SMU | Dedman School of Law

SMU Law Review

Volume 56 | Issue 1 Article 21

2003

Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax

Joseph M. Dodge

Follow this and additional works at: https://scholar.smu.edu/smulr

Recommended Citation

Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. Rev. 551 (2003)
https://scholar.smu.edu/smulr/vol56/iss1/21

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.

Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax

*Joseph M. Dodge**

THE administration of George W. Bush in 2001 came close to achieving complete and permanent repeal of the federal estate and generation-skipping taxes, if not the gift tax (which remains to back up the income tax).[1] Those opposing repeal have fallen back to the position of conceding the shortcomings of the federal transfer taxes and of proposing that they be "reformed," mainly by increasing the per taxpayer lifetime estate and gift tax exemption to a very large number somewhere in the $2-10 million range.[2] Alternatives to a reformed estate and gift tax system are a federal inheritance tax, an accessions tax, or a repeal of the income tax rule that excludes gratuitous receipts from gross income.[3] A principle purpose of this article is to put these alternatives on the table and to compare them to each other and to a reformed estate and gift tax system.

In the world of academia, there are various factions among those that

---

* Stearns, Weaver, Miller, Weissler, Alhadeff & Sitterson Professor of Law, Florida State University College of Law; LL.M., New York University, 1973; LL.B., Harvard University, 1967; B.A., Harvard University, 1963.

1. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. Law No. 107-16, 115 Stat. 38 (2001) [hereinafter The 2001 Act]. A description of the federal wealth transfer taxes (the estate, gift, and generation-skipping taxes) immediately prior to The 2001 Act is found in STAFF OF J. COMM. ON TAX'N, 107TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT LAW AND PROPOSALS RELATING TO FEDERAL ESTATE AND GIFT TAXATION (Mar. 14, 2001) [hereinafter JCT DESCRIPTION]. Under The 2001 Act, the estate and generation-skipping taxes are scheduled to expire at the end of 2009, but the repeal itself expires at the end of 2010, causing these taxes to reappear in their 2001 form. The 2001 Act, *supra* § 901.

2. Dennis J. Ventry, Jr., *Straight Talk about the "Death" Tax: Politics, Economics, and Morality*, 89 TAX NOTES 1159, 1168-69 (2000) (noting Democratic bills to raise the exemption level to $2 million and $4 million); H.R. 5008, 107th Cong. § 2(a)(1) (2002) ($3.5 million exemption); S. 179, 107th Cong. (2001) ($4 million exemption per married couple plus family-owned business interest deduction capped at $9,375,000); H.R. 543, 107th Cong. (2001) (lifetime exemption of $10 million, annual gift exclusion of $50,000, and maximum rate of 30%).

3. I.R.C. §§ 101(a) (life insurance proceeds), 102(a) (other gratuitous receipts), and 1014 (excluding pre-death appreciation from any income tax) (2002).

support some kind of tax on gratuitous transfers.[4] One camp (which includes this author) has advocated that wealth transfers received be included in the income tax base of the recipient, without deduction by the transferor.[5] Another camp favors the current gross income exclusion and supports the federal transfer taxes (if at all) from the external-to-tax perspective of being a mechanism to curb undue concentrations of wealth.[6] The second camp hasn't really engaged the first camp on the merits, except by invoking the specter of double-taxing the same thing, once to the transferor and again to the transferee.[7] The first camp replies that such double taxation is not per se illegitimate, because the transferor and the

4. There is a camp that favors repeal of the existing transfer taxes, but at least some members of this camp may favor some alternative. Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994) [hereinafter *Uneasy Case*]; Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215 (1984); Charles O. Galvin, *To Bury The Estate Tax Not To Praise It*, 52 TAX NOTES 1413 (1991) (preferring income-inclusion system).

5. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 57-58 (1938); 3 ROYAL COMMISSION ON TAXATION, REPORT 477-507 (1966) (Canada); Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978) [hereinafter *Income Inclusion*]; Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1 (1992); Charles O. Galvin, *Taxing Gains At Death: A Further Comment*, 46 VAND. L. REV. 1525, 1528-29 (1993); John K. McNulty, *A Transfer Tax Alternative: Inclusion under the Income Tax*, 4 TAX NOTES 24 (1976). Under current law, gratuitous accessions are excluded from gross income under I.R.C. § 102(a).

6. James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825 (2001); James R. Repetti, *The Case for the Estate and Gift Tax*, 86 TAX NOTES 1493 (2000); Jay A. Soled & Charles Davenport, *Cremating Transfer Taxes: Is There Hope for a Resurrection?*, 34 WAKE FOREST L. REV. 229 (1999); David H. Brockway, *Comprehensive Estate and Gift Tax Reform*, 67 TAX NOTES 1089 (1995); Gerald R. Jantscher, *The Aims of Death Taxation*, *in* DEATH, TAXES AND FAMILY PROPERTY 40, 51 (Edward C. Halbach, Jr. ed., 1977). A more modest version of the same justification is that the transfer taxes enhance the progressivity of the income tax. Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259, 271-73 (1983). The easy rejoinder is that there is much that could be done to the income tax to achieve the same end more directly and effectively, such as removing the permanent exemption for unrealized gains at death. Joseph M. Dodge, *A Deemed Realization Approach Is Superior To Carryover Basis (And Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001) [hereinafter *Deemed Realization*]; Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993).

7. One-sentence or summary dismissals of the income inclusion approach are found in DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 157-60 (1986); RICHARD GOODE, THE INDIVIDUAL INCOME TAX 99-100 (1976); Michael Graetz, *Expenditure Tax Design*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 161, 200 (Joseph A. Pechman ed., 1980); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1083-93 (1980). An attempt to sort out the issues is made in Joseph M. Dodge, *Gratuitous Transfers Under a Consumption Tax*, 51 TAX L. REV. 529 (1996) [hereinafter *Consumption Tax*], a parodied version of which is critiqued in Karen C. Burke & Grayson M.P. McCouch, *A Consumption Tax on Gifts and Bequests?*, 17 VA. TAX REV. 657 (1998). The main thesis of the latter piece appears to be that an estate tax or accessions tax is "more flexible" than an income-inclusion system, *id.* at 705, but it is not clear what interests are to be served by such flexibility other than exemption of the upper middle class. What represents "flexibility" to one is a "loophole" to another. In any event, there is no reason why an income-inclusion approach cannot be "tweaked" with such special features as annual or lifetime exemptions, deferral provisions (using a zero-basis mechanism), special rate structures, and so on.

transferee are separate taxpayers, each with an independent tax base.[8] A justification is needed for why "partial" double taxation under a wealth transfer tax is good (or at least tolerable) but comprehensive double taxation under an income tax is bad.[9] Indeed, several academics opposed to the income-inclusion approach seem attracted to a system that, in many respects, resembles an income-inclusion approach, namely, the accessions tax.[10] The accessions tax, like the income-inclusion approach, would tax the transferees. Under the accessions tax, gratuitous receipts would be added to the cumulative lifetime accessions tax base of the transferee, but lifetime accessions up to a fixed dollar amount would be exempt.[11] The income-inclusion approach, however, would simply treat gratuitous receipts as income includable in the annual income tax base, with no fixed-dollar annual or lifetime exclusions.

The theoretical merits of taxing vs. not taxing wealth transfers will not be taken up in this contribution,[12] which instead focuses on how alternative tax systems relating to gratuitous transfers would be structured in order to implement their basic premises. Part I argues that any transferee-oriented tax should possess greater appeal than a transferor-oriented tax with respect to achieving such goals as curbing undue accumulations of wealth or improving equality of opportunity. Part I also compares estate and gift taxes, inheritance taxes, accessions taxes, and income-inclusion systems with respect to their appropriate respective rate and exemption structures. Part II lays out the basic structural features (and design choices) that would inhere in any of these systems *insofar as they stay true to their underlying premises.* A fundamental thesis is that *it should not be simply taken for granted that features of the existing federal*

8. Both the notion of ability-to-pay and the Schanz-Haig-Simons concept of income look to each individual taxpayer's material resources during the taxable period relative to other taxpayers. Wealth gratuitously transferred to a private individual represents the exercise of economic power by the donor for personal use that cannot support a deduction, and it represents an increase in the material resources of the transferee.

9. Possible efficiency-type justifications for opposing the inclusion of gratuitous receipts in the income or consumption tax base are advanced, and rebutted, in *Consumption Tax*, *supra* note 7, at 573-88. *See also* Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469 (1995) (favoring policies that encourage inter vivos gifts, especially to charity, on theory that gifts enhance the welfare of both donor and donee, but not really addressing bequests or issues of tax system design).

10. Michael Boskin, *An Economist's Perspective on Estate Taxation*, *in* DEATH, TAXES AND FAMILY PROPERTY 56, 66 (Edward C. Halbach, Jr. ed., 1977); Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263, 337-47 [hereinafter *Wealth Taxes*] (appearing to favor a consumption tax modified to take into account the holding period of accessions); Burke & McCouch, *supra* note 7, at 701-04.

11. Edward C. Halbach, Jr., *An Accessions Tax*, 23 REAL PROP. PROB. & TR. J. 211, 229-35 (1988); William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967) (describing the 1968 ALI accessions tax proposal included as part of the ALI Federal Estate and Gift Tax Project); Harry A. Rudick, *A Proposal for an Accessions Tax*, 1 TAX L. REV. 25 (1945).

12. A recent survey of the economic issues posed by wealth transfer taxes is DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH (Joel B. Slemrod ed., 2000). For the view that these issues cannot be solved solely on the basis of distributive-justice theory, see Daniel N. Shaviro, *Commentary: Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397, 420 (2000).

transfer taxes should be carried over to any of the transferee-oriented systems.

Among the conclusions reached herein are: (1) the estate tax is the worst transfer tax except from the angle of neutrality with respect to bequests; (2) the justification for an accessions tax is somewhat shaky; (3) the accessions tax and income-inclusion approaches are sufficiently close as to suggest the possibility of a hybrid system that would combine the most appealing features of each; (4) generation-skipping transfers do not warrant a special tax; (5) an unlimited marital exclusion is contrary to the purpose of an accessions tax; (6) an accessions tax and an income-inclusion tax offer considerable simplification advantages over an estate tax or an inheritance tax; and (7) an income-inclusion system is doctrinally the simplest.

I. THE INADEQUACY OF THE ESTATE TAX

This Part argues the hardly-startling proposition that the current transferor-oriented system is the hardest kind of tax on gratuitous transfers to defend from the angle of political rhetoric and policy. This Part also suggests the contours of rate and exemption structures under the various modes of taxing gratuitous transfers or receipts.

A. ALTERNATIVE WAYS OF TAXING GRATUITOUS TRANSFERS

The core operating concept of the existing federal transfer taxes is that the cumulative (lifetime and deathtime) gratuitous transfers of an individual constitute a cumulative tax base that is subject to progressive rates.[13] The centerpiece of current federal transfer taxes is the estate tax. Both the gift tax and the generation-skipping tax (GST) are back-ups to the estate tax,[14] and the bulk of revenues from the transfer taxes are produced by the estate tax.[15] The estate tax (re-labeled the "death tax") is the target of the repeal rhetoric.[16]

The estate tax concept can be contrasted with three competing transferee-oriented modes of wealth transfer taxation. One (and the oldest) is the inheritance tax concept, where exemptions and (where applicable) progressive rate schedules apply on a per-legatee basis, and rate schedules typically increase as the degree of relationship to the decedent diminishes. The second and third modes are the accessions tax and the

---

13. *See* I.R.C. § 2001(b), (c) (2002) (tax base is lifetime post-1976 taxable gifts plus the taxable estate). The taxable estate is the gross estate less deductions.

14. The gift tax is also viewed as a back up to the income tax, by imposing a toll charge on income-assignment strategies. *See* Jonathan G. Blattmachr & Mitchell M. Gans, *Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 2001 TAX NOTES TODAY 10-110 (2001). The gift tax was not repealed by The 2001 Act, *supra* note 1.

15. Estimated net gift tax collections in 2001 were $3.9 billion, and estimated estate tax collections were $24.4 billion. *See Summary of Internal Revenue Collections, by Type of Tax, Fiscal Years 2000 and 2001*, Internal Revenue Service, *at* http://www.irs.gov/pub/irs-soi/01db01co.xls (last visited Nov. 21, 2002).

16. *See* authorities cited *supra* note 1.

income-inclusion system, already alluded to. On its face, any of the transferee-oriented alternatives to the current federal transfer taxes would be better suited to curb undue accumulations of wealth than the estate tax.[17]

B. Is a Tax on Gratuitous Transfers Necessary To Curb Undue Accumulations of Wealth?

If the problem is stated to be "undue concentrations of wealth," one can argue that a transfer tax is superfluous. Thus, "concentration" of wealth in a single individual by inheritance, given the abolition of primogeniture in the United States, is "naturally" unlikely since wealth tends to be divided among members of an ever-expanding family.[18] The principal of trusts often is eroded relative to inflation,[19] and large trusts are likely to have multiple current beneficiaries and remainders. Moreover, those who receive substantial legacies outright have little incentive to engage in gainful employment and may regress to the mean. There is evidence that *inherited* wealth tends towards dissipation rather than increased concentration and that most very wealthy individuals (other than surviving spouses of wealthy individuals) are not the beneficiaries of large inheritances.[20]

To the extent that these forces operate, it can be argued that the transfer taxes may be largely irrelevant in terms of curbing undue concentrations of wealth.[21] Nature will take its course. A handful of dynasties might sustain themselves over time, but that might not be sufficient to justify a wholly separate wealth transfer tax apparatus. On the other hand, statistical generalizations may mask significant instances of wealth concentration, and perhaps society should not tolerate even a relatively small and/or short-term hereditary economic aristocracy.[22]

---

17. Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 NAT'L TAX J. 119, 138-39 (1992); Eugene Steuerle, U.S. Treas. Dept., *Equity and the Taxation of Wealth Transfers*, OTA Paper 39 (June 1980) (both arguing that lifetime tax base should be earnings plus gratuitous accessions).

18. David Joulfian, U.S. Treas. Dept., *The Distribution and Division of Bequests: Evidence from the Collation Study* 8-10, OTA Paper 71 (Aug. 1994) (describing tendency of surviving spouse to leave property equally among children).

19. Although a basic principle of trust law is impartiality between income beneficiaries and remainders, the income beneficiaries (being alive and known) can bring pressure on trustees to favor themselves. Traditionally, trusts have invested 50-60% in debt obligations which guarantee income but lose principal value due to inflation. Robert B. Wolf, *Defeating the Duty to Disappoint Equally—The Total Return Trust*, 32 REAL PROP. PROB. & TR. J. 45 (1997).

20. James B. Davies, *The Relative Impact of Inheritance and Other Factors on Economic Inequality*, 97 Q.J. ECON. 495 (1982); *Uneasy Case*, *supra* note 4, at 354.

21. ALAN S. BLINDER, TOWARD AN ECONOMIC THEORY OF INCOME DISTRIBUTION 137-39 (1974).

22. Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419, 455 (1996) [hereinafter *Transferring Wealth*] (arguing that taxation of unearned wealth at higher rates could be justified even if earnings of legatees tend to regress to the mean).

C. Redefining the Aim of Taxing Wealth Transfers

The proponents of the wealth transfer taxes have allowed the opponents to frame the debate. The opponents refer to the transfer taxes variously as a tax on death (conveying the message that the suffering of bereaved widows and orphans is compounded by financial sacrifice), or as a tax on success (and, by implication, a penalty on moral virtue).[23] And a defense of the tax on the basis of curbing undue accumulations of wealth is swatted aside by claiming that wealth accumulation (by entrepreneurs and investors) is a good thing, and (as noted above) that concentrated wealth doesn't stay concentrated anyway.[24] Finally, there is no objective standard (or consensus) on what is an "undue" wealth accumulation; the target tends to recede into the distance.[25]

The message needs to be conveyed that any tax on gratuitous transfers is really a tax on gratuitous transferees (other than the surviving spouse). Purely as a matter of objective fact, a wealth *transfer* tax cannot curb the accumulation of wealth of the accumulating individual.[26] Any kind of tax on wealth transfers by its very nature reduces the net accessions of gratuitous transferees. Gratuitous receipts (by persons other than the surviving spouse) are passive "unearned" and "windfall" income. Such income (at a certain point) does the legatees *and us* more harm than good by creating disincentives to engage in productive economic activity. A tax on the receipt of unearned wealth (over a certain level) can directly reduce inequality of opportunity.[27] It may even be worthwhile to link revenues

23. *See, e.g.*, Edward J. McCaffery, *Grave Robbers: The Moral Case Against the Death Tax*, 85 Tax Notes 1429 (1999).

24. The conventional wisdom is that an *annual* wealth tax is unconstitutional as an unapportioned "direct tax." *Pollock v. Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), postulated that a tax on rental income from property was a "direct tax" on the property itself and, therefore, unconstitutional because it is not apportioned among the states in proportion to population. *Pollock* was countered by the Sixteenth Amendment, which provides that an "income tax" (even if a direct tax) is not subject to the apportionment requirement. One might turn *Pollock* on its head: if an income tax is really a property tax, then a property tax (at least one in which the rate was less than a very conservative income yield) could be called an income tax, and thereby valid under the Sixteenth Amendment without regard to apportionment. Nevertheless, I would not bet on Congress considering enactment of an annual wealth tax anytime in the foreseeable future, and (if it did) I wouldn't bet on the Supreme Court holding that an annual wealth tax is either an income tax or an indirect tax.

25. The motto might be: "Tax the very wealthy, that is, the people who are a lot richer than us middle-class folks." Since legal academics, media owners, top journalists, members of Congress, and high-level government officials are themselves likely to be (at least) in the upper middle class (top 85-98th percentile in terms of income or wealth), it is not astonishing that there is now little political support for a meaningful wealth transfer tax.

26. It is conceivable that the existence of the transfer tax might cause a person to decrease wealth-acquisition activity, but it is also possible that the tax might increase such activity. Another possible effect might be neutrality with respect to acquiring wealth but the creation of an incentive to either consume or save more than would have occurred without the tax. There is no consensus on how these incentives actually operate and, in any event, this issue will be ignored since any wealth transfer tax would impose parallel incentives.

27. These arguments are spelled out in Mark L. Ascher, *Curtailing Inherited Wealth*, 89 Mich. L. Rev. 69 (1990).

from wealth transfer taxes to programs aimed to alleviate such inequalities.[28] Finally, accumulations of unearned wealth allow a person to exercise unearned and unjustified power over others.

D. EXEMPTION AND RATE STRUCTURES

Rates and exemptions are so closely linked that they will be discussed in tandem.

1. Utility Curves

Justifications of multi-tier progressive rate structures are often couched in terms of the declining marginal utility of money.[29] Applying this concept to an estate tax is hazardous due to various possible motives for the making of bequests. Thus, a person with low bequest motives (who saves for retirement or future emergency but dies prematurely) would be insensitive to estate tax rates, as would a compulsive wealth accumulator. For a person who might be sensitive to estate tax rates, a large exemption (effectively a zero rate) would appear to be excessively generous. In any event, anything like a universal utility curve for bequests seems implausible.[30] It is hard to conceive of any theory that would justify the current rate system that, after exhaustion of a very large exemption, effectively starts at a 41% rate and tops off at only a 50% rate.[31]

The idea of a progressive rate structure is more promising with respect to the transferees, who are the ones whose wealth is increased by gratuitous receipts. But the idea of declining marginal utility to the transferee presupposes a cumulative tax base that encompasses more than the current gratuitous receipt. Obviously, an inheritance tax does not cumulate gratuitous accessions from a particular decedent with anything else, and an accessions tax cumulates current gratuitous accessions only with gratuitous accessions in prior years. Prior gratuitous accessions may be of special interest, but they are still only a subcategory of total transferee wealth at a given point in time or of total income for a period. A person with a large total of cumulative gratuitous accessions may possess a low stock of current wealth or may currently reside in a low income tax bracket. In any event, the declining marginal utility concept cannot justify a large lifetime exemption.

Only the income-inclusion approach cumulates gratuitous accessions with other income of the taxpayer during the year, without special ex-

28. *See* BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY (1999); RONALD CHESTER, INHERITANCE, WEALTH, AND SOCIETY 165-89 (1982).

29. SIMONS, *supra* note 5, at 1-20; WALTER J. BLUM AND HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953); 3 ROYAL COMMISSION ON TAXATION, REPORT, *supra* note 5, at 1-24 (using concept of "discretionary income").

30. Barbara H. Fried, *Who Gets Utility from Bequests? The Distributive and Welfare Implications for a Consumption Tax*, 51 STAN. L. REV. 641 (1999).

31. An exemption of $1 million delivered through the unified credit of §§ 2010 and 2505 has the effect of taxing the first dollar of the tax base in excess of $1 million at a 41% rate under § 2001(c).

emption. This feature of an income-inclusion system renders plausible the idea of progressive rates based on the declining-marginal utility idea.

2. *The Windfall Idea*

A possible argument for preferring an accessions or inheritance tax to the income-inclusion approach is the notion that gratuitous accessions are inherently windfalls and should be subject to a separate rate schedule with higher rates than the income tax. There are two possible notions of what constitutes a windfall. One view (but not the conventional one) might be that a windfall is unearned or undeserved income.[32] Such a definition, however, smacks of being conjured up solely to justify an accessions or inheritance tax. This concept of windfall also subverts the concept of a lifetime exemption, which has been viewed as an integral feature of an accessions tax, and it sits uneasily with any multi-tier progressive rate schedule.[33] But if a flat rate system is adopted with no lifetime exemption, what remains is simply an income tax on gratuitous accessions at a special rate.[34]

The usual notion of "windfall" refers to some unexpected "surplus" relative to one's normal "expectations."[35] But this notion of windfall extends beyond gratuitous accessions to encompass such other gains as found objects, prizes and awards, lottery winnings, and perhaps extraordinary investment gains (at least those attributable to blind luck). No tax system, however, has ever moved in this direction. In addition, the expectations concept of windfall is subjective and vague. In some cases, gratuitous accessions (annual gifts, trust distributions) may actually *create* a person's normal expectations. Any generalizations about the relation of gratuitous accessions to a person's other economic prospects is so hazardous as to subvert the notion, basic to an accessions or inheritance tax, that accessions should be subject to a separate rate and exemption system.[36] Whatever justifications ("poverty level," "declining marginal utility of money," or "non-discretionary income") exist for income tax exemptions and low marginal rates "at the bottom" also apply to windfall income. This point suggests that windfall income should be treated as any other income, and also that it should be reckoned on an annual basis. An

32. Only children (etc.) who actually contribute (without compensation) to the decedent's economic activities can legitimately claim to be outside of the windfall category, but a rational tax system would not want to be burdened with sorting factual claims along these lines. In addition, the children of the wealthy are not likely to perform substantial free services for their parents.

33. *See* Halbach, *supra* note 11, at 231-33 (favoring a flat rate on simplicity grounds).

34. Although the income tax generally does not follow a schedular system, net capital gains are systematically subjected to lower rates, § 1(h), and accumulated trust income is mostly taxed at the highest individual rate, § 1(e).

35. The windfall idea possibly lies behind that feature of the inheritance tax that imposes steeper rate schedules (with lower exemptions) as the degree of relationship of the legatee to the decedent decreases. Differential rate structures discriminate (inter alia) against accessions from a partner in a committed relationship, and they violate the principle of neutrality among potential legatees for no worthwhile purpose.

36. The windfall theory is critically discussed in Jantscher, *supra* note 6, at 49-51.

issue then is whether income-averaging should be allowed for windfall income in excess of some specified amount. Disallowing income averaging would be a backhand way of imposing a "surtax" on windfalls, but it would also create an incentive for transferors to leave bequests in a form that entailed periodic payouts. This incentive might be neutralized by imposing a flat rate on accessions income in cases where income from other sources exceeds a certain level (say, $50,000).

3. *Redistribution*

The tenuous relationship of estate (and inheritance) tax rates and exemptions to the issues of curbing undue accumulations of wealth and mitigating unjust inequalities of opportunity has already been commented upon.[37]

The income-inclusion system, which has no fixed-dollar exemptions, is not explicitly tailored to redistributive goals, although it would, of course, further them. If the income-inclusion system were deemed not to have sufficient "punch" at the level of the super rich, it could be combined with an accessions (or estate) tax having a generous exemption. Even without being combined with a wealth transfer tax, an income-inclusion system would probably extract a much greater amount of tax revenue from relatively well-off families than would alternative systems, because (lacking exemptions) the aggregate tax base would be vastly larger. At the same time, the income-inclusion approach would reach lower down the economic ladder, and that might be its political Achilles heel, unless the potentially huge revenue harvest could be linked to a general income tax rate reduction.

The major accessions tax proposals simply assume the fact of a quite substantial lifetime exemption by analogy to the estate and gift tax, without attempting to independently justify it.[38] The size of the estate tax exemption seems to be linked to a political balancing act of maintaining a meaningful revenue flow while exempting roughly 98% of decedents (which translates into targeting only the super rich). Assuming *arguendo* that there should be *some* meaningful lifetime accessions tax exemption system, its size and structure should be constituted according to its particular redistributive rationales, which are more specific than the vague idea of curbing "undue" accumulations of wealth. Thus, any exemption "at the bottom" should be set according to some notion of "unfair inequality of opportunity." Whatever view one might have as to what constitutes an "unfair" advantage to a person receiving gratuitous accessions, surely it must kick in at a level far below the current estate tax exemption. I would suggest $100,000, roughly the amount that would finance (tax free)

---

37. *See* text *supra* Part I.B.

38. Andrews, *supra* note 11, at 592 ($24,000 exemption, comparable to the then estate tax exemption of $30,000); Halbach, *supra* note 11, at 232 ($700,000 exemption, comparable to the then estate tax exemption of $600,000).

a good education.[39] On the other hand, if (as is suggested below) educational and other in-kind consumption benefits are automatically excluded, then the case for any fixed-dollar lifetime exemption, over some *de minimis* amount for cash accessions, drastically weakens. I offer no opinion on what the rate structure would look like above the exemption.

Two of the justifications for an accessions tax (inequality of opportunity and removing the tax disincentive for gainful employment) wane as the transferee advances in age, but the third (concentrations of unearned wealth) does not.[40] This observation could be accommodated by increasing any first-tier exemption (in stages or all at once) after the taxpayer advances past, say, age 30, and by increasing it again as the transferee's age advances beyond, say, age 60.[41]

4. *Dispersing Wealth*

Under current law, the per-transferor exemption under the unified estate and gift tax is $1 million. The estate tax exemption is scheduled to rise to $3.5 million by 2009.[42] On top of that, there is a generation-skipping tax (GST) exclusion of $1 million keyed to the initial transfer;[43] that exclusion grows in tandem with the growth in trust corpus and can shelter multiple successive generation-skipping transfers.[44] This system of per-transferor exemptions provides no incentive to disperse wealth among legatees. Stated differently, an estate tax is "neutral" between dispersion and non-dispersion, but that is not necessarily a good thing. In any case, a given transferee can obtain exempt gratuitous transfers from numerous transferors without limit, and thereby amass a vast amount of untaxed, unearned wealth.

Under an inheritance tax, exemptions (and progressive rate schedules) operate on a per-legatee basis. This system creates an incentive for a decedent to disperse legacies among multiple legatees. Although decedents tend to treat their descendants equally at each generation, an inheritance tax might operate to somewhat increase the total level of

39. The 1968 ALI accessions tax proposal had a per transferee exemption of $24,000. Andrews, *supra* note 11, at 592.

40. A related problem is that of successive accessions of the same property within a short time span. *See infra* text accompanying notes 123-25.

41. *Cf.* INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 317-49 (1978) [hereinafter Meade Report]; *Wealth Taxes*, *supra* note 10, at 334-47 (both suggesting that an accessions tax might be a function of the holding period of gratuitously-acquired wealth). Any system under which the tax is a function of holding period would necessitate some arbitrary convention for later consumption and wealth transfers "back" to gratuitous accessions received. The holding period concept would certainly be out of place in an income-inclusion system.

42. I.R.C. § 2010(c) (2002). The gift tax exemption is scheduled to stay at $1 million. I.R.C. § 2505(a)(1) (2002).

43. *See* I.R.C. § 2631(a), (c) (2002) (exemption indexed for inflation).

44. The per-transferor exemption is allocated to the transferor's various generation-skipping transfers and trusts under I.R.C. § 2632 (2002). The exclusion amount divided by the net transfer creates an exclusion ratio that, when subtracted from the number 1.0, produces an "inclusion ratio" that applies to all generation-skipping transfers with respect to the property transferred. *See* I.R.C. §§ 2641-42 (2002).

dispersal.[45] At the same time, a legatee under an inheritance tax can take advantage of multiple per-transferor exemptions with respect to different decedents, and thereby amass a large stock of unearned wealth.[46]

Both the accessions tax and the income inclusion-system favor dispersal. This incentive would operate far more strongly under an accessions tax having exemptions than under an income-inclusion system providing for no exemptions and imposing a high tax rate on the unearned income of persons under the age of 14.[47] Both major accessions tax proposals (which posit large fixed-dollar exemptions) react to this "scattering" incentive by imposing additional taxes on transfers beyond the first generation below the transferor, in the name of "neutrality."[48] In my view, these anti-scattering approaches increase complexity without convincing justification. First, if a reason for preferring an accessions tax is to encourage scattering, it hardly makes sense to neuter that incentive. Second, merely stating that taxes can be reduced by scattering does not mean that the behavior of transferors would be significantly affected. Since the accessions tax is imposed only on actual receipts, the problem cannot be described in terms of "illusory" or "phantom" beneficiaries, as is the case under the GST.[49] A person will not receive accessions unless the transferor seriously intends that such person be benefited for non-tax reasons. It is legitimate and reasonable to by-pass one's well-off children in favor of younger beneficiaries. If a person receiving an accession doesn't really want or need it, he or she should be able to pass it on by way of qualified disclaimer without adverse tax consequences. Next, even if there is a serious neutrality problem, there is an easier (and more precise) way of dealing with it, namely, by adopting a flat rate system with no per-taxpayer exemptions. Finally, the fact that revenues may be reduced in the

45. A minor defect in both the estate tax and the typical inheritance tax from the wealth-dispersion angle is that the decedent has the power to allocate the burden of taxes under her will. Thus, the tax burden can (in theory) be allocated to smaller legacies, leaving the larger legacies intact. This is not likely to occur in practice, since tax burdens are usually apportioned among taxable transfers on a pro rata basis or all to the residue, which usually contains the bulk of the probate estate. The ability to allocate tax burdens is consistent with the value of freedom of testation, but it is contrary to the notion, implicit in a transferee-oriented gratuitous transfer tax, that the tax should be borne by the transferees in accordance with what they receive. The transferor would have no direct control over the allocation of tax burdens under an income-inclusion system or an accession tax. Although estimated tax liabilities of transferees could be factored into the size of gratuitous transfers, the transferor might lack the requisite transferee-specific information, and such fine tuning would certainly annoy at least some of the transferees.

46. That is, each transferor can make bequests that come within per-transferee exemptions applicable to that transferor.

47. I.R.C. § 1(g) (2002) (known as the "kiddie tax").

48. Andrews, *supra* note 11, at 592 (creating a deduction for accessions from immediate relations); Halbach, *supra* note 11, at 240-48 (creating an elaborate system imposing an additional tax on accessions from non-immediate relatives that is structured like a generation-skipping tax). Whether generation-skipping is an issue divorced from scattering is considered *infra* following note 96.

49. *See* I.R.C. § 2652(c)(2) (2002) (stating that nominal interests are disregarded where the purpose is to postpone imposition of the GST).

short run[50] solely on account of multiple per-transferee exemptions and lower rates is inconsequential, first, because raising revenue is not the principal purpose of the system, and second, because other features of the system can be tweaked to make up for any revenue shortfall.

A per-transferee exemption system would seem to be untenable in the face of complex trusts having multiple current and successive beneficiaries, the interests in which cannot be accurately valued *ex ante*. As will be more fully explained below, the answer is simple; inclusion in the tax base is deferred until the actual receipt of cash or property (as opposed to the acquisition of an interest or expectancy in property). This operating principle avoids the problem of valuing interests *ex ante*, but it does raise the specter of deferral, which is discussed later.[51]

E. Summary of Part I

Briefly, an estate tax has little to be said for it either from an internal-to-tax perspective or from an external-to-tax perspective.[52] The only (possibly) positive aspect of an estate tax is that it is neutral with respect to the concentration vs. dispersal of gratuitous transfers. Any transferee-oriented tax on wealth transfers is preferable to an estate tax in theory and is easier to justify. The inheritance tax provides some incentive for the dispersal of wealth, but is flawed because the tax base is unrelated to the other wealth, income, or gratuitous accessions of the transferee. Other than rates and exemptions, an inheritance tax is structured like an estate tax and will be so treated in Part II below.

An accessions tax ties into the concept of an individual's cumulative unearned wealth, but does not connect to existing wealth or periodic income. Whether the concept of an accessions tax really posits a large per-transferee lifetime exemption is doubtful, but if exemptions are allowed they should be relatively modest and should relate to one or more purposes of the accessions tax. An income-inclusion system would contain no lifetime exemption but would treat a taxable gratuitous receipt like any other item of gross income (except for the possibility of income averaging). Such a system would advance, if not be specifically tailored to, concerns relating specifically to unearned, inherited wealth.

Apart from rates and exemption structures, the income-inclusion and accessions tax approaches would operate similarly, as will become apparent in Part II. This point suggests the possibility of some "hybrid" income-accessions tax, where the rate and/or exemption features of one tax are imported into the other, or else the possibility that an income-inclusion approach be combined with an "supplementary" accessions tax.

50. If lower-generation legatees receive early accessions, their respective exemptions and lower rate brackets will be exhausted earlier.

51. *See infra* text accompanying notes 137-55.

52. It might be claimed that a one-time estate tax is the easiest transfer tax to administer, but with computers and information reporting requirements imposed on transferors it is not clear that this would be the case.

II. STRUCTURAL ISSUES RELATING TO THE TAXATION OF GRATUITOUS TRANSFERS AND RECEIPTS

This Part deals with an analysis of the appropriate roles, if any, of major structural features, namely, the treatment of inter-spousal transfers, the relevance of the generational concept, gift exclusions, timing issues, and valuation issues, in relation to one or more plausible goals of a tax on gratuitous transfers or receipts.

A. Taxation of Married Couples

Gratuitous transfers from one spouse to another raise two principal issues: (1) the scope of any marital exclusion or deduction and (2) the qualification rules. The current estate tax treats husband and wife as separate taxpayers,[53] but allows an unlimited marital deduction for qualified transfers under complex qualification rules.[54]

1. *Inter Vivos Transfers Between Spouses*

Regardless of what theoretical construct of marriage one might favor, practical considerations overwhelmingly favor the unlimited tax free treatment of inter vivos transfers between spouses, under any system of taxing gratuitous transfers. Such considerations include: (1) transfers upon divorce would be free of tax,[55] (2) transfers in the nature of "support" would be tax-free[56] (and it would be difficult to erect a clear distinction between "gift" and "support"), (3) transfers between spouses would be ignored for income tax purposes under § 1041, (4) spouses often share (or alternate) the possession and enjoyment of assets, (5) the legal ownership of tangible personal property (other than vehicles) is often hard to determine, and (6) transfers and understandings between spouses would be hard to detect (and would we want the IRS to be able to pierce the veil of privacy?).

---

53. Conceivably, husband and wife could be treated as a single unit with a unique rate and exemption structure, but it would seem that any such single-unit concept would (as with the joint return for income tax purposes) ultimately serve as a transfer- or accession-splitting device. The single-unit approach would necessitate rules for the formation and liquidation of the unit (by divorce and death) and the reconstitution of units by remarriage. For a lengthy attempt to sort out the estate and gift tax issues posed by a single-unit theory, see Harry L. Gutman, *Reforming Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1219-39 (1985). The single-unit idea also has its conceptual downside. For example, in the estate tax context, either spouse could use up the full double exemption during life, without the other spouse's consent, and leave no exemption or lower brackets for the other spouse to use. Under an accessions tax, a high-accessions person could marry a low-accessions person, use up the latter's exemption against new accessions, then obtain a divorce and end up with all of the accessioned property, while leaving the other spouse with no exemption.

54. *See* I.R.C. §§ 2056(b) (estate tax), 2522(b)-(f) (gift tax) (2002).

55. *See* I.R.C. § 2516 (2002).

56. A support payment or transfer is not a transfer made "by gift" as required in § 2501(a)(1). *See also* Rev. Rul. 68-379, 1968-2 C.B. 414 (1998).

2. *Scope of Deduction or Exclusion for Estate Transfers Between Spouses*

Theoretical, as well as practical, considerations weigh on the issue of whether, and to what extent, interspousal estate transfers should be deducted or excluded.

a. Theoretical Approaches to Tax-Free Spousal Estate Transfers

What exactly might justify the tax-free death-time transfer of wealth to a surviving spouse? The argument that husband and wife are a continuing single unit is conclusory and question-begging, and posits unpalatable consequences.[57]

An initially plausible theory is the "support" (or "welfare") theory, which would posit the ideal that the surviving spouse should be entitled to receive a tax-free annuity that maintains her at (or near) her accustomed standard of living for her remaining life. This theory accords with the concept of permanent alimony, but that concept has now largely been abandoned in the United States in the divorce context and never has had a meaningful place in the inheritance context,[58] and, therefore, cannot pull much weight in the tax context. It certainly cannot justify an *unlimited* marital deduction. Under an estate, inheritance, or accessions tax, the exemptions already can be said to implement the welfare idea.[59] A system in which surviving spouses having considerable wealth, either on their own or resulting from very large bequests, would avoid any and all tax on spousal estate transfers cannot be justified under any support theory.

An unlimited marital deduction under the estate tax is said to carry out a "deferral" theory, i.e., that tax should be deferred until the death of the surviving spouse. This seems more like a description of how an unlimited estate tax marital deduction operates than a theory. Deferral makes no sense unless it is the surviving spouse alone who benefits from the defer-

---

57. Implementing the single-unit theory would allow the decedent spouse to appropriate the exemption of the surviving spouse, leaving the latter with no exemption for her own estate. No proposal along these lines has been, or is likely to be, made.

58. *See* LAWRENCE W. WAGGONER ET AL., FAMILY PROPERTY LAW 597-98 (3d ed. 2002); Frances H. Foster, *The Family Paradigm of Inheritance Law*, 80 N.C. L. REV. 199, 205-40 (2001) (critiquing lack of influence of welfare concept in family property law). Many states provide for a so-called "widow's allowance" out of the decedent's estate, but such an amount is of short duration and small in amount. A few states may allow an income interest in trust in a fraction of the decedent's estate to satisfy (or preclude) the spousal election against the will, but in no way is the income interest keyed to the surviving spouse's accustomed standard of living, and an income interest in a fraction of the estate is (obviously) worth less than a fee interest in the same fraction. Common law dower in kind has now been abolished in virtually every jurisdiction.

59. The welfare theory would also justify a deduction or exclusion for other "support obligation" situations, such as for minor children and the committed partners of gays and lesbians. However, the property system does not give such persons significant rights in a decedent's estate. From 1977 through 1981 there was an "orphan's deduction" of limited scope designated as I.R.C. § 2057, but it was repealed on the ground that the increased exemption was sufficient to shelter such transfers from tax.

ral, which is not the case under the current qualification rules. Finally, the concept implies deferral of the putative *tax* on the decedent's estate (with interest), not deferral of the tax base.

The deferral theory cannot operate in the context of an accessions or income tax because it is not possible to shift wealth from the tax base of one spouse to that of another by estate transfer. The accessions or income tax base of an individual, constituted by gratuitous *receipts*, cannot be reduced by gratuitous *transfers* without undermining the whole premise of the tax.

Another theory is the notion that a wealth *transfer* tax should be thought of as a once-per-generation wealth tax. The once-per-generation idea is critiqued below in Section B, and would seem to have no relevance to the purposes of an accessions tax or to an income tax that inherently operates on an annual basis. Even accepting the premise that a wealth transfer tax should be imposed once per generation, it is not clear why spouses should per se be considered to be in the same generation, regardless of relative ages and regardless of the length of time between their deaths, especially if the couple has no living descendants.

Far more promising is the partnership theory because, if the spouses are viewed as separate partners in a marital partnership, death causes the partnership to dissolve, and, therefore, each spouse's "equity" interest therein is liquidated. The taking of property that is one's "own" should, of course, be tax free (i.e., there is no "real" transfer upon liquidation). The extent to which a tax-free liquidation may be deemed to occur might be determined with reference to marital liquidation rights under state law. In the case of community property, each spouse has a right to one-half. Other "absolute" liquidation rights include elective share rights[60] and undivided interests in co-owned property. As a crude generalization, liquidation rights of surviving spouses on death might be said to fall within the 30-50% range. It would be reasonable for the tax law to adopt a 50% across-the-board rule, rather than simply following state law, because the 50% approach avoids geographical inequities. The historic (1948) rationale of the marital deduction was precisely to create equality between common-law and community property systems, but the 1948 rules operated crudely by limiting the marital deduction to 50% of only the decedent's adjusted gross estate[61] (excluding interests in community

60. The estate tax has treated a surviving spouse's dower, elective share, and intestacy rights as not rising to the level of any kind of fractional ownership in property. *See* I.R.C. § 2034 (2002). *Cf.* I.R.C. § 2043(b) (2002) (release of such rights not treated as consideration in money or money's worth). The 1976 enactment of § 2040(b) results in jointly-owned property being treated the same as community property for estate tax purposes.

61. The term "adjusted gross estate" means the gross estate reduced by deductible claims and administration expenses. The adjusted gross estate concept unnecessarily complicates tax compliance and planning, as well as estate administration. First, the amount of deductible claims may require some time to sort out, and second, there is an election to deduct administration expenses (which may have to be estimated) for income or estate tax purposes or § 642(j), and this election would affect the amount of the adjusted gross estate. Moreover, if community property is the tax norm, it is noteworthy that in a community

property). The co-ownership ideal would be "accurately" carried out, in cases where the wealthier spouse dies first, by imposing a limitation on the amount of deductible or excludable marital transfers equal to that amount which produces an equal division of *aggregate* spousal wealth.

b. The Pragmatic Case for an Unlimited Estate Tax Marital Deduction

Under an estate tax, it would be claimed that the aggregate-estate-splitting approach would be too difficult and costly to implement, because the surviving spouse's wealth (estate) would have to be inventoried and valued at the time of the decedent spouse's death, along with the estate of the decedent spouse. Also, since the limitation would shrink (or disappear) as the surviving spouse's wealth increased, an incentive would exist to conceal the surviving spouse's assets. These claims strike me as greatly overstated, however. The interests of the surviving spouse in community property and jointly-owned property would be automatically valued at an amount equal (or proportionate) to the value of the decedent's includable interests in the same property. Publicly traded securities could also be readily valued, as well as annuities and insurance company products. Closely-held businesses would need to be valued to determine the value of any interests held by the decedent spouse, and the same principles would be used to value the interests of the surviving spouse. All of these assets could be readily "discovered" by the IRS and estate administrators, as would other kinds of registered property, such as motor vehicles. The problem of "concealed assets" would not be unique to the assets of a surviving spouse.

A better objection to any kind of estate tax marital deduction limitation is that it would operate as a trap for the unwary. With a limitation in place, ill-advised decedents might effect non-deductible estate transfers that will be taxable to the surviving spouse, resulting in double taxation of the same wealth.[62] Even if double taxation is avoided, a limitation "forces" a dual-transfer dispositive plan, with one set of transfers qualifying for the marital deduction and the other set not qualifying.

> EXAMPLE 1: *H* has $1.4 million of wealth and *W* $0.6 million. Assume that there is no exemption. Suppose *H*, being poorly advised, leaves everything to *W* in a form that qualifies for the marital deduction. The marital deduction is limited to $0.4 million, so that *H* is taxed on $1 million of the $1.4 million. On *W*'s death her estate is $2 million, which is fully taxed. This disastrous result can be avoided if *H* transfers the nondeductible $1 million in a form that does not

property system all or most of the claims and administration expenses would be charged against the decedent's share of the community property, whereas under the adjusted gross estate concept half are effectively charged against the surviving spouse's share.

62. Double taxation can only be visited upon nondeductible transfers. Under a system that imposes a limitation on the estate tax marital deduction, nondeductible estate transfers are a virtual certainty.

qualify for the marital deduction and is not included in *W*'s gross estate.

The practical argument for an unlimited estate tax marital deduction is that it achieves the same end result as can be reached under aggregate estate splitting with proper planning (taxing the aggregate spousal wealth once) but without being a trap for the unwary and without forcing a two-transfer dispositive scheme.[63]

> *Example 2*: Same facts as Example 1, except that there is no limitation on the marital deduction. *H* makes a marital deduction bequest of $1.4 million to *W*. *H*'s taxable estate is zero and *W*'s taxable estate is $2 million.

But some say this is not good enough, because each spouse has a separate exemption and lower marginal rates, and these features produce the same dual-transfer incentives as would occur under an estate tax marital deduction limitation.

> *Example 3*: Same facts and assumptions (including an unlimited marital deduction) as example 2, but assume also that each spouse has an unused exemption of $1 million. If *H* leaves everything to *W* in a form that qualifies for the marital deduction, *H*'s taxable estate will be zero by reason of the marital deduction, but *H*'s exemption will have been wasted. *W*'s taxable estate will be $2 million (assuming no changes in value), half of which will be sheltered by *W*'s exemption. This problem can be avoided if *H* leaves $0.4 million in a marital deduction bequest and $1 million in a by-pass trust, as in Example 1.

This analysis leads to alternative conclusions, one being that we might as well opt for a limitation system based on the idea of aggregate estate splitting; the other being to seek an alternate cure for the unused exemption problem. However, in situations where spousal wealth is greater than the combined exemptions, an unlimited marital deduction provides an incentive to use the unlimited marital deduction to the extent of all of the decedent's estate in excess of the decedent spouse's exemption. Although this optimal deferral strategy may be inferior to an estate splitting strategy in some cases,[64] the deferral strategy is widely adhered to, and probably rules out any return to a limitation system. It turns out that bequest neutrality can be obtained under an unlimited marital deduction by adding a rule allowing one spouse to "bequeath" his or her unused

63. The textual discussion has assumed that the wealthier spouse dies first. Under a marital-deduction limitation, the limitation would be zero if the poorer spouse died first. There is no good reason to "force" transfers by the poorer spouse into a nonqualifying form to avoid the likelihood of double taxation. An unlimited estate tax marital deduction solves that problem.

64. Don W. Llewellyn et al., *Computing the Optimum Marital Deduction: Is a Zero-Tax Formula Appropriate?*, 24 Real Prop. Prob. & Tr. J. 331, 338-40 (1989); Jeffrey N. Pennell & R. Mark Williamson, *The Economics of Prepaying Wealth Transfer Tax*, Tr. & Est., June 1997, at 49 (both questioning conventional wisdom that complete deferral is always optimal).

exemption to the other spouse (but not in an amount that exceeds qualifying marital-deduction estate transfers).[65]

EXAMPLE 4: Same facts and assumptions as Example 3. *H* bequeaths $1.4 million to *W* in a form that qualifies for the marital deduction. *H* would have a taxable estate of zero on account of the marital deduction, and *W* would have a taxable estate of $2 million, but it would be offset by a $2 million exemption (half of which would be acquired from *H*, who didn't use any of it).

The bequest-neutrality rationale[66] for allowing unused exemptions to pass to the surviving spouse is that the decedent spouse could have used the exemption *but was dissuaded from doing so by the structure of the tax system itself* (specifically, the unlimited estate tax marital deduction). This rationale dictates that a decedent's unused exemption be allowed to pass to the surviving spouse *only to the extent that it would have been used by the decedent spouse in the absence of the marital deduction.* Thus, the passing-on of the exemption remaining after non-deductible transfers should be limited to the amount of marital-deduction estate transfers.[67]

Although this system would "allow" a single-transfer scheme for the wealthier spouse, it would not require it. The estate-splitting (dual transfer) option would be available to decedent spouses and may be preferable on either tax or non-tax grounds. Tax grounds might exist if a progressive rate schedule (as opposed to a flat rate) were to apply above the exemption level, since estate splitting would minimize aggregate taxes. Non-tax grounds might include the provision for children of a prior marriage.

If the poorer spouse were to die first, her unused exemption amount would pass on to the surviving spouse only to the extent of marital deduction transfers.[68] The non-passed-on portion of the exemption would be lost. Community property couples would possess an advantage in this respect, because the longer the marriage lasts, the more likely it is that spousal wealth would be allocated evenly as the result of the operation of community property law. For spouses outside of a community property system, the unequal-wealth problem could be remedied by the wealthier spouse making tax-free gifts to or for the benefit of the poorer spouse

65. *See Report on Transfer Tax Restructuring*, 41 TAX LAW. 395, 398-400 (1988).

66. As stated *supra* note 53, although a single-unit theory might also justify such a result, it would equally allow the decedent spouse to appropriate the maximum amount of the aggregate spousal exemption. Thus, *H* (in Example 4) could bequeath all $1.4 million to *C* tax-free, leaving nothing to *W* and leaving *W* with a remaining exemption of $0.6 million, which would be unpleasant if *W*'s estate were to grow above $0.6 million.

67. A serial widow should be able to accumulate unused exemptions from various husbands, because the rationale for allowing the exemption to be passed on is not tied to a "single marital unit" theory and is not affected by the poorer spouse's prior marital or tax history.

68. For example, assume an exemption of $1 million, none of which has been previously used by *W*, who has a net estate of $160,000, and who leaves $40,000 to *C* and the residue ($120,000) to *H*. The unused exemption is $960,000, but only $120,000 more of it could have been used if marital-deduction transfers had been foregone.

that would be included in the poorer spouse's transfer tax base.[69] If the wealthier spouse were unwilling to make such gifts, the wealthier spouse should not obtain the benefit of the poorer spouse's unused exemption. A rule that allowed a poorer spouse's unused exemption to pass to a wealthier spouse would create an inducement for a wealthy person to marry a poor person in bad health simply to obtain additional exemption amounts, a process that could be repeated serially. Such an inducement would require an antitidote in the form of a rule allowing the IRS to attack tax-motivated marriages of dubious substance.

c. The Marital Exclusion Under the Accessions Tax Should be Limited

Assuming that inter vivos transfers between spouses would be exempt from accessions tax,[70] it remains to be seen whether there should be an unlimited spousal exclusion for inter-spousal death-time transfers. Previous commentators have simply assumed that an unlimited marital exemption would be warranted by analogy to the estate tax.[71] This assumption is too facile. The idea of a marital exclusion needs to be harmonized with the underlying concept of an accessions tax. *It is my view that an unlimited marital exclusion is not warranted.* Basically, the whole idea of an accessions tax admits of no exclusions according to the identity of the transferor.

Under an estate tax, aggregate transfers by the marital unit to third parties are exempted, at most, by an amount equal to the sum of the spousal exemptions. The unlimited marital deduction, at best, postpones the taxable event with respect to the taxable amount (the amount in excess of the spousal exemptions) until the death of the second spouse. Thus, assuming that each taxpayer has an exemption of $1 million, if aggregate spousal self-made wealth is $10 million, the lowest taxable amount if $8 million, with the taxable event for all $8 million possibly being deferred until the death of the second spouse. If there is an unlimited spousal exemption under the accessions tax, there is no tax as the first spouse's wealth is transferred to the second spouse at the first spouse's death, and any tax could be deferred at least until the death of the second spouse.[72] At the death of the second spouse the taxable

69. The wealthier spouse can make a "QTIP trust" gift to the poorer spouse that will be included in the poorer spouse's transfer tax base but without being subject to the poorer spouse's dispositive control. *See* I.R.C. § 2523(f) (2002).

70. *See supra* text accompanying notes 55-56. *But see infra* text accompanying notes 76-77 for a possible exception to this rule.

71. Andrews, *supra* note 11, at 592; Halbach, *supra* note 11, at 224. Both authors acknowledge operating under the assumption that major features of an accessions tax would mimic those of the existing transfer taxes, including (of course) a marital deduction.

72. Deferral is harmless where the tax base increases according to normal rates of return. In the estate tax, the post-death rate of return can vanish from the tax base by way of consumption, bad investments, or tax-free gifts. The average period of deferral (period of survival by surviving spouse) is probably about 8 years. *See* U.S. Treas. Dept., 91st Cong., Tax Reform Studies and Proposals 260 (Comm. Print 1969) (citing mortality statis-

amount would be wholly a function of the unused accessions tax exemptions of the second spouse's legatees, which could be legion. The second spouse's accessions tax exemption would be helpful only with respect to gratuitous transfers to such spouse from third parties. The effect of such an unlimited marital exclusion system would be treat the transferee spouse as a non-person for accessions tax purposes simply by reason of being a surviving spouse. Admittedly, apart from the deferral aspect, this is the same result as would occur if the first spouse bequeathed his or her wealth directly to the same legatees, bypassing the second spouse. However, the second spouse is a real person (taxpayer) capable of possessing and enjoying wealth, not a mere conduit entity like a trust or estate. Under an unlimited marital exemption, surviving spouses would be able to amass huge wealth by gratuitous receipt (perhaps as the result of serial marriages), and it is precisely the aim of an accessions tax that gratuitous transferees should owe and pay the appropriate amount of tax on such accumulations of unearned wealth, *regardless of the identity of the transferor.*

It does not follow that there should be no marital exclusion whatsoever. A system that allowed no marital exclusion would never be enacted by Congress. Under a partnership theory of marriage (if imperfectly under property law), roughly half of the aggregate spousal wealth can be deemed to be already owned by the surviving spouse as of the decedent spouse's demise. The partnership concept, which avoids geographical discrimination,[73] can be carried out by the following two rules (in addition to the rule that inter-spousal gifts would be tax free). First, any taxable accession by either spouse during marriage would (as with taxable income) be attributed 50-50 between the spouses.[74] Second, on the death of one spouse (or upon divorce) the surviving (or "other") spouse would be able to walk away with at least half of the aggregate spousal wealth free of tax.

The surviving spouse should not be able to acquire the unused exemption of the decedent spouse, as any such acquisition would undermine the purpose of the limitation on spousal estate accessions. If the unused ex-

tics). Deferral under the estate and gift tax does not increase the number of exemptions or number of taxpayers in low brackets.

73. Under community property law, the surviving (or divorced) spouse *actually* owns half of the marital property.

74. There are three possibilities: (1) the accession could be attributed to the actual transferees in accordance with legal title, (2) the accession could be attributed wholly to the spouse that stands in the closest degree of relationship to the transferor, or (3) the accession could be split between the spouses. The first approach has the disadvantage of providing an unnatural incentive for third parties to make gifts to in-laws in order to take advantage of unused exemptions. Professor Halbach, favors the second alternative as being more realistic. Halbach, *supra* note 11, at 224-25. In my view, there is no telling what is "realistic" within the marriage. Certainly a person can spend, give, or bequeath (if not use) only money or property that is legally "hers." I prefer alternative (1) to alternative (2). I favor alternative (3) partly because it accords with the partnership ideal, partly because the donors could engage in tax-motivated "donee-splitting," and partly because the "real" donee can share the accession or make a gift of part or all of it to the other spouse free of accessions tax.

emption amount were passed on, a person with a large amount of prior gratuitous accessions and future expectancies could marry a person with a large unused exemption amount but in relatively poor health in order to acquire additional exemption amounts. In the worst-case scenario, the poorer spouse might be stripped of her exemption without obtaining the benefit of the accessions that were sheltered from tax by reason of it.[75]

The lack of any limitation with respect to inter vivos gifts would allow the wealthier spouse, nearing death, to avoid the estate transfer limitation by effecting unusually large inter vivos transfers to the other spouse.[76] Anti-abuse rules would need to be formulated with the aim of treating certain inter vivos spousal transfers as being "estate" transfers.[77] But one of the alleged virtues of an accessions tax is not having to distinguish between inter vivos and estate transfers.

The anti-abuse rules would not be the only practical problem raised by an exemption limited to half of the aggregate spousal wealth. Unlike an estate tax, where the transferor's total wealth and the amount of estate transfers to the surviving spouse are valued as of the decedent's death, the normal situation under an accessions tax is that the transferor's total wealth is irrelevant, and the only thing that matters is the current accession, taxable when received, in relation to prior accessions from all sources. Spousal accessions with respect to trusts, legal future interests, and annuities would occur after the decedent spouse's death. About the only workable approach would be to constitute a fraction, using date-of-death values, representing the percentage of the deceased spouse's "estate" that would be excludable by the surviving spouse if she were to have received the maximum amount of excludable "estate" transfers "at" the deceased spouse's death, and then to apply this fraction against all estate accessions from the deceased spouse whenever received. If this system were deemed too complex, Congress could fall back on some simplifying rule, such as one providing that 50% of any spousal estate accession would be tax free. This rule would only reach the "correct" result if the spouse who died first were to own 100% of the spousal wealth.

In any event, assuming some limitation on the exclusion for marital accessions, the surviving spouse would have her own fixed-dollar exemption to shelter otherwise taxable accessions. However, as suggested earlier, many of the aims of an accessions tax could be accommodated by providing that the exemption increase with age, because accessions in ad-

---

75. Wealth acquired by one spouse by way of gratuitous transfer, especially among the wealthy, is often not shared in practice, is typically not split on divorce, and is considered separate property under community property law. Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63, 75 n.37, 90 (1993).

76. If death is not on the horizon, the wealthier spouse would be unlikely to make gifts that would result in the donee spouse becoming wealthier than the donor spouse.

77. This concept is familiar under the estate tax, *see* I.R.C. §§ 2035-2040 (2002), but it would surely be necessary in this context to revive a "transfer within *X* years of death" rule to supplement rules relating to revocable trusts and other inter vivos trusts with retained interests and powers.

vanced age would not bear much on inequality of opportunity or disincentives to work. For example, if the initial exemption of a person is $200,000, it might rise by gradual increments between ages 55-65, and even greater increments thereafter, up to some maximum amount. In practice, such a system would mostly benefit non-wealthy elderly surviving spouses.

Although Congress would certainly be capable of enacting an accessions tax with a 100% marital exclusion, the problems raised by marriage and its dissolution might perhaps somewhat slow the stampede of tax experts to embrace the idea of an accessions tax.

d. An Unlimited Income Tax Exclusion

Marriage would affect all income, not just gratuitous accessions. Gratuitous receipts of a married person from third parties would be automatically dealt with by the joint return (income-splitting) system. Interspousal transfers during marriage would be ignored, as occurs under § 1041.

It might at first seem that the income-inclusion approach would be subject to the same conceptual and practical problems as an accessions tax with respect to excluding estate transfers from the deceased spouse.[78] However, the income tax is not really a wealth transfer tax, imposed without regard to whether the wealth was previously subject to income or transfer tax. Moreover, unused exemptions would not be an issue, or raise tax-avoidance opportunities, under an income tax. In contrast, a basic norm of the income tax is that income should not be taxed twice to the same taxpayer. The income tax treats a married couple somewhat like a partnership during the period where both spouses are alive, in the sense that the joint return rate schedule produces the same tax result as if aggregate taxable income were evenly split among married individuals filing separately. But a married couple differs from a commercial partnership in two ways. One way is that transfers between married couples are not treated as taxable sales and exchanges, whereas transfers between commercial partners are. The second is that the death of a partner in a commercial partnership causes a separate liquidation of each partner's interest, whereas in a marriage it is considered normal for the deceased marital partner's assets to be "continued by" (gratuitously transferred to) the surviving spouse. To the extent that the decedent's assets pass to the surviving spouse, the surviving spouse can be viewed as the sole equityholder in an entity that formerly had two equityholders. (In contrast, other legatees of the decedent spouse cannot be viewed as being equityholders in the marital-asset equity prior to the first spouse's death.) Under the "continuing entity" view of marital assets that end up in the hands of the surviving spouse, the logic of the income tax dictates that

78. *See also* I.R.C. §§ 1(a), 2(a) (2002) (providing that a surviving spouse can file under the joint return schedule for the two years following the year of the other spouse's death).

income taxed to the entity during life should not be taxed again to the survivor after death. This approach is reinforced by the intuitive notion that double income taxation of the same dollars to different taxpayers should occur only when the two taxpayers are truly distinct in the tax sense.[79]

Even apart from the entity concept, it may simply be decided that spousal estate transfers should be treated preferentially relative to transfers to third parties, and preventing pre-death income from being taxed a second time to the surviving spouse is the easiest and simplest way of implementing such a preference. Also, an exclusion for inter-spousal estate transfers would render irrelevant the possible distinction between gift and estate transfers. Finally, it is inconceivable that any adoption by Congress of an income-inclusion approach would lack a spousal exclusion.

Of course, the exclusion would be limited to amounts existing at the decedent spouse's death. Income arising subsequent to such death would be taxed. The existing Subchapter J rules for trusts are adequate to carry out the task of distinguishing between pre-death and post-death income.[80]

3. *The Marital Deduction (Or Exclusion) Qualification Rules*

This time the various tax modes will be considered in a different order.

a. The Accessions Tax

Qualification for any marital exclusion would not be a problem under an accessions tax, because accessions are deemed to occur when money or property is actually received, as opposed to when interests in property are initially acquired. For example, if *H* creates a trust, income and/or corpus to *W* for life, remainder to *C*, then *W* would be treated as receiving an accession "from *H*" on account of each distribution of income and corpus as and when it occurs. There would be no need for the "terminable interest rule" as found under the estate and gift tax, which deals with transfers subject to contingencies. Nor would it be necessary to assign a value to "interests" acquired by gratuitous transfer.

79. Avoidance of double taxation within the "entity" occurs naturally under an accessions tax with respect to self-acquired wealth (that is, wealth not subject to accessions tax as it is acquired by marital unit). At worst, some such wealth may be taxed under the accessions tax (a separate tax apart from the income tax) as it passes from the decedent spouse to the surviving spouse, but any accessions tax on property transferred by the surviving spouse would be payable by the legatees, meaning that any "second" accessions taxation that occurs at this point would not be "on" the surviving spouse.

80. Pre-death income earned by the decedent spouse but not included in income prior to death should either be accrued as income on his final income tax return or else be taxed to the recipient under existing rules relating to "income in respect of a decedent." *See* I.R.C. §§ 691, 1014(c) (2002).

b. Income-inclusion Approach

For this same reason, qualification would also not be a problem under an income-inclusion approach. Nevertheless, a qualification rule may be needed if inter-spousal transfers obtain a more favorable basis than other gratuitous transfers.[81]

c. Qualification Under an Estate or Inheritance Tax

Under the present estate and gift tax, the basic idea underlying qualification is that deductibility is conditioned on *certainty* that the property will appear in the transfer tax base of the transferee spouse (unless consumed or wasted by her). This idea is carried out by the notorious "terminable interest rule," which "tests" qualification solely by reference to facts existing at the date of transfer and looking at worst-case scenarios, somewhat like the Rule Against Perpetuities. Such an approach is necessary, conceptually, in a transfer-oriented tax, since the possibility of a current deduction cannot "wait-and-see" as to how future contingencies actually play out.[82]

In any event, qualification (and inclusion in the transferee spouse's tax base) will occur if the transfer to the spouse is outright[83] or is in trust with (a) an unrestricted general inter vivos *or* testamentary power of appointment in the transferee spouse (the "power-of-appointment trust," or PAT),[84] (b) a remainder in the transferee spouse's "estate" upon the transferee spouse's death (the "estate trust"),[85] or (c) an election that the property appear in the transferee spouse's tax base (the "QTIP trust").[86] In the PAT and QTIP situations, but not the estate trust, there is the further condition that the transferee spouse possess the right to all of the income for life.[87] In all of these situations, the entire transfer, not just the actuarial value of the transferee spouse's interest, is deductible, and the entire transfer is includable in the transferee spouse's tax base (unless consumed or wasted).

These rules do not assure that the transferee spouse has anything resembling full ownership. Qualification can be obtained by providing only the minimum benefit of *either* an income interest for life (the QTIP trust) *or* an "estate" remainder (the estate trust). An income interest isn't worth much where the income yield is minimal and the spouse's life ex-

81. *See* I.R.C. § 1022(c) (2002).

82. This is not to say that the terminable interest rule cannot be simplified and/or improved upon, but such a discussion is beyond the scope of this contribution.

83. An annuity qualifies if no payments can be made to a person other than the transferee spouse.

84. *See* I.R.C. §§ 2056(b)(5) (estate tax), 2523(e) (gift tax) (2002).

85. The transferee spouse's estate is considered to be an attribute of the transferee spouse herself. *See* I.R.C. §§ 2056(b)(1)(A), 2523(b)(1) (2002).

86. *See* I.R.C. §§ 2056(b)(7), 2523(f) (2002). A fourth possibility is the spousal remainder trust, where the transferee spouse has a vested remainder following a life or term interest in another party. Here the deductible amount is the actuarial value of the spousal remainder interest.

87. *See* I.R.C. §§ 2056(b)(5), (7)(B)(ii)(I) (2002) (estate tax).

pectancy is short.[88] There is only a requirement that an income interest be non-illusory.[89] Even combining these two features (as in a PAT with a general *testamentary* power of appointment) falls short of complete ownership (the transferee spouse lacking current access to principal), unless one assumes (wholly unrealistically) that a transferee spouse could borrow money in the entire amount of the trust principal and that her creditors can be made to satisfy their claims only out of the trust assets following the transferee spouse's death.

Where the transferee spouse does not possess complete ownership (or its equivalent, such as an unrestricted general inter vivos power of appointment), the tax benefit arising from qualification inures in whole or in part to the other beneficiaries of the trust. This is especially true of the estate trust, where the transferee spouse may not possess any current enjoyment rights at all.

It is obvious that these qualification rules are incompatible with the only two theories plausibly justifying a marital deduction in the first place, namely, the welfare theory and (especially) the estate-splitting theory. Survivorship rights, by way of community property, jointly-held property with rights of survivorship, and (except in a couple of states) elective share rights, are rights to take property in fee simple absolute. Since the transferee spouse is usually the wife, the qualification rules operate to undermine women's property rights, and women (not just feminists) should be outraged and indignant.

There are two possible solutions. One suggestion is to limit the marital deduction to the actuarial value of interests transferred to the surviving spouse.[90] However, this approach is seriously flawed, in my opinion. This rule would change nothing with respect to PATs, which give the transferee spouse only a testamentary power of appointment, and to estate trusts, since in both cases all "interests" in the property pass to the transferee spouse.[91] The most misogynist qualification device, the estate trust, would become widely used. As to the QTIP trust, the outcome

88. For a more detailed exposition of this point and its implications, see Joseph M. Dodge, *A Feminist Perspective on the QTIP Trust and the Unlimited Marital Deduction*, 76 N.C. L. REV. 1729, 1741-43 (1998) [hereinafter *Marital Deduction*].

89. The standard is that the trust "give her that degree of beneficial ownership of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust." Treas. Reg. § 20.2056(b)-5(f)(1) (2002). The law of trusts requires impartiality between income beneficiaries and remainders. Impartiality is normally satisfied by an income return of 3%, but anything over 1% might pass muster, and a rate of return lower than 3% is quite possible if trust investments underperform. The duty of impartiality is not self-executing, so that it is up to the income beneficiary to initiate action against the trustee if there is an impartiality problem or a problem with investments.

90. The actuarial-value approach has been advanced in Howard E. Abrams, *A Reevaluation of the Terminable Interest Rule*, 39 TAX L. REV. 1, 23-25 (1983).

91. In a PAT trust, the general testamentary power of appointment would be treated as the equivalent of a vested remainder, and any contingent interest of the takers in default would be valued at zero. In an estate trust, accumulated income is added to corpus and augments the remainder interest. The present value of the inception amount augmented by all economic yield at any future date is equal to the inception amount.

would hinge on accurate valuation of the spousal income interest. But income interests are greatly overvalued under the actuarial tables. First, the income yield is assumed to be 120% of the applicable midterm federal rate,[92] which is likely to be significantly higher than the actual 2-5% income yield of such trusts. Second, the discount rate is also set at 120% of the applicable midterm federal rate. The higher the discount rate the higher the valuation of income interests relative to remainder interests. These problems might be fixable by requiring that an annuity or unitrust interest (rather than an income interest) be given to the transferee spouse, and the discount rate lowered to 100% of the applicable federal rate. But that would still leave the problem of mortality. The argument that deviations from mortality means would "average out" revenue-wise is irrelevant from the equity point of view and is unrealistic in the aggregate due to the problem of "adverse selection." Estate planners would urge the use of QTIP-type trusts in cases where the transferee spouse is expected to under-perform in terms of life expectancy, in which case the deductible marital interest would be overvalued.

The second approach is, obviously, that the transferee spouse be given an interest in fee simple absolute or its equivalent (meaning a single-life annuity or a trust giving the surviving spouse an unrestricted inter vivos general power of appointment). The surviving spouse can, with a lump sum, purchase an annuity or self-settle a trust for her own benefit, if non-tax considerations so warrant.

Two rationales have been offered for the QTIP option,[93] but neither of them withstands scrutiny. One is that reducing the spousal interest to a QTIP interest was a fair trade-off for offering an unlimited marital deduction. But the entire trust qualifies for the deduction, not just the value of the spousal income interest. As previously noted, the real value of the spousal income interest in the *entire* estate may well be less than 50% of the total value. And, the QTIP trust may well be "in" an amount less than the decedent spouse's entire estate. Indeed, the ever-expanding estate and gift tax exemption has provided a powerful incentive *not* to use the maximum marital deduction, although that incentive could be neutralized by allowing a deceased spouse's unused exemption to pass to the surviving spouse (to the extent of qualifying marital-deduction transfers). Taxes aside, the decedent may simply not wish to use an unlimited marital deduction.

The second rationale was to allow wealthy (and presumably male) testators to exercise dead-hand control over the property after the surviving spouse's death. This rationale flatly contradicts the estate-splitting (the property was "theirs") norm, as it gives the decedent spouse the power to control the ultimate disposition of the entire corpus. It may be argued that the decedent spouse may wish to assure that transfers are made to

92. *See* I.R.C. § 7520(a)(2) (2002).

93. The history of the QTIP idea is described in *Marital Deduction*, *supra* note 88, at 1732-34.

children of a prior marriage or other family members, but a reasonable system does not in any way prevent transfers to such persons. Indeed, a generous per-taxpayer exemption facilitates them wholly apart from a marital deduction. A dual-transfer dispositive scheme of the estate-splitting variety may be optimal in this situation from both the tax and non-tax angles.

It may be argued that, in a late-in-life marriage of short duration producing no descendants, the estate-splitting norm simply should not apply. This observation, however, suggests that the decedent should be able to settle his marital obligations by devoting a fraction of his estate to the purchase of a single-life annuity for the surviving spouse. Alternatively, it suggests that a QTIP trust be tolerated *only* in situations of this type. Moreover, the trust should be required to provide an annuity or unitrust interest, and only the value of that interest should be deductible.

An argument against the position that qualification should (with the exception noted) be limited to outright transfers or their equivalent is that such a rule is not necessary due to community property and elective share rules. But community property status only attaches to property acquired during marriage. In a short-lived or late-in-life marriage, or where the decedent acquired large amounts by gratuitous transfer, the percentage of the decedent spouse's gross estate constituted by interests in community property may be low. In common law states, the elective share protection varies widely.[94] Given the relatively low pay-off for electing against an estate scheme containing a QTIP trust, a surviving spouse may be quite reluctant to "stir up trouble" and "appear greedy" by doing so, even if she is aware of her rights. Estate planners themselves do not view elective share rights as a credible threat against the use of QTIP trusts.[95]

5. *Summary of Inter-Spousal Transfers Discussion*

The present estate and gift tax gets low marks for tolerating full qualification of trust transfers on the basis of partial spousal interests. Although that defect could be cured, something like the terminable interest rule would need to be retained. An unlimited estate tax marital deduction can be justified on pragmatic, if not conceptual, grounds.

Contrary to the view of its proponents, the concept of an accessions tax does not allow for an unlimited marital exclusion. Also, it is not clear how accessions by a married person from third parties should be handled.

---

94. Section 2-202(a) of the 1990 revision of the Uniform Probate Code renders the elective share in common-law states a function of the length of the marriage. In addition, the spouse's own assets count against the elective share. UNIF. PROB. CODE §§ 2-206(b), 2-209. At the other extreme, Georgia has no elective-share statute. In most states that do have an elective share, the share is 30%, not 50%. In a small number of states, the elective share can be satisfied by an income interest in a percentage of the estate. Depending on state law, the elective estate may be "stripped" by various inter vivos transfers. WAGGONER ET AL., *supra* note 58, at 592-95, 600-22.

95. *See* Jeffrey N. Pennell, *Minimizing the Surviving Spouse's Elective Share*, 32 INST. ON EST. PLAN. 9-1 (1998) (claiming that most spouses would acquiesce in an *estate-equalization* QTIP trust rather than elect against the will).

Both problems can be accommodated under some kind of estate-equalization scheme, but an estate-equalization scheme would raise both conceptual and administrative problems of a very large order. At least qualification would be much simplified, as a wait-and-see approach is appropriate for an accessions tax.

The income-inclusion approach adopts the simplification aspects of both systems: an unlimited marital exclusion implemented by the joint return system and existing trust rules, combined with a simple wait-and-see qualification approach.

B. Does the Generational Idea Make Sense?

This section critically examines the notion that any tax on gratuitous transfers should operate as a once-per-generation wealth tax. Contrary to received wisdom, I conclude that a generation-skipping tax (GST) or its equivalent is not warranted and, in any event, can only operate in a fashion that is intolerably crude.

1. *Can a Transfer Tax Function as a Proxy Wealth Tax?*

It might be said that a transfer tax is best thought of as a wealth tax imposed at periodic intervals.[96] For this purpose a wealth tax is a tax on the ability of a person to pay (material wealth) on an annual (or other periodic basis) regardless of how such wealth was acquired. An initial observation is that the tax rate under an annual wealth tax would be set to be significantly less than the most conservative and safe rate of return,[97] whereas the rates under an estate tax, an inheritance tax, or an income-inclusion system could bear only a random relationship to any notion of an annualized rate of return.

A wealth tax is a tax on wealth acquired by any means, including labor, investment, and entrepreneurial activity.[98] In contrast, the aim and effect of any wealth transfer tax must be either to curb the transfer of whatever wealth is left over *after the consumption thereof* (as in an estate tax) or to curb the acquisition of a certain kind of (i.e., unearned) wealth acquired by gratuitous receipt.[99] Any attempt to convert even a wealth transfer tax into a periodic tax on *inherited* wealth would require that rates and exemptions be keyed to the holding period of gratuitously-acquired assets (and that would require a "tracing" convention), and the tax would have

96. An example is found in John T. Gaubatz, *A Generation-Shifting Transfer Tax*, 12 VA. TAX REV. 1 (1992).

97. Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 442 (2000).

98. Two entire issues of *Tax Law Review* (Volume 53, Nos. 3 & 4) were devoted to a wealth tax symposium. The lead article, *Wealth Taxes*, *supra* note 10, argues that a wealth tax is incompatable with liberal values. The same author appears to hold the view that a wealth transfer tax is not opposed to such values. *Transferring Wealth*, *supra* note 22.

99. Jantscher, *supra* note 6, at 46-48.

to be designed so that it could not be avoided by consumption.[100]

The GST is sometimes supported on the theory that it assures that wealth is taxed periodically.[101] But a GST no more captures the aggregate wealth of a transferor or transferee than does an estate, inheritance, or accessions tax. It is more accurate to say that the aim of a GST is to prevent the perceived avoidance of one of these wealth *transfer* taxes through the creation of successive-interest transfers,[102] an aim that I will shortly argue to be misguided. Of course, one might frankly advocate a GST simply as a tax on trusts, but then one would have to justify the proposition that wealth held in trust is uniquely deserving of a periodic wealth tax.[103]

The operation of a wealth transfer tax tied to the once-per-generation idea can only be crude and inequitable. The first imposition of transfer tax must be deferred until gift by, or the death of, the initial wealth acquirer, which may be several decades after wealth is acquired by labor or investment. Families that tend to produce children late in life can lengthen the intervals at which any wealth transfer tax can be imposed. There has never been any gift or estate tax exemption for gratuitous transfers to persons simply for being in the same or higher generation,[104] although there is such an exemption within the GST,[105] but there a generation of beneficiaries may be terminated prematurely or delayed by reason of longevity or fecundity. There is an estate tax credit[106] (provided by § 2013) with respect to property twice subject to estate tax within a short interval, but the credit is phased out if the interval between deaths is more than two years, and is not available against or on account of any gift tax or GST.

Ironically, the only tax system that comprehensively reaches the wealth of any individual is an income (or consumption) tax that does not exclude gratuitous receipts.

---

100. A proposal for a wealth transfer tax that mimics an annual wealth tax is found in Joseph M. Dodge, *The Taxation of Wealth and Wealth Transfers: Where Do We Go After ERTA?*, 34 RUTGERS L. REV. 738 (1982). *See also* Meade Report, *supra* note 41.

101. The GST (generation-skipping tax), found in Chapter 13 of the I.R.C. (§§ 2601 *et seq.*), imposes a tax on generation-skipping transfers. The two paradigm generation-skipping transfers are the "direct-skip" transfer (outright bequest to a grandchild) and the "taxable termination" (as occurs in a trust created by parent A, income to child B for life, remainder to grandchild C, upon the death of child B). *See* I.R.C. §§ 2611-2613 (2002). The GST is in addition to any estate or gift tax on the transfer. The definition of generation-skipping transfer is keyed to generations under I.R.C. §§ 2613, 2651 (2002).

102. Rationales for a GST are discussed in Joseph M. Dodge, *Substantial Ownership and Substance versus Form: Proposals for the Unification of Federal Estate and Gift Taxes and for the Taxation of Generation-Skipping Transfers*, 1976 U. ILL. L.F. 657, 662-70 (1976) [hereinafter *Substantial Ownership*].

103. Such a tax would arguably be an unapportioned direct tax, *see supra* note 24, but it might be defended as a reasonable proxy for a wealth transfer tax.

104. The marital deduction rests on independent grounds. The surviving spouse may clearly occupy a lower generation than the transferor spouse.

105. *See supra* note 43.

106. *See* I.R.C. § 2013 (2002).

2. Does the GST Further a Relevant Concept of Equity?

The only plausible normative basis for the GST within a wealth transfer tax system is that of transferee "equity." The problem is typically illustrated by positing a set of individuals that we can call *A*, *B*, and *C*. Wealth is taxed twice as it is transferred from *A* to *B* and then from *B* to *C*, and the double tax can be avoided if *A* transfers the property directly to *C*, by-passing *B*. An alternative technique is a trust created by *A*, income to *B* for life, remainder to *C*, as the death of B generates neither estate nor gift tax. The inequity in the situation is said to reside in the fact that, assuming no GST and a given wealth amount in the hands of the initial transferor (*A*), the terminal transferee (*C*) will end up with more wealth after tax if received directly from *A* than if the same wealth passed from *A* to *B* and then from *B* to *C*. The GST was originally enacted in 1976 precisely to "correct" this situation by imposing a tax on the trust by reason of *B*'s death. But the current GST,[107] enacted in 1986, goes so far as to impose a "second" tax, in addition to the estate and gift tax, on a direct (non-trust) gift or estate transfer directly from *A* to *C*.

Note that the equity issue is wholly independent of what generations are occupied by *A*, *B*, and *C* respectively. Note also that the hypothetical is artificial in that, in real life, it cannot be simply assumed that any amount received by *C* from *B* is the same property that *B* received from *A*. If it is assumed that *B* "first" consumed amounts received from *A* and that whatever *B* bequeathed to *C* came out of new wealth amassed by *B*, the whole equity problem dissolves.

Even if one takes the hypothetical at face value, it turns out that the perceived equity problem does not really exist. The concept of equity ("fairness") can only relate to individuals, not things. Nor can it properly be made to apply to "lineages,"[108] first, because there really are no such things as separate and distinct lineages,[109] and second, because there is no apparent normative basis for analyzing equity claims in terms of lineages rather than individuals.[110] The assertion that the problem involves equity among lineages is simply a way of framing the issue in a way that foreordains the conclusion.

To say that group *A*, *B*, and *C* may arrange their affairs to suffer tax less often than group *X*, *Y*, and *Z* is merely descriptive. This fact alone does not point to any inequity, unless group *X*, *Y*, and *Z* is unfairly constrained relative to group *A*, *B*, and *C*. But any difference in the *fre-*

107. I.R.C. §§ 2601-2664 (2002).

108. Economists invoke the notion of lineages and extended families in an attempt to explain bequest behavior. Douglas Holtz-Eakin, *The Uneasy Empirical Case for Abolishing the Estate Tax*, 51 TAX L. REV. 495, 505 (1996). This use of the lineages concept is divorced from equity analysis.

109. With the abolition of primogeniture, any given individual has multiple ancestors who count equally at each generation, and those ancestors have multiple descendants.

110. The general claim (in itself controversial) that families are the basic unit of society only applies to families as they exist at the relevant historical moment, because it is "in the moment" families that possess authority and welfare functions apart from society or the state.

quency of transfer tax within any group of the same size is a matter of free choice.[111] There is no *legal* constraint on any set of individuals to suffer transfer tax more frequently than other sets of individuals. It may be argued that only the very wealthy are *financially* able to effect transfers that can "skip" transfer tax. But there is no significant constraint upon even modest wealth being transferred in a successive-interest mode.[112]

If there is no external constraint on the making of successive-interest transfers, it becomes relevant to examine motivations. That is, does the tax system itself operate as a constraint, or are successive-interest transfers typically created for other reasons? The effect of a split-interest transfer is to (possibly) preserve (or augment) the principal after a period of enjoyment by current beneficiaries and to direct the disposition of such principal. This effect is compatible with motivations of the following types: (1) the desire to exert dead-hand control for its own sake, (2) the desire to create a lasting monument to the settlor, (3) the wish to protect beneficiaries from their own improvidence or incapacity, (4) the desire to keep wealth "within the family," and (5) the wish to provide for second-look flexibility through the exercise of discretionary powers and powers of appointment. These non-tax wishes and purposes are obviously interrelated, and they all converge in the notion of the successive-interest transfer, preferably in the form of a trust. The concept of a successive-interest transfer makes sense only where it is contemplated that the initial beneficiaries do not, might not, or should not "need" access to principal. It would be considered perverse to deprive one's needy children of economic resources simply so that more remote descendants might obtain a free head start on life. Any kind of successive-interest transfer is likely to be viewed as being far superior (apart from tax) over the next-best economic alternative, which is the making of various lump sum bequests to various beneficiaries in varying degrees of relationship that can (but don't have to) be invested in annuities or life insurance policies so as to mimic current-enjoyment and remainder interests.

Statistically, the propensity to think in terms of split-interest transfers is likely to be more common as wealth increases, since the greater the wealth the easier it is to provide for both current and successive beneficiaries at the same time, but that fact does not establish the proposition that generation-skipping trusts are (or ever were) tax motivated. This point effectively counters the "neutrality" version of the equity argument,

111. The intervals between taxes are a function of longevity, which in itself is not much a matter of choice. However, the constituent group can be freely selected with expected longevity in mind. For example, it would be dumb to leave a large bequest in fee simple (instead of an annuity) to an ancestor or sibling. In any event, the equity argument is posited in terms of frequency, not intervals.

112. Although financial institutions may not accept small trusts, a settlor can name a relative or friend as trustee, and once established a trust will not fail for want of a trustee. Numerous non-trust alternatives are available: legal life estates followed by remainders, joint and survivor annuities, joint tenacies with right of survivorship, and annuity-insurance combinations.

which is that a GST is necessary to counter-act the "tax" inducement to make generation-skipping transfers.[113] If the principal motivations for creating successive-interest transfers have nothing to do with tax, then there is no reason to create a tax disincentive for such transfers.[114] Indeed, it then becomes the case that the imposition of additional taxes on generation-skipping transfers is what violates neutrality. This non-neutrality is blatant in the case of the existing GST on direct-skip transfers (such as outright bequests to grandchildren).

Any equity argument not founded on the notion of unfair constraint must be founded on some notion of (equal) entitlement. Thus, in the *A*, *B*, *C* group hypothesized above, the question is whether *C* is "entitled" to the same after-tax amount originating with *A* regardless of whether: (1) *A* transferred the property outright to *B*, and *B* subsequently transferred it outright to *C*; (2) *A* transferred the property in trust, income to *B* for life, remainder to *C*; or (3) *A* transferred the property directly (and outright) to *C*. One observing that equity claims cut two ways would argue that the norm is the direct transfer from *A* to *C*, with the consequence that the transfer tax should either exempt the transfer from *A* to *B* or the transfer (or, in the case of the trust, the shifting of enjoyment) from *B* to *C*, as opposed to imposing an additional tax on the direct transfer from *A* to *C*. Indeed, the equity-of-succession argument is really an argument for no transfer taxation whatsoever, because only in a no-tax environment can such a norm be achieved. In any event, on the merits *C* is entitled to nothing at all. It is axiomatic in the United States that *A* and *B* are free to consume the property or give it to charity. Certainly *A* is free to choose to allow *B* to enjoy the property prior to allowing *C* to enjoy it.

A third possible approach to equity analysis is simply that likes should be treated alike, but this approach depends upon establishing that non-identical situations in fact are "really" the "same." The situation where *A* transfers wealth to *B* who in turn transfers it to *C* is fundamentally dissimilar from both the outright transfer from *A* to *C* and the trust transfer by *A*, income to *B* for life, remainder to *C*. The outright transfer from *A* to *C* gives nothing at all to *B*. On what basis can it be claimed that *B* "really" acquired the property from *A* and passed it on, in turn, to *C*? In the trust situation, what *B* receives is an income interest, but an income interest is considerably less than a fee interest, because the holder of the income interest cannot consume, appropriate, or dispose of the corpus. And, of course, the actual income received *does* augment the transfer tax base of the holder of the income interest. Thus, the three situations are not remotely identical.

113. *See, e.g.*, Halbach, *supra* note 11, at 225-29, 241-42 (arguing for additional accessions tax on generation-skipping transfers to counter tax inducement to make such transfers).

114. A tax on trusts might be plausible if it were concluded that trusts (or long-term trusts) are per se bad as a matter of policy, but that issue is beyond the scope of this contribution.

In general, tax rules are (and should be) tailored to what actually happens, not what might have happened under the highest-tax scenario. But the whole basis of the GST is to tax property somewhat "as if" property had passed in fee simple through each successive generation. Basically, an estate or inheritance tax should be imposed on wealth the transferor actually owned (or constructively owned), and not property he would have (or might have) owned if the worst possible transfer tax planning advice had been carried out. Similarly, under an accessions or income tax, the tax base should be keyed to what is received. Under an accessions tax (or income-inclusion rule), the prior tax history of the property (if any) in the hands of other persons is irrelevant, just as the identity of the transferor is irrelevant. What is important is what the transferee receives, not how it got there.

Stating the same point from the "neutrality" angle, a person in *A*'s position may be aware that that *C* will end up with more of the property after tax, in the absence of a GST, under a dispositive plan that either skips *B* completely or gives *B* only an income interest. But following either course of action is hardly a trivial matter even to a person concerned only about how he or she will be remembered (and who is indifferent to the welfare of *B*). Especially if a concern for *B*'s welfare is factored in, it seems unlikely that the dispositive plan will be driven by tax considerations. Indeed, imposing a GST only in the trust situation is likely to discourage the trust alternative, and imposing a GST on both the trust and direct-transfer alternatives is likely to discourage the direct-transfer alternative. Neutrality is, at best, a slippery concept in the present context.

3. *Is It Possible to Correctly Design a GST?*

Even allowing for "inequities" resulting from differences in generational spacing, it is not clear that it is possible to accurately design a GST that is based on the idea of what a person in a skipped-generation would have received if he or she had received the property outright prior to passing it on to the ultimate transferees. Any such system has to be based on speculation, such as that an income beneficiary would have received a fee-simple bequest. But a trust transfer may not have any fixed-interest income beneficiaries, or even any intermediate-generation beneficiaries. The 1976 GST generally assumed that the skipped person was the parent (descended from the original transferor) who was one of the parents of the highest-generation transferee below the transferor. Of course, there may have been perfectly good reasons why the transferor would not have bequeathed amounts outright to such parent. Also, since the parent (if he or she had received an outright bequest from the transferor) could have split transfers with his or her spouse, it seems more reasonable that both parents should have been treated as skipped persons. But then there is the problem of divorced parents and parents who predecease the transferor.

The 1976 GST attributed amounts to the skipped persons (the "deemed transferors") and the amounts so attributed were treated as gift or estate transfers of the deemed transferors under the gift and estate tax.[115] Various problems with the 1976 approach, especially the deemed-transferor concept,[116] led to its retroactive repeal and replacement in 1986 by the current "simplified" GST, which: (1) dropped the deemed-transferor concept, (2) added direct-skip transfers to the list of taxable transfers, (3) separated the GST from the estate and gift tax, (4) adopted a flat rate, and (5) keyed the exemption amount ($1 million, as indexed) to the original transferor.[117] All of these moves (except arguably the inclusion of direct-skip transfers) constituted a retreat from any pretence to accuracy (and, hence, equity and neutrality).

Particularly unfortunate, in my opinion, was the separate per-transferor exemption apart from (and in addition to) estate and gift tax lifetime exemptions. To illustrate, assume that both the GST exemption and the estate and gift tax exemption are $1 million per person. *D* bequeaths $1 million to a trust, income to *E* for life, remainder to *F*. This trust avoids estate tax on *D*'s death and GST on *E*'s death, but without using up any of *E*'s own gift and estate tax exemption at *E*'s generation. This result is harmless if *E* has no separate estate, but to the extent that *E* does amass a separate estate the next generation (that of *F*) in effect obtains the benefit of a double estate tax exemption. This system actually invites the creation of generation-skipping transfers but also complicates dispositive schemes by creating an inducement to limit such transfers to $1 million per transferor.

Another problematic feature of the exemption is that it "attaches" to the trust at the date of initial transfer and expands at the same rate as the trust expands. Thus, in the example just stated where *D* creates a trust worth $1 million, there is no tax on *E*'s death even if the trust is then worth $5 million.[118] The rationale of this rule appears to be precisely to "neutralize" the effect of future appreciation relative to a fixed-dollar exemption.[119] But the logic of such an approach would dictate similar treatment for non-trust transfers. Thus, assuming an exemption of $1 million, a bequest by *A* of $1 million to *B* would not only be exempt from tax but the latter transfer by *B* to *C* of the same property (now grown to $5 million) would also be wholly free of tax, and so on to infinity. *But the con-*

115. Professor Halbach's accessions tax proposal has a similar feature, except that unused exemptions of skipped persons can be used to offset any generation-skipping accession. Halbach, *supra* note 11, at 242-48, 253-62. But identifying "skipped persons" in this context is as problematic as identifying "deemed transferors" under the 1976 GST.

116. *See* Joseph M. Dodge, *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. PA. L. REV. 1265 (1977). The 1986 legislative history states that the 1976 GST was "unduly complicated." *See* H.R. REP. NO. 99-426, at 824 (1985).

117. Husband and wife are separate transferors. Thus, a married couple can effect tax-free generation-skipping transfers aggregating $2 million at date-of-transfer values.

118. In effect, there is an exclusion ratio of 100%, which adheres to the trust for its entire duration. I.R.C. § 2642(a)(1), (2) (2002).

119. *See* Halbach, *supra* note 11, at 217.

cept of a transfer tax does not allow for prepayments, particularly prepayments that can exempt a succession of gratuitous transfers involving the same wealth. The tax base and exemptions should be determined at the time of each and every taxable event, letting the chips fall where they may. Otherwise, the whole system would collapse.[120]

For basically the same reason, imposing the GST on an outright transfer to a grandchild is problematic due to the timing issue. That is, assuming that the aim of taxing direct-skip transfers is to produce a result equivalent to the successive bequest (or trust) situation,[121] the GST tax base for the direct-skip transfer is over-stated.[122]

4. *Can a Wealth Transfer Tax Be Imposed Too Often?*

Accepting the notion that the once-per-generation idea (and the GST) is misconceived and/or unworkable, it may still be thought that a person who dies shortly after receiving a gratuitous transfer never really "owned" or "acquired" the property to the degree that is sufficient to tax him or her on it. But (unlike the concept of an annual wealth tax) the *concept* of a tax on gratuitous transfers or accessions, strictly speaking, does not factor in the period for which the wealth was held.[123] Under the accessions tax or income-inclusion approaches, holding period and use are both irrelevant.

Thus, I do not really view holding period as a problem. But a better way of dealing with it (that does not involve the complications of present § 2013) would be to ignore an estate transfer that occurs within (say) two years of another estate transfer. Under the estate tax, such a system

120. Taken to its logical conclusion, a person could declare his wealth to be "taxable" at the moment her wealth equals the exemption level, so that subsequent growth in the same wealth would escape tax not only at such person's death but also for so long as the same property passed intact by gratuitous transfer. The whole point of anti-estate-freeze provisions, such as I.R.C. §§ 2701, 2702, is to counter moves of this sort.

121. The contention that, in the name of "neutrality," the tax should be the same as if *A* made a bequest to child *B* who *immediately* made a gift of the net proceeds to *C* (which is the result obtained under the current GST) should be rejected, as *B* never received anything, and a rational person in *A*'s position would never arrange a twice-taxed transaction along these lines.

122. The GST is a kind of proxy tax for the estate tax that would have been paid on the same property after one generation under certain assumptions. But this proxy tax is imposed in advance on the full value of the property. At the time the GST is imposed, the value of the property (using standard financial analysis of the type incorporated into the actuarial tables used for estate and gift tax purposes) is the sum of (a) the present value of the income stream (economic yield) for a period equal to, say, 25 years and (b) the present value of the principal at the end of the same period, which is assumed to be unchanged. Thus, if property worth $1 million is bequeathed outright to the decedent's grandchild, the present value of an income interest for 25 years might be worth $650,000 and that of the corpus interest would be $350,000. The GST is in fact imposed on the $1 million, but it should be imposed (if at all) on only $350,000, the present value of the corpus interest that "would be" subject to estate tax after 30 years. It is true that direct-skip transfers obtain an implicit deduction for the GST itself (payable by the transferor or her estate), § 2623, whereas other types of generation-skipping transfers do not. Thus, in the illustration used in this footnote, if the applicable rate is 50%, the GST tax base is really $666,667, and the GST $333,333. But the *ex ante* tax is still excessive by a significant margin.

123. *See supra* note 100.

would operate by treating the death of legatee *B* within two years of receiving a gift or bequest from *A* as a per se qualified disclaimer on *B*'s part, resulting in an exclusion from *B*'s estate of an amount equal to the gift or bequest from *A*.[124] Under an accessions tax or an income tax, the initial receipt (by *B* from *A*) would be retroactively treated as a non-accession or as non-income.

Another possible approach would be to exempt "upwards" and lateral transfers from tax, but such a rule would more radically alter the purpose and effect of the tax.[125]

C. Are Gift Exclusions Warranted?

Under any system the function of any gift exclusion should be to render unimportant the distinction between excludable "support"[126] and taxable transfer (or receipt) and to distinguish between a donor's consumption spending that benefits others from true wealth transfers (gifts of cash, investments, businesses, and non-wasting assets, plus transactions that reduce liabilities). Trust transfers and transfers of business and investment property would never be excluded.[127]

Under an income-inclusion scheme the rationale for a consumption exclusion would run deeper than administrative convenience. The income tax has always taxed consumption assets "only once," by disallowing a deduction for the cost of a consumption asset (or a consumption expense), whereas investment yield is "taxed twice" (by disallowing a deduction for the purchase price of the asset *and* including the yield in gross income).[128] *A corollary of this approach is that the purchase of a consumption asset (or the making of a consumption expense) by one party for the benefit of another is taxed entirely to the first party.* It is true that under present law, in-kind consumption is included in income in cases where the relationship between the parties is such that (1) the consumption received can plausibly be viewed as the receipt of cash wealth followed by a free spending choice and (2) not taxing the consumption would have the potential to systematically undermine the tax system (for

124. There could be an election out of this rule in a case where *B* is *A*'s surviving spouse. Also, in order to prevent excludable amounts from producing estate tax deductions, there would need to be some rule (such as "first out of the residue") to determine who is deemed to take from *A* the excluded amount.

125. *See* Halbach, *supra* note 11, at 234.

126. The IRS has never attempted to include in-kind support in the recipient's gross income. Cash support was excluded in the early case of *Gould v. Gould*, 245 U.S. 151 (1917), in an opinion devoid of convincing justification other than the implicit assumption that such support could only be taxed once across the transferor-transferee pair. This assumption was codified by the enactment in 1942 of the predecessors of §§ 71, 215.

127. Commentators have offered various schemes, but there seems to be widespread agreement on the general approach. *See* authorities cited in *Consumption Tax*, *supra* note 7, at 587 n.234. *See also* Halbach, *supra* note 11, at 235-36.

128. The cost of an asset is the present value of future returns. In the case of a consumption asset, the future returns take the form of satisfactions known as imputed income and objectively measured by the rental value of the asset.

example, by disguising compensation or dividends).[129] In the present context, the ongoing relationship is present, and there is a danger that transfers of wealth could be cloaked as in-kind consumption, but a consumption exclusion would pose little danger of concealing wage, business, or investment income. Since consumption assets usually decline in value, a strategy of buying expensive consumer assets prior to then transferring them to relatives would entail economic waste. Another consideration is that transfers resulting from separation and divorce and payments of child support would probably continue to be treated under a "single tax" mode.[130] Finally, it would be very difficult for the system to detect consumption expenses and gifts of small-time consumer assets. Therefore, the best income tax approach would be to adhere to the same notion of a consumption exclusion as would operate in any of the transfer taxes. Consideration should be given to extending the consumption-asset exclusion to bequests.

The integrity of the concept of "consumption asset" would need to be maintained by anti-abuse rules. The consumption-asset category would exclude collectibles and other assets of the type that would not be depreciable if held for investment. Personal residences would be on the borderline. There might be a more generous dollar "cap" on such residences compared to caps on other borderline assets, such as expensive motor vehicles. Under the income-inclusion system, an additional weapon is available; any excluded consumer asset would obtain a zero basis, and any sale or rental of a zero-basis asset would constitute a deemed realization event. The same principle could be adapted to an accessions tax in the form of a delayed-accession rule.

Given a consumption exclusion, there would be little reason to provide annual (or lifetime) dollar exclusions for taxable gifts, except possibly to remove trivia from the system that would be hard to enforce in any event. On the other hand, a possible rationale of excluding small cash gifts on an annual basis is that these gifts can usually be viewed as indirect gifts of in-kind consumption.

The categorical and unlimited exemption for bona fide consumption transfers should improve the acceptability of an accessions tax or income-inclusion system to the middle class.

D. THE TIMING OF TRANSFERS AND RECEIPTS

There are complex and separate sets of rules under the present estate tax, gift tax, and income tax for determining when an inter vivos transfer, subject to one or more retained interests and powers, is "complete."

129. JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY: TEXT, CASES, PROBLEMS ch. 4 (2d ed. 1999) (distinguishing between employee fringe benefits, on the one hand, and consumption benefits obtained through promotional and recruitment activities of business, on the other).

130. Sections 71 and 215 assure that such transfers will be taxed once across the payor-payee pair.

These rules operate somewhat like a Richard Strauss tone poem: basically tonal but discordant, with frequent modulations, yet always lush and complex. A gift tax must decide the issue of completeness *ex ante*, and an estate tax cannot defer taxability beyond death. An accessions or income tax can be patient, and wait beyond transfer to actual receipt.

1. Hybrid Transfers Under the Estate (or Inheritance) and Gift Tax

The estate and gift tax rules are overly reliant on property law concepts of "interests." Interests under the estate and gift tax require actuarial valuation,[131] but estate planners can turn actuarial tables to their advantage. The present system encourages devices (such as GRATs, private annuities, and sales of remainder interests) that would never (or hardly ever) be undertaken except to take advantage of current doctrine concerning "hybrid transfers" (inter vivos transfers with retained interests and powers). Since I have previously written about this topic in considerable detail,[132] I shall only summarize my recommendations here.

Basically, an inter vivos transfer should be treated as being incomplete for so long as there is *any* (more than a de minimis) *possibility* that possession or enjoyment or amounts (whether from income or corpus) may be distributed, or might revert, to the transferor or the transferor's estate. Such a possibility need only be inherent in the form of the transfer. Alternatively, any arrangement connected with the transfer (other than an installment sale of the entire property for a fixed dollar amount that is secured by the transferred property) under which future payments will (or may be) made to the transferor should trigger the incompleteness rule. A transfer of this type would be complete when (and to the extent that) the property (including net economic yield therefrom) ceases to be subject to the possibility of enjoyment by the transferor, but no later than the transferor's death. Any consideration received for such a transfer would, at best, reduce the amount included in the tax base dollar for dollar. There would be an exception for commercial transactions (but not private annuities, etc., entered into with family members).

The hard-to-complete rule described above serves three functions. First, it precludes the double taxation of the same amounts to the same taxpayer that would occur if the initial transfer were deemed complete and subsequently amounts derived from that transfer "came back" to the transferor. Second, it avoids inaccurate valuations (under actuarial tables) of transfers of current-enjoyment or remainder interests. Third (but related to the second), it forecloses tax avoidance through the making of "sales" (for full and adequate consideration) of partial interests to related parties, while still allowing the consideration received to offset the amount included in the tax base.

131. *See* I.R.C. § 7520(a) (2002).

132. Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-To-Value Lines*, 43 TAX L. REV. 241, 264-316 (1988) [hereinafter *Redoing*].

On the other hand, transfers with retained powers (and not otherwise within the incompleteness rule just described, such as retained powers to revoke or cause distributions to be made to the grantor) would always be treated as complete upon transfer. The notion of retained control may possess some necessary relevance for income tax purposes,[133] but not for transfer tax purposes. Moreover, current rules pertaining to retained control have been emasculated by judicial decision, and the task of drafting a statute that would effectively distinguish between "benign" and "meaningful" powers would be overwhelmingly difficult.[134]

Employee survivor benefits would always be included in the tax base of the deceased employee at death, whether or not the deceased retained any interest or power, and regardless of any earlier assignments (which would be ignored for gift tax purposes).[135]

Joint tenancies with right of survivorship should be treated as provided under current § 2040, except that the creation of the tenancy by one party should be treated as an incomplete transfer due to his or her retained interests.[136]

2. *Delayed Accessions Under an Accessions Tax*

The basic problem under an accessions tax has to do with the issue of when an accession taking the form of a present or future interest (in trust or otherwise) is deemed received. This problem extends beyond the death of the transferor. Under an accessions tax, actuarial valuation can be systematically avoided.[137] Inclusion would await the time when actual economic benefits are received (the *ex post* approach),[138] because accurate valuation is thereby achieved. This principle also avoids problems with contingent interests or interests subject to forfeiture conditions. Both income distributions and corpus distributions would be treated as accessions.[139]

Although it may be tempting to adopt the *ex ante* approach (or election) for situations where such valuation is reasonably reliable, the temptation should be resisted, since different valuation rules for different types of interests would violate neutrality.[140] About the only situation where an *ex ante* approach may be warranted is an annuity for a term of

133. Control is the key to assignment-of-income doctrine. Kornhauser, *supra* note 5, at 53.

134. *See Redoing*, *supra* note 132, at 309-13.

135. *Id.* at 318-20.

136. *Id.* at 316-17.

137. The wait-and-see approach avoids problems with split-interest charitable transfers, as well. Accessions by charities are ignored under either an accessions tax or an income tax. Under the estate and gift tax, charitable interests must be valued *ex ante*, and complex rules exist in §§ 664, 2055, and 2522 to prevent manipulation of valuation.

138. Andrews, *supra* note 11, at 591-92; Halbach, *supra* note 11, at 221-23.

139. The gratuitous transfer is a transfer of both income and corpus, neither of which is taxed until distribution. Trust income would continue to be subject to income tax according to Subchapter J.

140. Andrews, *supra* note 11, at 597-602.

years (and other term-certain fixed-payment obligations, but excluding unmatured life insurance policies, which have not yet matured).

Ex ante treatment could be adopted for life or term interests in tangible property not held in trust.[141] The alternative would be to "deem" distributions equal to the fair rental value of the property.[142]

Is there any downside to deferral? Although taxable events may be deferred, the aggregate tax base would grow assuming any positive economic return. In aggregate tax-base terms (and assuming no exemptions), the value of a sum in hand that can be invested equals the present value of all future returns from such sum. Assuming a flat rate and no exemptions (and a risk-free investment return), any tax collectible now would equal, in present value terms, the taxes collected later. Since the revenue collected by an accessions tax would be relatively inconsequential in budgetary or economic terms, the deferral of collection is equally inconsequential from the government's point of view. Assuming that the population increases somewhat, the government might lose slightly by the aggregate increase in the number of lifetime exemptions, but this is likely to be outweighed by an increase in aggregate amounts over current exemptions.[143]

Taxpayers would generally prefer to avoid deferral in a climate of fixed-amount exemptions (and progressive rates) because the larger aggregate tax base attributable to a given transferor will be subject to higher tax rates with the passage of time. Of course, this problem would vanish if the accessions tax were imposed at a progressive rate without any lifetime exemption. But assuming either or both the existence of exemptions or flat rates, there would appear to be a disincentive to create long-term trusts. However, such a dis-incentive would not necessarily be a bad thing, for two reasons. First, non-tax legal constraints on the duration of trusts are weakening.[144] Second, it is hard to justify dead-hand control, if it can be justified at all, beyond the horizon of persons known to a transferor.[145] Even if a slight tax disadvantage might attend deferral, it cannot be said with any confidence that decisions concerning the creation of trusts will be affected much by it, especially since the tax disadvantage will occur in the (perhaps distant) future and upon taxpayers other than the transferor. Finally, the possible taxpayer remedies that have

141. *See* Halbach, *supra* note 11, at 261-62.

142. Andrews, *supra* note 11, at 595, 604-05.

143. The ALI Proposal described in Andrews, *supra* note 11, at 595-97, views deferral as a possible problem for the government and suggests it be remedied by imposing an upfront tax on large trusts that operates as a withholding tax, i.e., that is creditable against transferee taxes on grossed-up distributions from the trust. Such a system would operate most smoothly if the ex-ante tax were imposed at a flat rate with no exemptions.

144. John C. Cribbet & Corwin W. Johnson, Principles of the Law of Property 114 (3d ed. 1989); Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends—An Essay*, 35 Real Prop. Prob. & Trust J. 601 (2000).

145. *See* Adam Hirsch & William K.S. Wang, *A Qualitative Theory of the Dead Hand*, 68 Ind. L. Rev. 1, 14-18 (1992) (acknowledging the point but not necessarily reaching the same conclusion).

been advanced to cure the so-called "deferral penalty" are misconceived and would add unneeded complexity. These possible remedies are (1) a tax prepayment option[146] and (2) a rate-freezing option.[147] But it has to be emphasized that deferral under an accessions tax is not a mere rule of convenience that deviates from the norm of a tax being imposed on a transfer. Rather, the *deferral of the taxable event until receipt is the accessions tax principle itself.*

It should be noted that any beneficiary holding a saleable trust interest (or legal present or future interest) could accelerate the taxable event by selling the interest.[148] This possibility might suggest the tax-avoidance device of selling alienable, but highly-contingent, interests to related parties in an effort to accelerate the taxable event. Another problem raised by sales to related parties is that, ordinarily, a purchaser of any such interest for full and adequate consideration in money or money's worth would be an investor, so that actual receipts would not be treated as accessions. The only realistic way of closing this potential loophole would be a rule that essentially disregarded any such related-party sale, on the theory that such a transaction would not be undertaken without a tax avoidance purpose. Moreover, such a *de facto* prohibition would not interfere with any legitimate market. Assuming the sale is not between spouses, the purchase price would be treated as an accession by the seller, and the purchaser could offset subsequent accessions by an amount equal to the purchase price.[149]

In sum, under an accessions tax, deferral of the taxable event would be "the rule," but this feature may weaken its appeal among those favoring the meaningful taxation of gratuitous transfers, even though deferral will typically be accompanied by the dispersion of wealth among multiple beneficiaries.

3. *Delayed Transfers Under an Income Tax*

Similar considerations as apply to an accessions tax apply to an income-inclusion system with regard to present and future interests, in trust or otherwise, but there are three principal differences.

One difference is that, unlike an accessions tax, current income cannot be relegated to limbo until distributed but must (or at least *can*) be attributed to some taxpayer on a current basis. The existing system recognizes this point by treating the trust as a separate taxable entity. Basically, the trust is treated as the taxpayer of last resort to whom income is attributed on a current basis when it cannot appropriately be taxed to the transferor

---

146. Andrews, *supra* note 11, at 602-03. This option would only make sense for certain trusts and under certain assumptions relating to the rate structure, so that it does not comprehensively "solve" any perceived neutrality problem.

147. *See* Halbach, *supra* note 11, at 253-60 (an exemption-leveraging solution), which is critiqued *supra* text accompanying note 120.

148. Andrews, *supra* note 11, at 603.

149. Such a rule would, however, require monitoring, as it would allow tax base shifting between related parties (other than spouses).

during life or to a beneficiary in actual or constructive receipt of the income.[150]

Second, during a trust grantor's lifetime the policy of protecting the progressive rate system may cut in favor of taxing the grantor on trust income not actually received by the grantor. This task is presently performed by the grantor trust rules of §§ 671-77. I have argued elsewhere that the income (and gains) of an inter vivos trust should always be taxed to the grantor while alive, regardless of retained interests and powers.[151] If this option is not followed, I would prefer a reform of the grantor trust rules in the direction of simplification according to two basic principles. First, the grantor should be taxed on the income and gains of a trust if there is any (non *de minimis*) possibility that the income and/or corpus can (directly or indirectly, and by whatever means) revert to the grantor or grantor's spouse (or the estate of either of them).[152] As to retained-power transfers, § 674 is too complex.[153] The rule should be that the grantor should be taxed if the grantor or the grantor's spouse, alone or in conjunction with others, and without regard to the existence or non-existence of standards, can alter the beneficial enjoyment of income and/or corpus.

Second, the basic norm of income taxation is that investments are "after tax."[154] Moreover, under an income-inclusion scheme (as opposed to an accessions tax), the trust, as a separate taxpayer, can plausibly operate as the "stand-in investor" representing the various beneficiaries and their interests, as essentially occurs under present law, because under the income-inclusion approach there would be no per-transferee exemptions for which a trust-level proxy would need to be constructed.

These points would play out as follows with respect to trusts. First, completed transfers into trust (whether in cash or in kind) would be treated as fully included in the income of the trust (possibly subject to a flat rate or some special rate schedule), just as an outright gift or bequest would be treated as gross income in full to any legatee. This tax, which would *not* be treated as a creditable withholding tax pending future distributions, would be implicitly borne by all beneficiaries in proportion to their interests.[155] Second, such inclusion would give the trust an incep-

150. *See* I.R.C. §§ 1(e), 641(b), 651(a), 661(a) (2002) (trust treated as separate taxpayer with tax base equal to trust net income less distribution deduction).

151. Joseph M. Dodge, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 AM. J. TAX POL'Y 127, 150-56 (1997).

152. This principle would combine the rules of §§ 673, 675, 676, and 677(a). A power to obtain the corpus indirectly by non-arm's-length dealings would be considered an indirect possibility. Another indirect possibility is for income or corpus to be paid to legal dependents. Section 677(b), which requires payments to actually discharge a support obligation, should not survive reform.

153. Section 674 provides three tiers of rules, depending on the identity of the trustee, for dealing with the issue of when trustee powers cause the trust to be a grantor trust.

154. In the paradigm situation, where an investment is purchased, the cost of an investment (acquired with dollars, such as salary, previously subject to tax) is a non-deductible capital expenditure.

155. *See Consumption Tax*, *supra* note 7, at 592.

tion-value basis in the trust assets for income tax purposes. Third, following inception the system would (perhaps with some modifications) operate along the lines of current Subchapter J, under which distributed current income is taxed to the distributees, nondistributed current income is taxed to the trust, and non-income distributions are tax-free to distributees. This system would avoid the indefinite deferral of tax on corpus.

E. Powers of Appointment

Under the estate and gift tax, the possession of a general power of appointment is treated as ownership for estate and gift tax purposes, so that the lapse (at death or otherwise), exercise, or release of such power is treated as a transfer for estate and/or gift tax purposes.[156] The term "general power of appointment" is a power to obtain the property (free of any trust) or vest it in oneself, one's estate, or the creditors of either, but there are exceptions for powers subject to certain ascertainable standards or which are jointly held with adverse parties (or the creator of the power).[157] There appears to be no compelling reason to substantially alter this scheme in the context of an estate or inheritance tax.

Prior accessions tax proposals would have treated the acquisition of a general power of appointment (however defined) as an immediate accession of the underlying property under a constructive ownership theory.[158] This approach, however, is inconsistent with the principle that the acquisition of a trust interest is not itself an accession. Certainly, a general *testamentary* power is hard to distinguish from a remainder interest. There are additional reasons for not following the traditional approach. First, although the concept of a general power of appointment is useful (and perhaps necessary) under the current federal transfer taxes as a means to identify transferors, under an accessions tax such a purpose is irrelevant. Second, a general power of appointment could be used to accelerate accessions tax (that is, to negate deferral), if the holder of the power also held one or more beneficial interests in the trust. Third (and outside of the anti-deferral context), if the acquisition of a general power of appointment were treated as an accession with no compensating tax benefit (as typically occurs under the current transfer taxes),[159] then nobody would create such a power (or, stated differently, the general power of appointment concept would become a trap for the unwary). Fourth, transfer tax law would be simplified if the concept were rendered irrelevant. Thus, the accessions tax should attribute no significance to the possession, expiration, lapse, or release of a general power. If the exercise of

156. *See* I.R.C. §§ 2041(a)(2), 2514(b) (2002).

157. *See* I.R.C. §§ 2041(b)(1), 2514(c) (2002).

158. *See* Andrews, *supra* note 11, at 595; Halbach, *supra* note 11, at 237.

159. Compensating tax benefits include qualification for the marital deduction, qualification for gift tax annual exclusions, and avoiding the GST. Under an accessions tax, treating the acquisition of a general power of appointment as an accession would not prevent trust distributions to other persons from being treated as taxable accessions.

a power causes a distribution, the accession attributable to the distribution would be charged to the recipient.

Under the current income tax, the possession (by a person alone) of an unrestricted power to currently obtain the income and/or corpus of a trust causes the current income to be taxed to the holder of the power under § 678. Under an income-inclusion system that follows Subchapter J in part, § 678 could be used to facilitate tax avoidance, because a low-bracket person could be given an inter vivos general power of appointment so as to "attract" income to such person rather than the trust or the actual distributees. Accordingly, § 678 should be repealed.

F. Life Insurance

Under an estate or inheritance tax, there are various possible bases for taxing life insurance proceeds to the insured's estate: (1) the insured's involvement in "taking out" the policy, (2) the insured's payment of premiums, and (3) the insured's rights in, and powers over, the policy at death. The first two have been tried and abandoned due to the difficulty of ascertaining the facts and sorting out their significance,[160] leaving the third as the current basis of taxation, but the third is not without problems of its own.[161] If the third approach is retained, the statute should be clarified. Another possibility is to move to a rule that life insurance proceeds are per se included in the gross estate of the insured, which would be based on the theory that the death of the insured brings the proceeds into being and that in virtually all cases the insured was involved in procuring, maintaining, and/or controlling the policy and its disposition.

The problem of connecting the proceeds to the insured or to premiums vanishes under a transferee-based tax. The receipt of life insurance proceeds by a non-owner of the policy would be gross income under an income tax and an accession under an accessions tax.

An issue would be whether the receipt of proceeds is an accession under the accessions tax where the beneficiary is also the owner of the policy.[162] In theory, the resolution of this issue would depend on how the

---

160. For example, the significance of premium payments clearly differs between pure term insurance and ordinary life insurance, and in the latter case all premium dollars should not be weighted the same. *See Substantial Ownership*, *supra* note 102, at 702-12; Douglas A. Kahn & Lawrence W. Waggoner, *Tax Consequences of Assigning Life Insurance—Time for Another Look*, 4 FLA. TAX REV. 381 (1999).

161. Under § 2042, the proceeds are included in an insured's estate by reason of the possession by the insured at death (or within 3 years of death) of "incidents of ownership" over the policy (or the proceeds being payable to the insured's estate). As a result of the Second Circuit's decision in *Estate of Skifter v. Comm'r*, 468 F.2d 699 (2d Cir. 1972), the Service issued Rev. Rul. 84-179, 1984-2 C.B. 195, holding that the term "incidents of ownership" possesses a different meaning according to whether the insured retained them or acquired them by other means. In my opinion, this distinction has no basis in the text of § 2042, the regulations, the legislative history, or relevant case law.

162. The accessions tax proposals virtually ignore the life insurance issue, and simply assume that the estate and gift tax approach would carry over. *See* Andrews, *supra* note 11, at 591; Halbach, *supra* note 11, at 294.

person acquired the policy. If the uninsured person acquired the policy by gift or bequest, the transaction would be viewed as the equivalent of the gratuitous acquisition of a remainder interest, which would be a non-taxable event, and the receipt of the proceeds would be a taxable accession. If the policy were purchased, then receipt of the proceeds would not be an accession. However, a rule distinguishing gifts from purchases would create an open invitation to avoid accessions tax by the insured selling the policy to a relative.[163] The only way that such a device can be realistically avoided[164] is to treat all life insurance proceeds received (directly or indirectly) by a person outside of a commercial context as being taxable, with a consideration offset equal to amounts paid to acquire or maintain the policy.

Under an income-inclusion system there would be little harm in following the purchase-gift distinction, since in both cases the proceeds would be includable by the recipient subject to appropriate basis offset.

G. Valuation

Under any form of wealth transfer tax, there are two basic conceptual issues pertaining to valuation. One is whether property should be valued as if it were changing hands in an arm's length market transaction or instead should be valued taking into account the facts surrounding the transfer (such as family relationships). The present estate and gift tax has taken the first approach, which is known as the willing-buyer-willing-seller test.[165] The second issue relates to situations where the transfer (or death causing the transfer) itself may affect the value of the property. Here, four possible valuation principles present themselves: (1) the value of what the transferor had just prior to the moment of death, (2) the value of what the transferees severally receive, (3) the greater of the two, or (4) the lesser of the two. Judicial and administrative output appears to have evolved towards the lesser-of-the two approach, although this can hardly be said to be a clear rule.[166] Indeed, confusion is understandable if the current command to value assets "at death" is taken seriously, since, if there is such an "instant," it has no "duration."[167] An asset can be meaningfully valued at the moment just prior to death (ignoring the

163. The problem here is basically the same as that of selling a trust interest to a relative. *See supra* note 146 and accompanying text. .

164. The purchase-gift distinction is hard to sort out in practice, since the insured may give or lend cash to the related-party purchaser "under the table," or pay premiums after the putative purchase.

165. Treas. Reg. §§ 20.2031-1(b), 25.2512-1.

166. *Compare* Goodman v. Granger, 243 F.2d 264 (3d Cir. 1957), *cert. denied*, 355 U.S. 264 (1957), *and* Estate of Harrison v. Commissioner, T.C. Memo. 1987-8 (looking to what legatee received), *with* Ahmanson Found. v. United States, 674 F.2d 761 (9th Cir. 1981) (looking to what decedent had).

167. The lesser-of-the-two approach might be based on the supposition that the estate tax is imposed on the value of property as it passes from a decedent to a legatee, as § 2031(a) requires valuation "at the time of death." *See* Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) (holding that valuation must be made without regard to facts occurring *after* death). Arguably, the so-called loss-of-key-man discount, see Moskowitz v.

fact of actual death) or just after death (taking death into account, if not events subsequent to death), but the concept of a value "at" death has no "real world" meaning.

1. Valuation Under a Transferor-Oriented Tax

It is arguable that the present estate and gift tax has resolved these issues in precisely the wrong way. Thus, the value of property in a particular person's estate should depend on the facts and circumstances surrounding the actual transfer, not some analytical construct possibly divorced from reality. Nevertheless, only objective facts and circumstances should be considered.

Moreover, a transferor-oriented tax should be based on what the transferor had, not what the various transferees receive individually.[168] Plain meaning interpretation of the statutory statement that the tax is on the estate "of the decedent" (not the decedent's successors) should have guided interpretation in the direction of the "value of what the transferor had" principle.[169] However, the present estate and gift tax has instead looked to the value of what the transferees severally obtain on the theory that "valuation inherently looks to the future."[170] This statement is true in the sense that the value of an asset is largely a function of discounting future returns to the present. However, the statement ignores the issue of *what assets* are to be so valued, and under a transferor-oriented tax, it is the assets owned by the transferor, not the assets received individually by transferees. Thus, the rule should be that assets are to be valued at the moment just prior to death (or gift) disregarding the actual fact of death or gift.[171]

Even one who disagrees with one or both of the previous points might feel that there is internal inconsistency within current doctrine. That is, if a "hypothetical market transaction" test is adopted as a guiding principle with respect to the underlying property, then the fact of death would seem to be irrelevant, or vice versa.

Conceptualisms aside, instrumental concerns should also play a role in valuation doctrine. One problem is that the factual flavor of many valuation cases imposes heavy transaction costs on the parties and the system.

United States, 76-1 USTC ¶ 13,117 (N.D.N.Y. 1975), is illegitimate, since the consequences of the loss occur after death.

168. This statement has principal relevance to (1) the situation where minority interests in enterprises are created by the act of transfer and (2) situations where restrictions depressing value appear (or disappear) by reason of the transfer. These situations are discussed below.

169. Similarly, the statutory command under the gift tax is the "value at the date of gift," *see* I.R.C. § 2512(a) (2002), and the gift tax is imposed on the "transfer of property by gift," *see* I.R.C. § 2501(a)(1) (2002).

170. United States v. Land, 303 F.2d 170, 173 (5th Cir. 1962).

171. Such a rule would appear to be inconsistent with the § 2033 rule that the value of present or future interests that terminate at death is zero, but there is really no inconsistency, because in these cases the asset itself is an interest that terminates or lapses at death, whereas otherwise the assets do survive the transfer.

Therefore, one should look to the possibility of designing fair or appropriate rules of substance and procedure to reduce such costs. Second, a system that encourages the actual destruction of wealth, or transactions that appear to destroy wealth (but actually do not), is a bad system.[172] Third, transactions that would be unheard of or rare in the absence of transfer tax should not be treated as legitimate or having substance.

These principles and concerns can be played out under a transferor-oriented tax in various ways. Since I have recently offered some suggestions along these lines concerning such familiar issues as enterprise valuation, the blockage rule, lack-of-marketability discounts, and minority-interest discounts,[173] it would serve little purpose to repeat them here. I would only add that any restrictions (direct or indirect, such as through the interposition of an entity)[174] on the liquidation of the enterprise or the alienation of any interest therein should generally be viewed with suspicion, just as are other restrictions on alienation.[175] Since self-imposed restrictions that depress value are against the economic self-interest of the transferor and/or her successors, a presumption should arise that they would not have been imposed except to avoid tax. Therefore, any present or future restriction imposed during the transferor's lifetime (or when owned by a person from whom the asset was obtain by one or more gratuitous transfers) should be disregarded unless the transferor's representative can prove that tax avoidance was not a significant purpose.[176] Only legitimate "business" reasons would be allowed as justification for taking such a restriction into account.[177] A reason relating to "preserving going concern value" should not be given credence unless going concern value is demonstrably greater than liquidation value in the absence of the restrictions. A reason relating to "continuity of family involvement (or family control)" should not be considered as a *business* reason at all.

Until the enactment of § 2703 in 1991, the value of an asset could often be depressed by entering into an enforceable contract that restricted the alienation of the interest, typically by allowing a (related) person to purchase the asset for a price below actual fair market value. Section 2703 operates to disregard agreements of this type, but there is an exception where the agreement is a bona fide business arrangement (and its terms are comparable to similar agreements entered into at arm's length)

172. Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978).

173. *See Deemed Realization*, *supra* note 6, at 488-94.

174. This is a back-handed way of referring to the use of investment holding companies.

175. Section 2704(a) roughly conforms to the idea stated in the text. Under that section, the lapse of valuable rights is treated as a gratuitous transfer. The lapse of a valuable right is equivalent to the imposition of a restriction.

176. Compare § 2704(b), which causes restrictions on liquidation to be disregarded, but only if (1) they will (or may) drop off at or after the transfer and (2) the restriction is not imposed by State or Federal law. This last qualification renders § 2704(b) largely ineffective.

177. *Cf.* I.R.C. § 2703(b) (2002) (restrictions relating to the transferor's interest in the enterprise).

and the agreement is not a device to transfer value to family members for less than full and adequate consideration in money or money's worth. But, objectively, *any* bargain sale to a relative (within the requisite degree of relationship) operates as a gratuitous transfer to such person, and it is far easier to accurately value this transfer when the bargain purchase occurs than when the restriction is imposed. Hence, the bona-fide-business-arrangement concept should never justify a discount keyed to a restriction on alienation when the buyer is a "family member" (however defined) or a natural object of the taxpayer's bounty. Only if there is conflicting evidence as to the relationship between the parties should the concept of a bona fide business arrangement possess relevance.

In an entity estate freeze, the owner of a controlling interest in a closely-held entity carves out a senior equity interest (such as preferred stock) that "hogs" the value of the enterprise by virtue of carrying a high fixed rate of return, leaving the junior equity (hopefully with a high appreciation potential) with a zero or low value. The owner then makes a gift of the low-value junior equity and retains the senior equity (the value of which is essentially frozen). Present § 2701 "attacks" such a device mainly by treating the gift of the junior equity as being also a gift of the retained senior equity. This results in double estate and gift taxation of the same property (the senior equity). In my view, § 2701 imposes too harsh a remedy, but at the same time it is too easy to avoid.[178] Entity estate freeze transactions appear to have been uncommon until their tax avoidance potential was publicized.[179] Entity estate freezes are similar to gifts (and sales) of remainder interests and should be treated similarly. That is, the gift of the junior equity should be treated as incomplete until the death of the donor or such earlier time as the donor or donee (with attribution rules) ceases to have a significant interest in the enterprise.[180]

2. *Valuation Issues Under an Accessions Tax*

Although many of the same valuation issues and possible solutions described above would also arise under an accessions tax, there would be some significant differences attributable to the fact that an accessions tax is explicitly imposed upon what the transferee receives, not on what (if anything) the transferor had. The following would all be treated as gratuitous accessions without regard to any alleged business purpose: (1) a bargain purchase from a person to whom the transferee is a natural object of the person's bounty, (2) the lapse of a restriction imposed while a related party was the owner, and (3) the acquisition of a majority interest by one or more accessions, or in combination with property already owned by

178. Section 2701 can be avoided by assuring that payments on the senior equity are (essentially) guaranteed, the theory being that a mandatory pay-out interest (and by subtraction the junior equity interest) can be accurately valued.

179. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 195-204 (1977).

180. This was the approach taken by § 2036(c), enacted in 1987, but was repealed in 1991 in conjunction with the enactment of § 2701.

the transferee. In addition, restrictions imposed by, or with the agreement or connivance of, the transferee or other related party should be disregarded, unless it can be shown that the restriction would have been imposed for business (but not family-control) reasons in the absence of accessions tax. On the other hand, the case for recognizing minority-interest discounts in this context appears somewhat stronger than under an estate tax, unless a policy decision is explicitly made to impose family attribution rules.

An accessions tax can more effectively combat entity estate freezes than an estate tax. Whereas the estate tax can deem the gift of junior equity to occur no latter than the donor's death, under an accessions tax the accession can be delayed until the donee disposes of junior equity, even if such disposition occurs after the donor's death.

3. *Valuation Under an Income-Inclusion System*

Valuation under an income-inclusion system would operate along the same lines as under an accessions tax. However, the income tax is more flexible than an accessions tax insofar as inclusion can be delayed indefinitely in the case of certain hard-to-value or politically-favored in-kind assets (closely-held business interests and so-called family farms) by means of giving such assets a zero basis, pending a subsequent recognition event (sale, exchange, event rendering valuation possible, or termination of qualification).[181]

III. CONCLUSION: IS THE ACCESSIONS TAX REALLY THE BEST ALTERNATIVE?

One of the more controversial aspects of this contribution is the argument that the generation-skipping problem is illusory. Whether or not this thesis is accepted on the merits, eliminating generation-skipping-tax features from the federal transfer taxes, an accessions tax, and/or an income-inclusion system greatly simplifies these systems.

The accessions tax and income-inclusion systems are advantaged over even a reformed and simplified estate and gift tax not only in being easier to justify in terms of functions and goals but also by being able to operate *ex post*, which eliminates certain valuation problems and simplifies qualification rules with respect to marital transfers. Initially it might appear that the major difference between the two systems has to do with exemptions and rates. However, closer examination of the purposes of an accessions tax, in combination with the point that any of these systems should possess a basically unlimited exclusion for consumption-type inter vivos gifts (and perhaps bequests), undermines the assumption that lifetime exemptions are a necessary feature of an accessions tax or that ex-

181. For a discussion of possible eligibility rules, see *Deemed Realization*, *supra* note 6, at 515-18. Conceivably, a delayed-accession analogue could be designed for an accessions tax.

emptions and rates should be keyed to prior accessions rather than other annualized income. At the same time, although an unlimited marital exclusion is easy enough to justify under the income-inclusion approach, it would be fundamentally incompatible with an accessions tax approach. Although tax-free wealth splitting between spouses would be allowed under an accessions tax, such a system would entail complications and administrative problems that would be absent from an income-inclusion approach. Finally, an income-inclusion approach would treat transfers to a trust as an accession by the trust itself (which would operate thereafter according to the Subchapter J rules), whereas under an accessions tax the taxable event, could be indefinitely delayed until distribution, unless a withholding-credit system is interposed.

In sum, the income-inclusion approach appears to be the simplest possible system and, with an unlimited marital exclusion and integration with Subchapter J, the system that would seem most familiar and comfortable to laypersons and tax experts alike as a substitute for the federal transfer taxes. In any case, the accessions tax and income-inclusion system, both being keyed to gratuitous receipts, would be operationally so similar that it would be tempting (and easy) to combine the two, or to use one to supplement the other.