation for estate tax purposes.¹⁶⁹ The lien continues from the date of death to the termination of 15 years after the date of death, the death of the qualified heir, or the disposition or cessation of qualified use of the property.¹⁷⁰

The election to use special valuation methods on farms and closely held business real estate must be made with the estate tax return, and must be signed by each person who has an interest in the property.¹⁷¹ The agreement evidences their consent to be subject to the recapture provisions and their understanding of the required continued use.¹⁷² The statute of limitations for assessment of deficiencies and collection of the recapture does not begin to run until the Internal Revenue Service has notice of the recapture event, and it runs for three years thereafter.¹⁷³ In no event may the use of a special valuation method for a farm or closely held business reduce the gross estate of a decedent by more than \$500,000.¹⁷⁴

This trio of tax relief measures, the liberalized deferral of payment provisions, easier redemption of stock to pay death taxes, and special valuation methods, provides needed relief for the estate tax burdens imposed on family farms and small businesses. If it has any single weakness, it may be that the payment deferral and stock redemption provisions are not especially keyed to nonliquidity, in an absolute sense. It is conceivable, though not entirely probable, that an estate could have one-half of its value in highly liquid assets and one-half of its value in qualifying farm or business properties. In this situation, a fifteen-year deferral of estate taxes would not appear warranted.

However, the probability of this situation occurring, as has been noted, is slight, and should not detract from what is a sound revision of the estate and gift tax laws to eliminate some of the unfair burdens imposed on some estates by their own circumstances and the structure of the federal estate tax laws.

Generation Skipping Transfer Tax

In any consideration of tax reform, a balance must be struck between the needs for equity and simplicity. In few areas has this reconciliation been more difficult than that of the generation skipping

¹⁶⁹ I.R.C. § 6324B, (added by Act, *supra* note 12, § 2003(b)).

¹⁷⁰ I.R.C. § 6324B(b), (added by Act, *supra* note 12, § 2003(b)).

¹⁷¹ I.R.C. § 2032A(d)(1), (added by Act, *supra* note 12, § 2003(a)).

¹⁷² House Report, *supra* note 11, at 27.

¹⁷³ I.R.C. § 2032A(f), (added by Act, *supra* note 12, § 2003(a)).

¹⁷⁴ I.R.C. § 2032A(a)(2), (added by Act, *supra* note 12, § 2003(a)).

transfer. An examination of the measure adopted in the Tax Reform Act of 1976 to correct the perceived inequities of generation skipping trusts shows, however, the complexity which is sometimes occasioned by the search for tax equity.

Formerly, the federal estate and gift tax laws imposed no transfer tax when one life tenant of a property interest was succeeded by another or when the beneficial interest passed to a remainderman upon the life tenant's death.¹⁷⁵ Because no tax was imposed, a grantor could establish a trust of long duration, limited only by the Rule Against Perpetuities, permitting several generations of beneficiaries to enjoy the income and corpus without payment of additional transfer taxes. These trusts, and similar non-trust transfers,¹⁷⁶ are commonly known as "generation skipping" transfers.¹⁷⁷

The problems raised by generation skipping transfers are typically manifested when a grantor establishes a trust providing his or her children with a life estate and their children with the remainder interest.¹⁷⁸ The initial transfer will be subject to either an estate tax or a gift tax, but the succession of the grantor's grandchildren to the corpus would have gone untaxed prior to the Tax Reform Act of 1976. Furthermore, the interests of the life tenants could be bolstered to include income rights, rights to invade limited amounts of corpus

¹⁷⁵ The federal tax laws subject to estate taxes only property in which the decedent had an interest "at the time of his death." I.R.C. § 2033. No estate tax was imposed at the termination of a life estate under the theory that at his or her death, the decedent's interest had lapsed and nothing existed which could be called an interest. One commentator has noted that if the estate tax had an "analogue to the Clifford doctrine which imposed a tax where there exists a substantial ownership," the problem of generation skipping trusts would be cured because the life tenant would have the value of that interest included in his or her gross estate. Oshins, *Generation Skipping Trusts*, 38 NEV. ST. B.J. 10 n.3 (1973).

¹⁷⁶ Other transfers which, though not involving trusts, are considered generation skipping include life estates, estates for years, and certain insurance and annuity contracts. See *House Report*, *supra* note 11, at 47.

¹⁷⁷ The term "generation skipping" appears to have been coined by Gerald R. Jantscher in 1967. Dr. Jantscher defined a "generation skipping" transfer as a disposition "in long lived trusts, . . . that permit members of successive generations to enjoy beneficial interests without a transfer tax liability being generated when their interests expire." G. JANTSCHER, *TRUSTS AND ESTATE TAXATION* 54 (1967). While Dr. Jantscher appears to have coined the term "generation skipping," he was not the first to note the problem. In 1954 Randolph Paul discussed the need for estate tax reform to curtail tax avoidance through the use of life estates, the nontrust aspect of generation skipping. R. PAUL, *TAXATION IN THE UNITED STATES* 540-42 (1954).

¹⁷⁸ Hereinafter, all generation skipping transfers will be referred to as "generation skipping trusts," although it is recognized that many such transfers are not in the form of trusts, but in other forms. See note 176 *supra*.

annually for any reason, and rights to invade unlimited amounts of corpus subject to an ascertainable standard relating to health, education, support or maintenance.

The principal limitations on a grantor's ability to tie up property in this fashion, prior to the new law, were the state and common law rules against perpetuities and the tax laws regarding powers of appointment. The former, as normally construed, preclude creation of a trust or other transfer of indefinite or extreme duration.¹⁷⁹ The latter includes in the gross estate of the beneficiary any interests which are deemed to be a general power of appointment.¹⁸⁰

Under the Rule Against Perpetuities, a grantor may not create an interest which is not sure to vest within twenty-one years of a life in being at the time of the transfer.¹⁸¹ In the case of a generation skipping trust established by testamentary disposition, for example, the life interest could pass to the children of the grantor and the remainder interest pass to their children who may survive. This transfer would not violate the Rule Against Perpetuities. However, restrictions on the qualification of the grandchildren to receive the remainder interest could disqualify the transfer. For example, the Rule Against Perpetuities would preclude the grantor's giving the life estate to his or her children and the remainder interest to those grandchildren who may attain the age of 25 years. The Rule would be violated because the interest of the beneficiaries in the remainder is a class gift and, for purposes of the Rule, class gifts are not vested in any member of the class until they are vested in all members of the class.¹⁸² Because there may be grandchildren of the grantor who will not attain the age of 25 years within twenty-one years of the death of the grantor's children (the lives in being at the death of the grantor) this transfer would violate the Rule and be void.

Another major limitation placed on generation skipping trusts by the Rule Against Perpetuities is a limitation on the number of generations which may be skipped when the beneficiaries are classes. As noted, no member of a class of beneficiaries is vested under the Rule until all members of the class are vested, and this vesting must occur within twenty-one years of the life or lives in being at the date of the transfer. If a grantor transfers successive life interests to his children, grandchildren, then to such great grandchildren as may survive, the

¹⁷⁹ GRAY, RULE AGAINST PERPETUITIES § 201 (4th ed. 1942); 6 AMERICAN LAW OF PROPERTY § 24.1 (A. J. Casner ed. 1952) [hereinafter cited as *Casner*].

¹⁸⁰ I.R.C. § 2041.

¹⁸¹ See note 179 *supra*.

¹⁸² *Casner*, *supra* note 179, at § 24.26.

Rule will be violated because the class of great grandchildren will not be vested until the death of all of the grantor's grandchildren. This event need not occur within twenty-one years of the death of the grantor's children.¹⁸³ Therefore, the Rule limits the number of generations which may be skipped in certain cases, as well as the conditions which may be imposed upon receipt of beneficial interests.

The limitations imposed on generation skipping trusts by the estate taxation of powers of appointment restricted the value and worth of the interests enjoyed by life beneficiaries. When an individual dies possessed of a general power of appointment, its value is included in his or her gross estate.¹⁸⁴ Whether the power is considered general under applicable state law or the instrument itself is not relevant.¹⁸⁵ The tax law looks, rather, to the nature of the power itself. Any interest affecting the beneficial enjoyment of the trust property by the power to alter, amend, revoke, or terminate the trust instrument or its terms is a general power of appointment for estate tax purposes, and its value will be included in the decedent's gross estate.¹⁸⁶ The ambit of these rules, however, is as much determined by the exceptions as by the general rule.

Certain interests do not constitute a general power of appointment, although they may be substantial interests in the corpus of the trust. These interests include a right to income,¹⁸⁷ a power to invade the corpus of the trust subject to an ascertainable standard relative to health, education, support or maintenance,¹⁸⁸ a power to draw down annually from the corpus of the trust the greater of \$5,000 or five percentum of the corpus,¹⁸⁹ a power to manage the trust assets for the benefit of the other beneficiaries,¹⁹⁰ and a power to appoint any or all of the decedent's share to anyone, either by *inter vivos* or testamentary disposition, as long as the interest may not be ap-

¹⁸³ *Id.*

¹⁸⁴ I.R.C. § 2041.

¹⁸⁵ Treas. Reg. § 20.2041-1(b)(1)(1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940); *Maytag v. United States*, 493 F.2d 995 (10th Cir. 1974); *First Virginia Bank v. United States*, 490 F.2d 532 (4th Cir. 1974); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972).

¹⁸⁶ Treas. Reg. § 20.2041-1(b)(1)(1958).

¹⁸⁷ Treas. Reg. § 20.2041-3(f)(Example 1)(1958).

¹⁸⁸ I.R.C. § 2041(b)(1)(A); Treas. Reg. § 20.2041-1(c)(2)(1958); *see also* *Estate of Effie Kells Jones*, 56 T.C. 35 (1971), *aff'd sub nom. Estate of Jones v. Commissioner*, Civil No. 71-2050 (3d Cir. Jan. 30, 1973), *disposition recorded*, 474 F.2d 1338, 32 A.F.T.R. 2d 73-6193 (3d Cir. 1973); Moore, *The Tax Importance of Ascertainable Standards in Estate Planning*, 111 Tr. & Est. 946, 998 (1972).

¹⁸⁹ I.R.C. § 2041(b)(2).

¹⁹⁰ Treas. Reg. § 20.2041-1(b)(1)(1958).

pointed to the decedent, the decedent's estate, the decedent's creditors or the creditors of the decedent's estate.¹⁹¹ A power of appointment also is not considered general if it may be exercised only in conjunction with the creator of the power or another person having a substantial interest adverse to the exercise of the power in favor of the decedent.¹⁹² If the power is classified as a general power of appointment but is exercisable only in conjunction with another person or persons, the estate of the decedent will include a ratable share of the property subject to the power, computed as if the power had been exercised in favor of all the beneficiaries equally.¹⁹³

Under these rules, the life beneficiary may enjoy substantial beneficial interests from the trust corpus without having its value included in his or her gross estate. Because of the nature of these rights a number of commentators have claimed that there exists a parity between the position of a life beneficiary of such a trust and an individual owning the trust *res* outright. Therefore, it is asserted, there should be a parity in the tax treatment of the two situations.¹⁹⁴ With regard to generation skipping trusts, the Tax Reform Act of 1976 brings such a parity to the tax laws.

The 1969 Treasury proposals based their generation skipping trust tax on two policy beliefs. First, the law permitting generation skipping trusts to go untaxed resulted in an "inequitable distribution of the transfer tax" because only wealthy taxpayers could utilize the generation skipping trust to avoid their taxes. Second, a transfer tax was thought most equitably applied "with respect to each generation regardless of whether that generation receives the property or is skipped in favor of a succeeding generation."¹⁹⁵

The Treasury suggested imposition of an additional transfer tax on the transfer of an interest, in trust, directly or indirectly, to a person more than one generation below the beneficiary.¹⁹⁶ The tax liability would be an obligation of the trust, but would be computed on the marginal or grossed-up rates of the beneficiary whose interest was being terminated.¹⁹⁷ The tax would be imposed at a rate of sixty-percent of the rate that the beneficiary would have paid had he or

¹⁹¹ I.R.C. § 2041(b)(1).

¹⁹² I.R.C. § 2041(b)(1)(C)(i), (ii).

¹⁹³ I.R.C. § 2041(b)(1)(c)(iii).

¹⁹⁴ *ALI Proposals*, *supra* note 27, at 6-7, 28-29; G. JANTSCHER, *TRUSTS AND ESTATE TAXATION* 54-59 (1967); PECHMAN, *FEDERAL TAX POLICY* 192-93 (1966); *Treasury Proposals*, *supra* note 27, at 377-401; Oshins, *Generation Skipping Trusts*, 37 *NEV. ST. B.J.* 10, 11 (1973); and Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 *HARV. L. REV.* 986, 1006-1013 (1970) [hereinafter cited as *Westfall*].

¹⁹⁵ *Treasury Proposals*, *supra* note 21, at 389.

¹⁹⁶ *Id.* at 393.

¹⁹⁷ *Id.* at 391.

she made the transfer outright.¹⁹⁸ The beneficiary could file an election with the Internal Revenue Service and the trust immediately would become liable for the transfer tax based on the marginal transfer tax rate of the beneficiary in that year.¹⁹⁹ This would increase the transfer taxes paid by the beneficiary on subsequent transfers because the integrated estate and gift tax table would compute tax on a grossed-up lifetime basis.²⁰⁰ Under no conditions, however, could the tax be postponed beyond the date of death of the last beneficiary to whom a gift or transfer would not be generation skipping.²⁰¹

The American Law Institute, in their 1968 proposals, looked to a tax on the transfers to individuals of different generations as well, but excluded both outright transfers to individuals of different generations and trusts or transfers skipping only one generation.²⁰² The imposition on taxable generation skipping trusts would be computed on the basis of the average rate applicable to transfers made by the transferor during the taxable period.²⁰³

Both the House and Senate estate and gift tax reform proposals imposed a tax on the transfer of beneficial interests in property to a generation skipping heir by distribution or termination of the intervening beneficiary's or deemed transferor's interest.²⁰⁴ In fact, it was in this area of generation skipping trust taxation that the two houses of Congress found, perhaps, their greatest general agreement on estate and gift tax reform.

The new laws regarding generation skipping trusts define as covered transfers those providing for splitting the beneficial interest in the trust *res* among beneficiaries of more than one generation below

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at 391-92.

²⁰⁰ *Id.* This proposal has been criticized by at least two authors as opening the door to tax avoidance through use of nominal beneficiaries who are members of the skipped generation in order to defer taxes on the subsequent beneficiaries. *Westfall, supra* note 194, at 1010; Note, *Current Suggestions for Gift and Estate Tax Legislation*, 30 TAX L. REV. 451, 460 (1975).

²⁰¹ *Id.*

²⁰² *ALI Proposals, supra* note 27, at 28-29. The proposition that one level of beneficiaries or generation be skipped without tax is based on the belief that simplicity is more important than lost tax equity or revenues when only one generation is skipped. This proposal was commended by at least one author. *Westfall, supra* note 194, at 1009-1011.

²⁰³ *ALI Proposals, supra* note 27, at 29. The ALI acknowledged that this is an arbitrary rate but reasoned that "too many variables are involved to calculate the additional tax that is to be paid on the basis of how much property passed outright to the successive takers whose limited interests invoke" the tax. *Id.*

²⁰⁴ I.R.C. § 2601, (*added by Act, supra* note 12, § 2006(a)).

the grantor.²⁰⁵ Beneficiaries are assigned to generations either by reference to common ancestors with the grantor or, where no family relationship exists, by their relative ages.²⁰⁶

The generation skipping transfer tax is imposed on the passage of both rights, including right to receive income or corpus or terminating distributions, and powers, including the powers to alter or establish beneficial enjoyment of corpus or income.²⁰⁷ The tax is applied whether the interests are assured or discretionary, as in the case of "sprinkling" trusts.²⁰⁸ Limited powers of appointment permitting only allocation of income or corpus among lineal descendants of the grantor belonging to a generation younger than that of the individual holding the power, however, are expressly excluded from the list of taxable interests unless coupled with other rights or powers.²⁰⁹

The tax is imposed at either the termination of an intervening beneficiary's interest or a trust distribution of accounting income to a younger generation beneficiary. A termination is taxable if it eliminates an interest or power of a younger generation beneficiary in favor of another younger generation beneficiary at least one generation further removed from the grantor.²¹⁰ If there is more than one benefi-

²⁰⁵ I.R.C. § 2613(a), (added by Act, *supra* note 12, § 2006(a)).

See also *House Report*, *supra* note 11, at 48; *Senate Report*, *supra* note 13, at 20.

²⁰⁶ I.R.C. § 2611(c), (added by Act, *supra* note 12, § 2006(a)). A beneficiary within 12 1/2 years of the grantor is deemed the same generation; 12 1/2 - 37 1/2 years younger is deemed one generation removed; each 25 years younger is deemed another generation removed.

²⁰⁷ I.R.C. § 2613(d), (added by Act, *supra* note 12, § 2006(a)); *House Report*, *supra* note 11, at 48-49; *Senate Report*, *supra* note 13, at 21. While neither the power to draw down an annual \$5,000 or five percent of corpus nor the power to invade corpus subject to an ascertainable standard of health, education, support or maintenance constitute general powers of appointment under estate tax law, both constitute taxable powers for purposes of the generation skipping transfer tax. *House Report*, *supra* note 11, at 49.

²⁰⁸ *Id.* Sprinkling trusts are trusts in which the trustee has discretion to allocate the income and corpus among different beneficiaries (i.e., "sprinkling" the benefits of the trust). Sprinkling trusts raise certain special problems in the area of terminations of interest, as well as being generally covered as taxable interests under the generation skipping trust provisions. See note 211 *infra*.

²⁰⁹ As noted in the report of the House Committee on Ways and Means, a trust would not be a generation skipping trust merely because the grantor's child had a power to allocate income among his or her children prior to their receiving the remainder interest. However, if the same child also had a right to income himself or herself, the power would be taxable. *House Report*, *supra* note 11, at 49.

²¹⁰ I.R.C. § 2613(b), (added by Act, *supra* note 12, § 2006(a)); *House Report*, *supra* note 11, at 50-52; *Senate Report*, *supra* note 13, at 21. A future interest not coupled with a present interest does not result in a taxable event when terminated. This prevents imposition of a tax on the termination of an interest which never became

ciary in the same generation, there is no termination until all interests have been terminated.²¹¹ If the taxable termination occurs at the death of the deemed transferor, the alternate valuation date may be elected by the person liable for the tax.²¹²

A distribution of trust accounting income to a younger generation beneficiary, even without a termination of the deemed transferor's interest, is a taxable transfer under the new rules.²¹³ To prevent tax avoidance, any distribution out of trust corpus while accounting income exists at the time of the distribution will be deemed to be from the income, rather than the corpus of the trust.²¹⁴

The tax on a generation skipping transfer is computed in a manner intended to equate it with imposition of an estate tax on a similar transfer outright at the deemed transferor's death.²¹⁵ As such, the tax base is the value of any money, property, or power or interest in such money or property, passing from the deemed transferor to the next

present. "For example, if a trust provided income to the child for life, then to the grandchild for life, with remainder to the great grandchild, and the grandchild was the first to die, there would not be a taxable termination because the grandchild never held a present income interest in the trust." *House Report*, *supra* note 11, at 50. This clearly is required since, if the underlying policy behind generation skipping trust taxation is the equivalence of holding property outright and holding a substantial beneficial interest, a mere future interest should not be subject to tax.

²¹¹ I.R.C. § 2613(b)(2)(A), (*added by Act*, *supra* note 12, § 2006(a)). In a "sprinkling" trust, the use of the class measurement of termination is reasonable and proper, since it is not until termination that the beneficiaries can value their interests. For example, if a beneficiary shares the right to discretionary distributions with two other beneficiaries, it is possible that he or she may never receive anything or, alternatively, may receive the entire corpus. *House Report*, *supra* note 11, at 50. This rule does hold a potential for tax avoidance where the grantor makes a trust discretionary to defer taxation of the interest of the beneficiaries he or she actually intends to receive the corpus. The Treasury is expected to issue regulations looking through this type of artifice to the real nature of the transaction. *House Report*, *supra* note 11, at 51.

²¹² I.R.C. § 2602(a)(1)(A), (*added by Act*, *supra* note 12, § 2006(a)). This is normally the trustee, but may also be the deemed transferor.

²¹³ I.R.C. § 2613(a), (*added by Act*, *supra* note 12, § 2006(a)). The selection of trust accounting income, rather than distributable net income or another measuring rod, was merely an administrative convenience. *House Report*, *supra* note 11, at 52. Trust accounting income is the income of the trust computed under state law and the trust instrument. I.R.C. § 643(b).

²¹⁴ *Id.* A similar device was used to prevent tax avoidance with respect to distributions of accumulated income by complex trusts. In the Revenue Act of 1942, Congress attempted to curtail the tax-free distributions of trust corpus by complex trusts accumulating ordinary income. It accomplished this by treating any distribution by a trust having both income and corpus as a distribution of income. Int. Rev. Code of 1939 § 263(d)(3).

²¹⁵ *House Report*, *supra* note 11, at 53; *Senate Report*, *supra* note 13, at 20.

generation beneficiary, adjusted for certain deductions and credits.²¹⁶ The tax base is adjusted for any portion of the deemed transferor's unified transfer tax credit available at the time of transfer,²¹⁷ the charitable deduction, when part of the interest passes to a charitable organization,²¹⁸ the credit for previously taxed property,²¹⁹ the credit for state death taxes to the extent levied on the generation skipping transfer,²²⁰ and the estate and administration expenses of the deemed transferor.²²¹

The marital deduction may also play an important part in computing tax on the generation skipping transfer. If the transfer occurs within three years and nine months of the death of the deemed transferor, the value of the property in the transfer is included in the estate of the deemed transferor for purposes of computing the marital deduction.²²² This will usually raise the marital deduction, lowering the total taxable estate and the taxes paid on the generation skipping transfer itself.

The carryover basis at date of death, discussed earlier,²²³ will also apply to property received under the generation skipping transfer. The basis of property received in such a transfer is carried over from the decedent-deemed transferor, although the "fresh start" of December 31, 1976, is available.²²⁴ The basis is increased, though not

²¹⁶ I.R.C. § 2602(a), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54-55; *Senate Report, supra* note 13, at 20-21.

²¹⁷ I.R.C. § 2602(c)(3), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54.

²¹⁸ I.R.C. § 2602(c)(2), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54. Of course, the charitable organization receiving the property interest must be one meeting the qualifications of section 2055 of the Code, dealing with the estate tax deduction for charitable contributions.

²¹⁹ I.R.C. § 2602(c)(4), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54. Under the provisions of current law dealing with the credit for previously taxed properties, an estate may receive a credit against tax liability for up to eighty percent of the taxes paid on property included in the gross estate of another decedent within the past 10 years. I.R.C. § 2013. This may be of importance to both younger generation beneficiaries who will get a credit for prior generation skipping transfer taxes and also to the deemed transferor whose estate may be comprised of recently inherited property, so as to lower the marginal tax rate on the generation skipping transfer.

²²⁰ I.R.C. § 2602(c)(5)(C), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54-55.

²²¹ I.R.C. § 2602(c)(5)(B), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 55.

²²² I.R.C. § 2602(c)(5)(A), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 54.

²²³ *Id.* at 30-40.

²²⁴ I.R.C. § 2614, (*added by Act, supra* note 12, § 2006(a)); *Conference Report, supra* note 13, at 614.

above its fair market value for purposes of the generation skipping tax, by the tax imposed. The trust is not eligible for either the \$60,000 or \$10,000 exclusions.²²⁵

The parent of the transferee of the generation skipping transfer most closely related to the grantor of the trust will normally be the deemed transferor.²²⁶ If that parent is not a younger generation beneficiary at any time and if there is another ancestor of the transferee who is a younger generation beneficiary of the grantor, such other ancestor will be the deemed transferor.²²⁷ If the interest passes to an individual outside the family of the grantor, the deemed transferor will be the parent of the transferee having the closest "affinity" to the grantor, by relationship or age.²²⁸

The principal difference between the House and Senate versions of the generation skipping transfer tax was the specific exemption. The law provides for a specific exemption from the generation skipping transfer tax for each deemed transferee in the amount of \$250,000. However, the deemed transferee must be the grandchild of the grantor.²²⁹ The House Committee on Ways and Means had originally proposed a \$1 million per grandchild exemption, and the Senate had proposed no exemption. The \$250,000 per grandchild exemption was a compromise between the two proposals.²³⁰

The generation skipping transfer tax is computed on the marginal rates of the deemed transferor but he or she is not liable for its payment. The tax is to be paid out of the proceeds of the trust property.²³¹ If there is a taxable distribution of trust property, the distributee is personally liable for the tax up to the amount of the distribution.²³² Otherwise, only the trustee is liable for payment of the tax.²³³ In

²²⁵ *Id.*

²²⁶ I.R.C. § 2612, (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 56.

²²⁷ *Id.*

²²⁸ *Id.*; *see id.* at 69 n.206, delineating the degrees of "affinity" by relative ages.

²²⁹ I.R.C. § 2613(b)(6), (*added by Act, supra* note 12, § 2006(a)); *see Conference Report, supra* note 13, at 614. The Treasury Department will issue regulations to devise a "separate share" rule, noting when multiple interests should be treated as a single item for purposes of the generation skipping trust tax exemption.

²³⁰ *Id.*

²³¹ I.R.C. § 2601, (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 57-58.

²³² I.R.C. § 2603(a)(3), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 58.

²³³ I.R.C. § 2603(a)(1), (*added by Act, supra* note 12, § 2006(a)); *House Report, supra* note 11, at 57. The trustee is also required to file the trust's generation skipping trust tax return, at which time, if appropriate, he or she may elect the alternate valuation date. *Conference Report, supra* note 13, at 615.

consideration of the liability of the trustee, he or she may file with the Department of the Treasury a written request for information on the rate bracket of the transferor and the remaining portion of the trust's per-grandchild, \$250,000 exclusion. The trustee is not liable for taxes resulting from erroneous information provided by the Department of the Treasury.²³⁴

The new law will generally apply to generation skipping transfers occurring after April 30, 1976.²³⁵ However, the law will apply to neither irrevocable *inter vivos* trusts existing on April 30, 1976, nor revocable trusts and wills in existence on that date, where the decedent dies before January 1, 1982, without revoking or amending the instrument.²³⁶ In the case of a decedent who was incompetent to alter or amend his or her instrument on April 30, 1976, the effective date is extended to two years after removal of the disability.²³⁷

The principal objection which may be raised against the generation skipping trust tax is its extreme complexity. Part of the complexity is ascribable to the complex nature of the estate planning techniques being dealt with. It is unreasonable for an estate planner to claim immunity from tax revision because of the complexity of his or her planning devices. To this extent, therefore, the new rules should not be highly faulted.²³⁸

Part of the complexity of the new rules could have been avoided through greater reliance upon certain other proposals. The American Law Institute's proposals would have excluded from the new rules any trust skipping only one generation.²³⁹ They reasoned that the complexity involved in curing the tax inequity arising from a single-generation skipping transfer was sufficient to outweigh the inequity itself.²⁴⁰ Another proposal has been made that the generation skipping trust problem be addressed through positive legislation encouraging outright transfers. The suggestion was that a "parental deduction" be granted the estate of a decedent for 40 percent of the value of property transferred outright to a child. The proposal reasoned that the reduction in taxes on the grantor's estate would discourage

²³⁴ *Id.*

²³⁵ Act § 2206(c).

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Hearings on Revision of the Federal Estate Tax Law Before the Senate Finance Committee, 94th Cong., 2d Sess. 179 (1976) (statement of Stanley S. Surrey).*

²³⁹ *ALI Proposals, supra note 27, at 28-29.*

²⁴⁰ *Id.*

the use of generation skipping transfers, which would not qualify for the deduction.²⁴¹

A third approach was the so-called accessions tax, which would have imposed a tax on the recipient of property transferred by gift or testamentary disposition, graduated by the transfers received, rather than those made.²⁴² This would be in substitution for the basic estate and gift tax structure currently employed. The accessions tax would determine the liability when the funds reached the recipient, not when the interests were created in an uncertain form. This provision was promoted as a solution to the generation skipping trust problem, because it requires no immediate identification of the recipients and interests to be taxed and because the incremental growth of the assets transferred during the period when taxes were deferred, would increase the tax when the asset was received, discouraging deferral.²⁴³

In addition to the suggested complexity of the new generation skipping trust rules, there have also been raised questions regarding the conceptual soundness of the tax's philosophical bases. One commentator notes that the tax treats as equivalent to absolute ownership of property, certain bundles of rights which are not so equivalent.²⁴⁴ While it is not difficult to perceive certain compositions of rights which could be sufficiently similar to ownership as to be equated therewith, simple income interests or limited corpus rights do not appear sufficiently like ownership to be equated with it for tax purposes.²⁴⁵

Considering the conceptual problems and the complexity of the provisions on generation skipping trust taxation, it is arguable that Congress should have given greater consideration to some of the alternative proposals. The accessions tax is a dramatic departure from our conceptions of an estate tax and, rather expectedly, should be viewed with some skepticism. However, the American Law Institute's pro-

²⁴¹ *Westfall*, *supra* note 194, at 1012-13; see 1973 *Panel Discussions*, *supra* note 10, at 1552 (statement of Richard Covey); *Hearings on Federal Estate and Gift Taxes Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 155 (1976) (discussion draft on Transfer Taxes by the American Bankers' Association).

²⁴² This tax was promoted as a proposal of the American Law Institute in 1968. *ALI Proposals*, *supra* note 27, at 446-589. See Andrews, *The Accessions Tax Proposal*, 22 *Tax L. Rev.* 589 (1969). The proposal has the support of the American Bar Association's Section on Taxation. *Hearings on Federal Estate and Gift Taxes Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 1416 (1976) (statement of Edward C. Halbach, Jr.) [hereinafter cited as *ABA Statement*].

²⁴³ *ABA Statement*, *supra* note 242, at 1417.

²⁴⁴ 1973 *Panel Discussions*, *supra* note 10, at 1530-31 (statement of Bart A. Brown).

²⁴⁵ *Id.*

posals to exempt from the generation skipping trust rules any trust skipping only one generation, or the alternative proposal for a parental deduction, may have been worthy of far greater consideration and possibly adoption.

Orphan's Exclusion

Various parts of the new estate and gift tax revision are based upon interests of tax equity, revenue needs or technical corrections of the law. The so-called "orphan's exclusion," however, has been criticized as being supportive of none of these basic principles of reform. These criticisms are not altogether unfounded.

The Department of the Treasury proposed, in 1969, that a special deduction be provided for the parents' testamentary transfers to orphaned children. The Department contended that there was a "need for special relief . . . when a decedent has no surviving spouse but leaves minor children."²⁴⁶ Under their proposal, an exclusion would have been allowed an estate for transfers to orphaned minor children of the decedent. The exclusion would have been \$3,000 for each year of the orphan's age below 21.²⁴⁷

The House Committee on Ways and Means proposed, and the Congress adopted, the new exclusion almost without change from the 1969 proposals. Under the new provision, the exemption would apply as described in 1969, but the amount would be increased to \$5,000 for each year of the orphan's age below 21.²⁴⁸

To qualify for the orphan's exclusion, the interest passing to the minor child must be of a character which, if passing to a surviving spouse, would qualify for the marital deduction.²⁴⁹ The orphan's exclusion is expected to lose only a negligible amount of revenue.²⁵⁰

The exclusion has been criticized because it provides a substantial

²⁴⁶ *Treasury Proposals*, *supra* note 21, at 30. While the Treasury did not so state specifically, the proposal was probably derived from section 812 of the 1939 Code, which provided an estate tax exemption for any amounts "reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent. . . ." Int. Rev. Code of 1939, § 812 (repealed by Act of Sept. 23, 1950, § 502, 64 Stat. 959, 962).

²⁴⁷ *Treasury Proposals*, *supra* note 21, at 43.

²⁴⁸ I.R.C. § 2057, (*added by Act, supra* note 12, § 2007(a)).

²⁴⁹ I.R.C. § 2057(c), (*added by Act, supra* note 12, § 2007(a)). This precludes from qualification for the orphan's exclusion any terminable interest, including contingent interests and life estates not coupled with a non-limited power of appointment.

²⁵⁰ STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 94th Cong., 2d Sess., CONFERENCE COMPARISON ON H.R. 10612, 112 (1976) (Comm. Print 1976).

benefit to those estates not in need of it.²⁵¹ While the exclusion appears predicated upon an intention to aid the minor who inherits only a moderate-sized estate, the entirety of which will be needed to support him or her, two defects make the impact deviate from the design.

First, a moderate-sized estate will probably stem from a middle-class household, which will be unlikely ever to have made taxable gifts. The \$3,000 per donee annual exclusion will probably have covered all gifts made by such a family.²⁵² Therefore, the unified transfer tax credit will be intact and protect up to \$175,000 of estate properties from tax.²⁵³

Second, by failing to limit the exclusion to moderate estates, a number of orphans of substantial means will receive the exemption. An orphan receiving a \$10 million bequest will not only receive the exclusion but, because of the higher marginal estate tax rates of the estate from which he benefits, receive a greater dollar value from the same exemption.²⁵⁴

The orphan's exclusion is a grant of tax revenues to beneficiaries who may or may not have a financial need for assistance of the public fisc. Perhaps a better approach would have been to limit the exclusion to the difference between the unified transfer tax credit available against the estate and \$100,000 of estate properties. This would assist orphans whose parents depleted or exhausted their unified credits, but would not permit excessive combined use of the two provisions. In addition, the exclusion could be denied estates with adjusted gross value in excess of \$150,000, precluding the use of the exemption by larger estates.

Thus, the orphan's exclusion may be faulted on some points, including its failure to limit applicability to smaller estates. However, where there are middle-sized estates passing to orphans who will need these properties undiminished by estate taxes to support themselves in future years, the provision may prove useful and a valid expenditure of public revenues.

Administrative Provisions

The scope of the current estate and gift tax reform measures ex-

²⁵¹ *Hearings on Estate and Gift Taxes Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 124 (1976) (*Discussion Draft of Transfer Tax by the American Bankers' Association*); *ABA Statement*, *supra* note 242, at 1413-14.

²⁵² *House Report*, *supra* note 11, at 59.

²⁵³ I.R.C. § 2505, (added by Act, *supra* note 12, § 2001(a)).

²⁵⁴ I.R.C. § 2001, (amended by Act, *supra* note 12, § 2001(a)). The maximum rate on an estate under the new tables is 70 percent on estates over \$5 million in value.

tends beyond the substantive revision of the tax laws to revision of certain procedural matters relative to estate and gift taxes. The new law contains three measures of procedural reform: a revision of the provisions for contesting asset valuations, requirements on filing gift tax returns, and indexing of estate tax liens.

(1) Furnishing of Statement Explaining Estate or Gift Tax Valuations

While many tax planners concentrate their efforts on determining which assets can be removed from the taxpayer's estate, of equal importance in determining the level of estate and gift taxes is the valuation placed on assets.²⁵⁵ While some assets are relatively simple to value, such as securities or automobiles with "blue book" valuations, others may be subject to significant variances in opinion, leading to many disputes with the Internal Revenue Service.

The fiduciary includes a listing of the assets of an estate and their valuations as part of the estate tax return.²⁵⁶ The Internal Revenue Service, of course, is free to contest any valuation placed by a fiduciary on any asset of the estate. With regard to gift taxes as well, the valuation placed on the gift is the key determinant of the amount of tax imposed.²⁵⁷ The tax return filed by a grantor includes an accurate valuation of the asset, and the Internal Revenue Service may also contest the valuation placed upon a gift.²⁵⁸

When the Internal Revenue Service contests a valuation placed by a fiduciary or grantor on a gift, the grantor or fiduciary is placed in a difficult, defensive position. The determination of tax and valuation of assets by the Internal Revenue Service has a presumption of correctness which, if challenged in court, the taxpayer must overcome.²⁵⁹ Furthermore, if the taxpayer does not desire to litigate, seeking instead administrative review,²⁶⁰ the Service has not previously been required to furnish any information regarding the mode of valuation used by its agents.

²⁵⁵ LOWNDES, KRAMER & McCORD, *FEDERAL ESTATE AND GIFT TAXES* 973 (3d ed. 1974).

²⁵⁶ Treas. Reg. § 20.6018-3(a)(1973).

²⁵⁷ I.R.C. § 2502.

²⁵⁸ Treas. Reg. § 20.6018-3(a)(1973).

²⁵⁹ *Welch v. Helvering*, 290 U.S. 111 (1933); *Wickwire v. Reinecke*, 275 U.S. 101 (1927).

²⁶⁰ The taxpayer may seek two levels of administrative appeal of an assessment or a valuation. First, he or she may seek a conference in the District Director's Office, Audit Division. Then an appeal may be taken to the Appellate Division of the District Director's Office. See WHINERY, *TAX PRACTICE AND PROCEDURE* 284 (1975).

The Tax Reform Act of 1976 added a new provision to the estate and gift tax procedures which will facilitate taxpayer challenges to the valuations proposed by the Internal Revenue Service. Under the new provisions, the Government must furnish the taxpayer, upon written request of the grantor or executor, a written statement with respect to the valuation of the asset it has proposed.²⁶¹ The statement must be furnished within 45 days of the request or within 45 days of the determination or proposed determination by the Service that a deficiency is owing, whichever is later.²⁶²

The new law also delineates the substance of the notice. The notice must explain the basis upon which the valuation has been made. Furthermore, it must include details of any computations used in arriving at the valuation, and any expert appraisals used by the Government.²⁶³ The burden of proof in valuation contests is not changed by this requirement. It still remains with the taxpayer.²⁶⁴ However, this bill does attempt to provide the taxpayer with some reasonable guidance in valuing his or her assets for purposes of estate and gift taxes. The taxpayer is still free to contest the Service's valuation and this notice is not binding upon the Government, so that it may either fight for its valuation or settle the case.²⁶⁵

(2) Elimination of Certain Quarterly Gift Tax Returns

In 1970 the tax laws were changed to require quarterly, rather than annual, filings of gift tax returns.²⁶⁶ Congress felt that the annual filing requirements, which sometimes resulted in deferral of tax liability for as much as 15 1/2 months, produced too much tax avoidance.²⁶⁷ Therefore, the law was changed to require filing of a gift tax return in any quarter in which there is a gift tax liability.²⁶⁸ The quarterly filing requirement has proven to be a major administrative obstacle for the Internal Revenue Service, as well as for the gift tax-

²⁶¹ I.R.C. § 7517(a), (*added by Act, supra* note 12, § 2008(a)).

²⁶² *Id.*

²⁶³ I.R.C. § 7517(b)(1), (2)(3), (*added by Act, supra* note 12, § 2008(a)).

²⁶⁴ An exception to the general imposition of the burden of proof on the taxpayer in tax cases is where, in the United States Tax Court, the Internal Revenue Service increases a deficiency or asserts an affirmative defense. U.S.T.C. Rules, No. 39.

²⁶⁵ I.R.C. § 7517(c), (*added by Act, supra* note 12, § 2008(a)).

²⁶⁶ Act of Dec. 31, 1970, Pub. L. No. 91-614, § 102, 84 Stat. 1836.

²⁶⁷ S. REP. No. 1444, 91st Cong., 2d Sess. 12 (1970). As noted by the Senate Finance Committee, if an individual made a taxable gift in January, 1970, and another in April, 1970, the donor would have until April 15, 1971, to file gift tax returns on both gifts and to pay the taxes.

²⁶⁸ I.R.C. § 6075.

payer.²⁶⁹ Where a taxpayer has little gift tax liability in a given quarter, a return must still be filed.

The new estate and gift tax revision includes some relief for both the Internal Revenue Service and the gift taxpayer whose liabilities may be moderate in any given quarter. Now, where the taxpayer has less than \$25,000 in taxable gifts for the entire year, no quarterly return will be required. Only annual returns must be filed by taxpayers with less than \$25,000 in annual taxable gifts.

The change from quarterly filing to annual filing also produces an ancillary change in the substantive tax law. The gift tax marital deduction, which reduced the amount of certain interspousal gifts by one-half,²⁷⁰ is limited to the amount of gifts exceeding the annual perdonee exclusion.²⁷¹ Since 1970, this has been applied on a quarterly basis rather than an annual basis, placing a premium on the amount and timing of such gifts.²⁷² For example:

If, prior to the filing requirement changes, the donor made separate gifts of \$4,000 and \$2,000 in different calendar quarters of a year, no gift tax would be imposed with respect to those gifts (total gifts of \$6,000 less \$3,000 for the marital deduction and \$3,000 for the annual exclusion). If the same amount of gifts were given in different quarters under the quarterly filing system, no gift tax would be imposed with respect to the \$4,000 gift (\$4,000 gift less \$1,000 marital deduction and \$3,000 annual exclusion). The marital deduction is only \$1,000 because it is limited to the amount of gifts remaining after deduction for the annual exclusion. However, for the subsequent quarter in which the \$2,000 gift is made, the donor would have been treated as making \$1,000 in taxable gifts (\$2,000 gift less \$1,000

²⁶⁹ *Hearings on Federal Estate and Gift Taxes Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 718 (1976) (statement of John M. Martin, for the American College of Probate Counsel); *House Report*, *supra* note 11, at 62. The Service was required to process 120,000 more gift tax returns for each year after 1970 than prior to 1970. *House Report*, *supra* note 11, at 62.

²⁷⁰ The estate and gift tax revision includes a change in the gift tax marital deduction, from a flat one-half of the gift to a total exclusion on gifts under \$100,000, no exclusion on gifts between \$100,000 and \$200,000, and one-half of all gifts above \$200,000. See text accompanying notes 63-68 *supra*.

²⁷¹ I.R.C. §§ 2523-24. The regulations note that this rule, applicable to both the marital deduction and charitable contributions deduction, permits deductions only where the gift is included in the "total amount of gifts" made during the year. *Treas. Reg.* § 25.2524-1 (1972).

²⁷² *Treas. Reg.* § 25.2524-1 (1972)(Example 1)); *House Report*, *supra* note 11, at 62.

marital deduction and no amount of the exclusion is taken into account since it has been used against the value of the gift made in the preceding quarter). Thus, the donor's taxable gifts for the year have been increased by \$1,000 solely because of the quarterly filing requirements.²⁷³

The annual computation of gift tax liability for taxable gifts under \$25,000 per year will correct this situation because of the change in basis of calculating the tax liability and return filings.

(3) Public Index of Tax Liens

The tax liens have not always been filed under procedures evoking total taxpayer satisfaction. The tax liens must be filed in either a state-designated location or with the clerk of the United States District Court in the district wherein the properties are located.²⁷⁴ These liens, furthermore, take priority over most purchasers for value, holders of subsequent security interests, subsequent mechanics' lienors or judgment creditors.²⁷⁵

One of the more difficult problems comes from the lack of actual notice required for the tax lien to be effective. If the lien is incorrectly indexed by the local clerk or federal clerk, the lien is still valid and takes priority over other interests as if it were clearly evidenced in the record. However, an individual searching the chain of title could not find the tax lien at all, and would have no notice of its existence.

Under the new provisions of the Tax Reform Act of 1976, the Internal Revenue Service will be required to keep an index of all tax liens at each District Director's office, and make a reasonable effort to check the indexing of tax liens by other offices of the state and federal courts, where the tax liens are filed therein.²⁷⁶ The House Committee on Ways and Means had proposed that the Service be required to check all indexing by federal courts and local authorities, but this was defeated in the Conference Committee, presumably upon the belief that it imposed too great a burden on the Government.²⁷⁷

²⁷³ House Report, *supra* note 11, at 65.

²⁷⁴ I.R.C. § 6323(a), (b). Furthermore, notices of tax liens may be filed in the United States District Court regardless of other state law lien filing places, as long as the state does not designate a place for filing Federal liens. Rev. Proc. 71-37, 1971-2 C.B. 573.

²⁷⁵ *Id.*

²⁷⁶ I.R.C. § 6323(f), (*added by Act, supra* note 12, § 2008(c)).

²⁷⁷ See House Report, *supra* note 12, 14844, § 9.

Miscellaneous Provisions

In addition to the major, substantive provisions of estate and gift tax revision, and the three administrative provisions, the Tax Reform Act of 1976 also makes four additional changes in the substantive tax law which were perceived as technical adjustments. Because they did not fall into any of the major categories of estate and gift tax reform, discussed heretofore, they are categorized as "miscellaneous provisions." This does not, however, reflect a diminished importance, as these provisions are among the most useful and interesting of the entire reform package.

(1) Inclusion of Stock in Decedent's Estate Where Decedent Retained Voting Rights

On occasion, a major judicial decision construing legislation is viewed by Congress as either in conflict with the actual legislative intent or in opposition to the perceived public interest.²⁷⁸ Such a situation arose respecting *United States v. Byrum*.²⁷⁹ Acting to correct what it saw as an improper result, the House Committee on Ways and Means proposed an amendment to the tax laws later adopted by Congress which included in the estate of a decedent the value of any stock transferred by him or her during life but over which voting rights were retained.²⁸⁰

In *Byrum*, the decedent had established an irrevocable trust for the benefit of his grandchildren and children. He transferred to the trust shares of stock in three closely-held corporations which he had controlled. Byrum designated a sole corporate trustee for the trust and retained the power to remove the trustee and appoint another corporate trustee at any time. He also retained the rights to vote the shares, veto the sale or transfer of trust property, and veto any changes in trust investments.²⁸¹ At his death, the Commissioner determined that the stock was includable in Byrum's estate because he had retained powers constituting a general power of appointment.²⁸²

²⁷⁸ Other examples of this same practice may be found in Code section 337, enacted as a result of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), and the grantor trust rules, sections 671-678, enacted as a result of *Helvering v. Clifford*, 309 U.S. 331 (1940).

²⁷⁹ 408 U.S. 125 (1972).

²⁸⁰ *House Report*, *supra* note 11, at 64-65.

²⁸¹ 408 U.S. at 127.

²⁸² *Id.* at 130-31. The Commissioner made this determination as an interpretation of I.R.C. § 2036(a), which includes in the gross estate of any decedent the value of property transferred by him or her prior to death but over which was retained a general

The Government's principal rationale was that because Byrum could control the corporation through possession of a majority of the voting stock rights, he could control corporate dividend policy and, thus, beneficial enjoyment of the stock.²⁸³ The Court, however, viewed the power to elect directors of the corporation and, thereby, control flow of income into the trust, as dissimilar to a control over the enjoyment of the trust corpus and income.

Congress, not necessarily disagreeing with the Court's interpretation of the tax law, nevertheless did not want individuals to avoid estate taxes on closely held corporate stock by transferring it away with retained voting rights. Accepting the proposal of the House Committee on Ways and Means,²⁸⁴ Congress amended the law to characterize retention of voting rights in transferred stock as a retention of control over the beneficial enjoyment of the stock.²⁸⁵

It should be noted, however, that the measure enacted to "legislatively reverse" *Byrum* goes further than this simple goal. In *Byrum*, the Government contended that because the decedent held voting control over the corporations involved, he controlled the value and enjoyment of the stock they issued. However, under the new amendments, no matter how small the total corporate power the transferor controls, the value of the stock will still be included in his or her gross estate.

This amendment could be considered "overkill" by the Congress. Some situations may arise where the transferor of a minority interest in corporate stock will wish to retain voting rights in the shares transferred, but will be totally unable to control the dividend policy of the corporation. Nonetheless, the transferor's estate will be increased by the value of the stock transferred away. Such instances should presumably be few in number, and, the general import of the statutory change will be to prevent some stock from being removed from the estate of a decedent while voting control is retained.

Perhaps more significant is the framework of the newly unified estate and gift tax structure in analyzing the anti-*Byrum* provision. When *Byrum* was decided, the transferor of the shares was able to

power of appointment. The same provision defines a general power of appointment as any lifetime right to the possession or enjoyment of the property or income, or the right to designate who shall enjoy or possess the property or income. Consequently, the Commissioner determined that the rights retained by Byrum constituted general powers of appointment.

²⁸³ 408 U.S. at 138-44.

²⁸⁴ *House Report*, *supra* note 11, at 64-65.

²⁸⁵ I.R.C. § 2036(a), (*amended by Act*, *supra* note 12, § 2009(a)).

avoid taxes only because the gift tax rate was lower than the estate tax rate, and he had an additional gift tax exemption. However, since the two taxes are unified in rate and credit, it is advantageous for a taxpayer to defer the taxes until death by making incomplete gifts and gifts with a retained power of appointment.

Consequently, an individual, under the new anti-*Byrum* amendment, could transfer away \$250,000 of I.B.M. stock, retaining what could not be considered by anyone a large portion of the voting control, and pay a reduced gift tax. Rather, the individual would defer part of the transfer tax until date of death. For this reason, the anti-*Byrum* provision may be somewhat ill-conceived and improperly drafted. The *Byrum* fact situation should rarely arise after the unification of the estate and gift tax, and the provision added to counter the decision of the Supreme Court would appear unnecessary and perhaps even harmful to tax equity and compliance.

(2) Disclaimers

Disclaimer legislation has been much needed in recent years, due both to the impact of certain judicial decisions and the disunity of applicable state law.²⁸⁶ The provisions on disclaimers, enacted as part of the estate and gift tax revision of the Tax Reform Act of 1976, provide an adequate answer to this need.

A disclaimer is a renunciation of an individual's interest in property and may have both estate and gift tax implications. If an individual disclaims a gift, there is no valid transfer, and no tax is imposed.²⁸⁷ The disclaimer by a transferee of a testamentary disposition, while not rendering the transfer non-taxable, may lower estate taxes by increasing either the marital deduction or charitable deduction available to the estate.²⁸⁸

Where the marital deduction has been improperly funded, for example, a disclaimer may reduce estate taxes on either the decedent's estate or that of the surviving spouse. Where the marital deduction has been underfunded, that is to say, where less property passes to the surviving spouse than would pass without tax under the marital deduction, a disclaimer of all or part of another beneficiary's interest in favor of the surviving spouse may increase the marital

²⁸⁶ See Newman & Kalter, *The Need for Disclaimer Legislation—An Analysis of the Background and Current Law*, 28 TAX LAW. 571 (1975) [hereinafter cited as *Newman & Kalter*].

²⁸⁷ Treas. Reg. § 25.2511-1(c).

²⁸⁸ I.R.C. § 2056(d)(2)(A). See *Newman & Kalter*, *supra* note 286, at 572-80; LOWNDES, KRAMER & MCCORD, *FEDERAL ESTATE AND GIFT TAXES* 1013-16 (3d ed. 1974).

deduction and reduce total estate taxes.²⁸⁹ Where, on the other hand, the marital deduction has been overfunded, that is to say, where more than one-half of the adjusted gross estate passes to the surviving spouse outright, a disclaimer of part of his or her interest will reduce estate taxes when the surviving spouse dies.²⁹⁰

The disclaimer may also be used to reduce estate taxes in other ways. A disclaimer of an interest by a beneficiary in favor of a charitable beneficiary may help fully fund an underfunded charitable deduction.²⁹¹ In addition, while a release of a general power of appointment is a taxable event, the disclaimer of such a power is not.²⁹²

Consequently, it becomes apparent that the ability to make an effective disclaimer is crucial to post mortem estate planning. However, prior to the Tax Reform Act of 1976, the law did not provide either a definitive rule as to what constituted a disclaimer or any rules of general application as to the impact of a disclaimer. The tax consequences depended upon the treatment of the disclaimer under local law.²⁹³ Therefore, if a disclaimer was a valid renunciation of the interest under local law, it was also valid for federal estate and gift tax purposes. This rule has led to significant problems, as the laws among the various states are divergent on the definition of a disclaimer.²⁹⁴

Another problem in the interpretation of the law regarding use of disclaimers in estate planning has been the time element. No other rules exist as to when a disclaimer must be made to be effective other than provisions of the estate tax law holding that disclaimers affecting the marital or charitable deductions must be made before the due date for the estate tax return.²⁹⁵ In this area the judicial gloss on the law has hindered the lawyer's ability to plan for the impact of a

²⁸⁹ I.R.C. § 2056(d)(2)(A), (*amended by Act, supra* note 12, § 2009(b)). The disclaimed interest is treated as if it passed directly to the surviving spouse, thereby raising the marital deduction. I.R.C. § 2056(b).

²⁹⁰ I.R.C. § 2056(d)(1), (*amended by Act, supra* note 12, § 2009(b)).

²⁹¹ I.R.C. § 2055(a), (*amended by Act, supra* note 12, §§ 1307(d), 1313(b), 1902(a), 2009(b)).

²⁹² I.R.C. §§ 2041(a)(2), 2514(b).

²⁹³ Treas. Reg. § 25.2511-1(c).

²⁹⁴ Although the Commissioners of Uniform State Laws have proposed a Uniform Disclaimer Act, this act has not been consistently adopted. The variances in state disclaimer laws may be noted in the fact that only thirty-three states have statutory provisions governing disclaimers. The other states rely upon judicial interpretations to provide guidance in making renunciations, and these may vary even more than the statutory provisions. *See also Newman & Kalter, supra* note 286, at 589-92.

²⁹⁵ I.R.C. §§ 2055(a), (*amended by Act, supra* note 12, §§ 1307(d), 1313(b), 1902(a), 2009(b)), 2056(d)(2), (*amended by Act, supra* note 12, § 2009(b)).

disclaimer. In one decision, for example, a court held that while a local court upheld the validity of a disclaimer for state purposes, this was not dispositive for federal gift tax purposes. The court held that a remainderman who disclaimed a known gift for 19 years had made a disclaimer within a "reasonable" period because it was immediately after the termination of the intervening life estate.²⁹⁶ This type of decision has led to much confusion in the tax profession regarding how a disclaimer may be used.

In its 1968 study and proposals, the American Law Institute proposed that disclaimers made within 15 months of the transfer, or six months of the beneficiary's learning of the transfer, whichever came later, would be valid. Furthermore, the disclaimant would have had to exercise no control or dominion over the benefits from the transfer. In addition, a statutory definition of disclaimer was promoted.²⁹⁷

The Department of the Treasury also set forth a proposal on disclaimers in 1969. Its proposal was substantially identical with that of the American Law Institute, permitting the disclaimant to designate only the decedent's spouse or a charity as recipient for the disclaimed property. Absent a designation, the property would pass under local law.²⁹⁸

The disclaimer provisions added by the Tax Reform Act of 1976 appear to have been influenced by the Treasury and American Law Institute proposals. Under the new law, a single set of rules and definitions governs the use of disclaimers in federal estate and gift tax planning. A person making a qualified disclaimer will be ignored for purposes of estate and gift taxes, and the law will apply as if the interest had never been transferred to the disclaimant.²⁹⁹ A disclaimer is "qualified" if it is (1) irrevocable and unqualified, (2) a refusal to accept an interest in property, (3) in writing, (4) received by the transferor or his legal representative, or the holder of legal title to the disclaimed interest, not later than 9 months after the date on which the transfer is made or the date on which the disclaimant turns 21 years of age, whichever is later, (5) the disclaimant has accepted no benefits in the interest nor has he or she accepted the interest itself, and (6) the interest passes to a person other than the disclaimant.³⁰⁰

²⁹⁶ *Kienath v. Commissioner*, 480 F.2d 57 (8th Cir. 1973), *rev'g* 48 T.C. 352 (1972).

²⁹⁷ *ALI Proposals*, *supra* note 27, at 96-97.

²⁹⁸ *Treasury Proposals*, *supra* note 21, at 365-66.

²⁹⁹ I.R.C. § 2518(a), (*added by Act*, *supra* note 12, § 2009(b)(1)).

³⁰⁰ I.R.C. § 2518(b), (*added by Act*, *supra* note 12, § 2009(b)(1)). It is explained that the time for disclaiming an interest in properties applies to each taxable transfer individually, not to an aggregate of transfers. Therefore, if an individual is to receive

Disclaimers are also permitted with regard to undivided portions of an interest in property, validating the so-called "partial disclaimer."³⁰¹

As noted earlier, the disclaimer legislation included in the Tax Reform Act of 1976, is much needed and sound legislation. While it does little to expend or enhance current law on the subject of disclaimers, it does much to clarify the law and provide a firm basis for estate planning with disclaimers.

(3) Changes Relating to Certain Retirement Benefits

Two problems regarding estate and gift tax treatment of retirement benefits arose during the consideration of the Tax Reform Act of 1976, and Congress addressed both in the miscellaneous provisions of that act. The first deals with the exclusion for qualified retirement benefits and its former inapplicability to individual retirement accounts and retirement plans for self-employed individuals (H.R. 10 plans). The second deals with the gift tax treatment of certain retirement benefits in community property states.

The estate and gift tax laws provide numerous benefits for qualified retirement plan participants. The value of an annuity payable from such a plan is excluded from the individual's gross estate, except to the extent that the value is attributable to employee contributions.³⁰² Paralleling this provision, the exercise or nonexercise of an option for a survivor's annuity in a qualified retirement plan is not considered a gift, except to the extent of employee contributions.³⁰³ Neither of these tax benefits has previously been available for the participants in an individual retirement account or self-employed retirement plan.

During the hearings on estate and gift tax reform, the House Committee on Ways and Means heard testimony that these distinctions in tax treatment constituted "severe inconsistencies and . . . inequities . . ." discriminating against H.R. 10 plans and individual retirement accounts.³⁰⁴ Larger H.R. 10 plans, it was noted, were re-

a general power of appointment, and if he or she is over the age of 21 and other requirements are met, the recipient has 9 months in which to disclaim the power, and the individual to whom the power passes has another 9 months in which to disclaim it. *Conference Report, supra* note 13, at 623-24.

³⁰¹ I.R.C. § 2518(c), (*added by Act, supra* note 12, § 2009(b)(1)).

³⁰² I.R.C. § 2039(c), (*amended by Act, supra* note 12, § 2009(c)).

³⁰³ I.R.C. § 2517, (*amended by Act, supra* note 12, § 2009(c)).

³⁰⁴ *Hearings on Federal Estate and Gift Taxes Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 781 (1976) (statement of William D. Brownie).

quired to provide significant life insurance policies to fund the estate taxes owing upon the death of the beneficiaries.³⁰⁵ In answer to these problems, the Committee suggested, and the Congress adopted, a provision to equalize the estate and gift tax treatment of retirement plans for corporate employees and other individuals.

Under the new provisions, the gross estate does not include the value of an annuity received by a participant in either an H.R. 10 plan or individual retirement account, except to the extent of any contributions which were not deductible to the participant.³⁰⁶ Furthermore, the distribution from an individual retirement account or H.R. 10 plan is excluded whether or not it takes the form of a typical commercial annuity, as long as it is an annuity.³⁰⁷

With respect to the gift tax treatment, a corresponding amendment was made to exclude from treatment as taxable gifts, any election of a survivor's annuity option in an individual retirement account or H.R. 10 plan, to the extent of contributions which were deductible for income tax purposes.³⁰⁸

Another problem arose regarding the taxation of certain retirement benefits in community property states. An Internal Revenue Service ruling had held that, where a deceased spouse had a vested interest in half of the annuity payable from an employee retirement system, due to residence in a community property state, the interest of the spouse was includable in his gross estate, without exclusion, if he predeceased the participant-employee.³⁰⁹ Congress legislatively overturned this ruling in 1972, providing that, to the extent the retirement interest of an employee is attributable to employer contributions and, to the extent the predeceasing spouse's interest in that benefit is only attributable to the state community property law, the value of the annuity is excluded from his or her gross estate.³¹⁰

In 1975, however, the Internal Revenue Service issued another ruling, holding that the 1972 amendment had not changed the gift tax treatment of these spousal interests in employee benefit rights. Where an employee participating in a qualified retirement plan pre-

³⁰⁵ *Id.* at 782.

³⁰⁶ *Id.*

³⁰⁷ I.R.C. § 2039(e), (*added by Act, supra* note 12, § 2009(c)(1)). The rationale is that the exclusion should apply wherever there may be a liquidity problem. *Conference Report, supra* note 13, at 624. Where there has been a roll-over of benefits from another plan, these too are excludable, although no deduction was available for them. *House Report, supra* note 11, at 69.

³⁰⁸ I.R.C. § 2517(a)(5), (*added by Act, supra* note 12, § 2009(c)(4)).

³⁰⁹ Rev. Rul. 67-278, 1967-2 C.B. 323.

³¹⁰ Pub. L. No. 92-580, § 2, 92d Cong., 2d Sess. (1972).

deceases his or her spouse in a community property state, the surviving spouse is deemed to have made a gift to the other beneficiaries of one-half of the retirement benefit.³¹¹

Congress perceived this situation as one incident wherein they had merely failed to alter legislatively the gift tax laws as well as the estate tax laws. Acting to provide a gift tax exclusion for the value of an employee annuity or benefit attributable to employer contributions, it has set two conditions for this treatment. First, the benefit must be due to employer contributions under a qualified pension or retirement plan, or deductible contributions under an H.R. 10 or individual retirement account. Second, the amount involved cannot be considered a non-tax deductible employee contribution.³¹² Where these two conditions are met, there is a gift tax exclusion for the value of the death benefits.

This amendment is clearly a technical change in the law inadvertently omitted in earlier legislation. It also has the impact of equating the gift tax treatment of an annuity, for gift tax purposes, in a community property state at the employee's death and at his or her spouse's death.³¹³

(4) Income Tax Treatment of Certain Selling Expenses of Trusts and Estates

The tax law generally attempts to preclude double deductions for the same expenditure. Generally, an estate or trust is not allowed to deduct any item for income tax purposes that is also deducted for purposes of estate taxes, such as funeral expenses or administration costs.³¹⁴ However, in a number of judicial decisions, an exception has been carved out of this general rule which Congress, as part of its estate and gift tax revision, has seen fit to close.

A number of decisions have held recently that selling expenses relative to property disposed of by an estate may be used both to reduce the amount realized on the sale of the property, and as administration expenses for estate tax purposes.³¹⁵ The rationale was explained in one of the earliest of the decisions:

³¹¹ Rev. Rul. 75-240, 1975-1 C.B. 315.

³¹² I.R.C. § 2517(c), (amended by Act, *supra* note 12, § 2009(c)(5)).

³¹³ House Report, *supra* note 11, at 70.

³¹⁴ I.R.C. § 643(g).

³¹⁵ Commerce Trust Co. v. United States, 438 F.2d 111 (8th Cir. 1971); Commissioner v. Bray, Estate, 396 F.2d 452 (6th Cir. 1968); Kreher v. United States, 70-1 U.S.T.C. ¶ 9331 (D. Fla. 1970); Mercantile-Safe Deposit & Trust Co. v. Commissioner, 311 F. Supp. 670 (D. Md. 1970).

It has long been the position of the Internal Revenue Service that brokerage fees and other selling expenses paid by an individual who is not a dealer in stocks or the fiduciary of an estate in connection with the sale of securities . . . are to be used only as an offset against selling price in an income tax return reporting the sale We agree with the petitioner that . . . the longstanding distinction between offsets and true statutory deductions . . . [is] available for living individual taxpayers and fiduciaries of estates filing income tax returns It would seem to be unfair to tax the estate on the date of death value, with no deduction for selling expenses, and equally unfair to deny the offset of selling expenses against selling price in computing the estate's income tax.³¹⁶

Faced with repeated judicial accord with the double deduction, the Internal Revenue Service conceded in 1971.³¹⁷

The Tax Reform Act of 1976 provided Congress with a forum for changing this double deduction. An amendment was made to preclude taking a deduction in the form of an offset against sales price for selling expenses.³¹⁸ This would appear to be well within the scope of Congress' tax policy role, as it is merely a redetermination of the scope of a tax law the courts had viewed far less restrictively than Congress apparently intended.

Conclusion

Tax reform is never an easy task because contradictory equities must be balanced. Tax equity often begets complexity, and vice versa. The resolution of this constant conflict is never simple.

The new estate and gift tax revision, contained in the Tax Reform Act of 1976, is clearly an improvement over the sixty-year-old estate and gift tax structure with which we have previously dealt. The unified estate and gift tax rate schedules, the unified transfer tax credit and the carryover basis for property received by inheritance will preclude a significant amount of distortion in natural disposition patterns as was caused by the former tax framework.

The new marital deduction and higher total credit value will relieve the tax burdens on all small- and moderate-sized estates, and the special valuation provisions for farms and closely held businesses,

³¹⁶ Estate of Bray, 46 T.C. 577, 580-83 (1966).

³¹⁷ Rev. Rul. 71-173, 1971-1 C.B. 204, *revoking* Rev. Rul. 56-43, 1956-1 C.B. 210.

³¹⁸ I.R.C. § 642(g), (*amended by Act, supra* note 12, § 2009(d)).

as well as the special deferral of tax payment provisions, will ease some particularly unfortunate and unfair tax burdens.

The new generation skipping trust provisions will clearly improve the tax equity, precluding what could constitute a major device to evade estate taxes. However, to effectuate this equity interest, simplicity in administration had to be sacrificed. This provision is difficult to deal with and difficult to understand, and it is going to take considerable efforts on the part of the estate and tax bars to acquire competency in dealing with the new generation skipping trust rules.

Altogether, though, Congress should be commended for its revision of the estate and gift tax laws. The new laws will promote greater tax equity and, for most taxpayers, greater ease in administration. This is always a difficult combination to achieve, and Congress has been successful in the enactment of the estate and gift tax revision of the Tax Reform Act of 1976.