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RETHINKING GENERATION-SKIPPING TRANSFERS

by
Howard E. Abrams*

GRATUITOUS transfers to generationally remote beneficiaries traditionally have been perceived as tax avoidance devices available only to the wealthy. For most taxpayers wealth is passed from generation to generation in fee simple absolute, with a federal transfer tax paid each generation. The very wealthy, though, use cascading life estates¹ and special powers of appointment² to approximate outright transfers while avoiding the periodic imposition of transfer tax.

Chapter 13 of the Internal Revenue Code,³ technically entitled the "Tax on Certain Generation-Skipping Transfers," speaks to these tax avoidance devices of the wealthy, imposing an extra tax on gratuitous transfers to beneficiaries in multiple generations. The first generation-skipping tax, enacted as part of the Tax Reform Act of 1976,⁴ proved unworkable because of ad-

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1. A cascading life estate includes all transfers in which ownership is divided among one or more holders of life estates as well as remainder beneficiaries. The shortest cascading life estate is a transfer from *A* to *B* for life, then to *C* in fee. The longest is a fee tail, prohibited in most states. See generally 3 A. CASNER, ESTATE PLANNING 1126-38 & n.157 (4th ed. 1980) (discussion of rule against perpetuities).

2. A power of appointment over property is a power to appoint [direct] the trust property by a deed or by will, and the power of appointment may be unlimited as to the objects to whom the appointment can be made, including the donee of the power or the donee's estate as a possible appointee, or it may be limited as to the objects of the power with the donee of the power and the donee's estate excluded as objects.

RESTATEMENT (SECOND) OF PROPERTY (DONATIVE TRANSFERS) § 1.2 comment d (1983). The Internal Revenue Code defines a general power of appointment to be any power of appointment other than certain powers limited by an ascertainable standard or exercisable only in conjunction with another person, I.R.C. §§ 2041(b)(1), 2514(c) (1986), for which the class of permissible appointees includes one or more of the following: the power holder, the power holder's creditors, the power holder's estate, or creditors of the power holder's estate. *Id.* The holder of a general power of appointment is, in general, taxed under federal estate and gift tax provisions as an outright owner. *But see id.* §§ 2041(b)(2), 2514(e). A special power of appointment is any power other than a general power of appointment; in other words, a special power of appointment is any power not treated as the equivalent of ownership under the estate and gift taxes. See R. CAMPFIELD, ESTATE PLANNING AND DRAFTING ¶ 11,067, at 399 (1984).

3. I.R.C. §§ 2601-2622 (1986).

4. Pub. L. No. 94-455, §§ 1879-1890, 2600-2622, 90 Stat. 1520.

ministrative difficulties.⁵ The American Bar Association has proposed outright repeal, while the American Law Institute (ALI) and the Treasury Department have favored the slightly less radical alternative of replacing chapter 13 with an entirely new tax.⁶ In fact, Congress has amended chapter 13 as part of the Tax Reform Act of 1986⁷ in ways similar to those proposed by the ALI and the Treasury Department while still retaining most of the basic structure of the generation-skipping tax.

The generation-skipping taxes proposed by the Treasury and the ALI are similar in most major respects. In particular, both reject the premise that a single gratuitous transfer will support only a single layer of transfer taxation. For example, if a donor devises property in fee simple absolute to a grandchild (this devise is called a direct skip), the property so devised will be subject to the federal estate tax. Because the property is subject to estate taxation, the pre-1986 generation-skipping tax would not also have been applicable.⁸ The Treasury and the ALI proposals, as well as the recently amended law, would subject this devise to a second layer of taxation despite the single gratuitous transfer.⁹

The two proposals share another similarity: each is needlessly complex. These proposals, like all prior generation-skipping tax proposals, see the basic generation-skipping tax problem as a deficiency in the federal estate and gift taxes.¹⁰ Accordingly, the proposals recharacterize generation-skipping transfers in ways that allow traditional transfer taxation principles to be applied. Such recharacterization techniques work well in the context of cascading life estates, which are perceived as the paradigmatic generation-skipping abuse, but the techniques are less appropriate when applied to other generation-skipping transfers such as the direct skip. Unfortunately, the recent tax reform fails to move away from the recharacterizations enacted as part of the 1976 generation-skipping tax law and continued in the ALI and Treasury Department reforms.

This Article will demonstrate that cascading life estates and similar arrangements present no generation-skipping abuse. In fact, the need for any kind of generation-skipping tax is much smaller than has been thought: if a generation-skipping problem exists, it occurs only in transfers akin to the direct skip. Yet, these direct skip transfers are precisely the transfers that do not fit into the proposed alternatives to chapter 13. Once the generation-

5. See Stephens & Calfee, *Skip to M'Loo*, 32 TAX L. REV. 443, 450 (1977); Verbit, *Annals of Tax Reform: The Generation-Skipping Transfer*, 25 UCLA L. REV. 700, 729, 736-37 (1978).

6. *Additional Estate and Gift Tax Issues: Hearings Before the Subcomm. on Estate and Gift Taxation of the Senate Comm. on Finance*, 97th Cong., 1st Sess. 112 (1981) (statement of David R. Brink, President of the American Bar Ass'n); see also Anderson & Fitzpatrick, *Tax Information Disclosures Under the Generation-Skipping Tax: Due Process vs. Right of Privacy*, 32 U. FLA. L. REV. 62, 94 (1980) (violations of deemed transferor's privacy under ch. 13 could lead taxpayers to conceal information in tax returns).

7. Pub. L. No. 99-514, §§ 1431-1433, 100 Stat. 2085.

8. See I.R.C. §§ 2613(a)(4)(B), 2613(b)(5)(B) (1982) (repealed 1986).

9. See I.R.C. §§ 2601, 2611(a)(3), 2612(c) (1986).

10. See *infra* text accompanying notes 11-28.

skipping problem is reoriented to focus on the direct skip, drafting a simple generation-skipping tax becomes possible.

I. THE GENERATION-SKIPPING PROBLEM: TRADITIONAL VIEW

At least since 1946, cascading life estates have been identified as a generation-skipping problem. Professor Eisenstein stated:

If . . . *A* bequeaths his property [in trust] to *B* and *B* thereafter bequeaths the property to *C*, the government collects an estate tax when *A* dies and another estate tax when *B* dies. If, however, *A* bequeaths his property in trust so that *B* receives the income for life and *C* is given the remainder, the government collects a tax when *A* dies but collects nothing when *B* dies. . . . I cannot understand why the government's toll should be affected because *C* happens to obtain possession and enjoyment as a remainderman under *A*'s trust rather than as a beneficiary under *B*'s will.¹¹

Eisenstein's suggested remedy was to include the value of the trust corpus in the taxable estate of *B*, the life tenant.¹² This solution treated the life estate as sufficiently akin to outright ownership to justify equivalent taxation, an approach used throughout the federal estate tax to justify estate taxation of lifetime transfers that are functionally equivalent to testamentary transfers.¹³ In fact, a taxpayer who gratuitously transferred property, but retained a life estate in the property, had long been taxed at death as if he had made no lifetime transfer.¹⁴ Nonetheless, no further concern with generation-skipping transfers was expressed during the 1940s.

The generation-skipping problem resurfaced in the 1950 congressional hearings on estate and gift tax reform,¹⁵ and the problem attracted increasing attention after Stanley Surrey's 1950 article on estate and gift tax reform.¹⁶ Armed with impressive statistics showing that almost one-half of all property in large estates was transferred in trust, and that three-quarters of that value skipped the estate tax of one or more generations,¹⁷ Professor Surrey argued in favor of "enter[ing] upon a brave new world of transfer taxation—the taxation of life interests."¹⁸

11. Eisenstein, *Modernizing Estate and Gift Taxes*, 24 TAXES 870, 872 (1946). In 1944 William Vickrey made a step in the direction of taxing cascading life estates by suggesting that the transfer tax burden should not turn on the number of transfers during any one period but rather on the length of time between transfers. Vickrey, *An Integrated Successions Tax*, 22 TAXES 368, 369-79 (1944).

12. Eisenstein, *supra* note 11, at 872. Eisenstein derived his suggestion from the English estate duty, which included the trust corpus in the estate of the life tenant. *Id.*

13. See I.R.C. §§ 2035-2038 (1986). See generally S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION* 271-72 (2d ed. 1982) (Congress implemented unified transfer tax rate structure to equalize taxation of lifetime and testamentary gifts).

14. I.R.C. § 2036(a)(1) (1986).

15. *Hearings on Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 23 (1950).

16. Surrey, *An Introduction to Revision of the Federal Estate and Gift Taxes*, 38 CALIF. L. REV. 1 (1950).

17. *Id.* at 18; see also C. SHOUP, *FEDERAL ESTATE AND GIFT TAXATION* 39-41 (1966).

18. Surrey, *supra* note 16, at 18.

One significant contribution Professor Surrey made in his article was his analysis of the generation-skipping transfer in which an estate for a term of years is used instead of a life estate, such as *A* transfers property to *B* for twenty years, then to *C* in fee. Professor Surrey suggested that *B* might be taxed as if he makes a gift to *C* at the end of the term interest.¹⁹ In so doing, Professor Surrey implicitly argued in favor of treating an income beneficiary as an outright owner for transfer taxation. The 1976 generation-skipping tax incorporated the Surrey approach. If a grantor established a trust with a generationally remote beneficiary, and if a member of an intervening generation also had an interest in the trust, then a generation-skipping tax was imposed on the termination of the intervening generation's interest.²⁰ Thus, a gift given in trust for the benefit of a child for any period, then given to a grandchild in fee, was subjected to the generation-skipping tax at the termination of the child's interest. Furthermore, the amount of the generation-skipping tax was computed by treating the child as if he had made an actual transfer, with either gift or estate tax rates used depending on whether the child, the deemed transferor,²¹ was alive or deceased at the time of the deemed transfer.²²

The 1976 generation-skipping tax went one step beyond Professor Surrey, however, by imposing a generation-skipping tax even if no member of an intervening generation had an interest in the trust: the tax occurred even when a member of an intervening generation merely had a power over the trust.²³ For example, a transfer in trust for the benefit of grandchildren, with the child given the power to accumulate or distribute trust income, was subjected to the generation-skipping tax because of the child's power over the beneficial enjoyment of the trust. This extension was anything but radical: the estate and gift tax provisions are replete with sections that treat a power to affect beneficial enjoyment of property as the taxable equivalent of outright ownership.²⁴

19. *Id.* at 20.

20. See I.R.C. § 2613(b)(1) (1982) (repealed 1986). Under *id.* § 2613(b)(2) the generation-skipping tax consequences of a taxable termination are postponed when the termination of a beneficiary's interest does not represent the termination of all interests of beneficiaries in the same or higher (i.e., older) generations.

21. *Id.* § 2612(a) defined a deemed transferor as

(1) except as provided in paragraph (2), the parent of the transferee of the property who is more closely related to the grantor of the trust than the other parent of such transferee (or if neither parent is related to such grantor, the parent having a closer affinity to the grantor), or

(2) if the parent described in paragraph (1) is not a younger generation beneficiary of the trust but 1 or more ancestors of the transferee is a younger generation beneficiary related by blood or adoption to the grantor of the trust, the youngest of such ancestors.

22. See *id.* § 2613(b)(1).

23. Although almost any power to affect the beneficial enjoyment of property placed in a generation-skipping trust was treated as a taxable power for purposes of the generation-skipping tax, *id.* § 2613(d)(2), a power restricted to disposing of trust property in favor of lineal descendants of the grantor, *id.* § 2613(e)(1), as well as many powers of independent trustees, *id.* § 2613(e)(2), were nontaxable.

24. Although virtually all retained powers are equated with ownership under the estate and gift taxes, powers given to third parties, except in the context of the generation-skipping

In essence the 1976 generation-skipping tax provided that any transfer to a generationally remote beneficiary that also vested a member of an intervening generation with some interest in or power over the property would be recharacterized and taxed as if the transfer followed the more normal course from transferor to member of the intervening generation to generationally remote beneficiary. The Treasury and the ALI propose to extend the reach of the generation-skipping tax by taxing transfers made to generationally remote beneficiaries even if no member of an intervening generation has an interest in or power over the transferred property. The Treasury and the ALI thus propose to tax direct skips such as outright devises from a grandparent to a grandchild.

Generation-skipping taxation of direct skips is not a new concept. In 1969 the Treasury proposed a generation-skipping tax that included the taxation of direct skips.²⁵ An ALI proposal at that same time included taxation of direct skips as one of seven alternative possibilities.²⁶ The law eventually enacted in 1976 as chapter 13 of the Internal Revenue Code²⁷ deviated substantially from the Treasury proposals in ways that made the generation-skipping tax more closely approximate the estate and gift tax that would be paid if the donor transferred the property in normal ways that did not skip generations.²⁸ Since direct skips do not closely resemble a "normal" multi-generational transfer, Congress put them beyond the reach of chapter 13.

Both the Treasury and the ALI propose to reverse this rule by imposing a generation-skipping tax on direct skips. The Treasury and the ALI justify this approach not as an end in itself but rather as the only way of ensuring the integrity of generation-skipping taxes.²⁹ Cascading life estates closely

tax, are generally ignored unless they are substantial. Compare I.R.C. § 2036(a)(2) (1986) (gross estate includes transferred property over which decedent retained right to designate those who will get property or income) and *id.* § 2038(a)(1) (gross estate includes transferred property over which decedent retained right to alter, amend, revoke, or terminate the transfer) with *id.* § 2041 (existence of special power of appointment at death or exercise or release of special power of appointment during life in manner similar to transfer of property does not cause property subject to power to be included in gross estate).

25. STAFF OF SENATE FINANCE COMM. AND HOUSE WAYS AND MEANS COMM., 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS 393-400 (J. Comm. Print 1969) (drafted by U.S. Treasury Department) [hereinafter U.S. TREASURY DEPARTMENT].

26. AMERICAN LAW INSTITUTE, FEDERAL ESTATE AND GIFT TAXATION 26-31, 169-72 (1969) [hereinafter ALI RECOMMENDATIONS].

27. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1879-90.

28. See Verbit, *supra* note 5, at 718-19.

29. In testimony before the House Committee on Ways and Means then acting Assistant Secretary for Tax Policy to the Department of the Treasury Ronald A. Pearlman justified this shift in policy:

[W]e have concluded that the only way to impose a generation-skipping transfer tax that is an effective backstop to the estate [and] gift tax system, but that also results in a fair and neutral system, is to impose a tax at each generation regardless of whether a member of that generation has an interest in or power over that property.

If a generation-skipping transfer is imposed on transfers from a grandparent directly to a grandchild, a so-called direct skip, property passing from the grandparent to the grandchild will always be subject to tax.

This makes the system neutral because taxpayers with accumulations of wealth are free to let nontax considerations determine how they pass their

resemble outright devises and, for that reason, will be taxed like outright devises under the proposed generation-skipping taxes.³⁰ Because direct skips can substitute for cascading life estates, direct skips also must be subject to the generation-skipping tax.

The way in which the proposals tax direct skips confirms that the drafters viewed direct skips as generation-skipping loopholes.³¹ Both the Treasury and the ALI propose to recharacterize direct skips as a transfer from the donor to a fictional trust followed by a distribution from the fictional trust to the donee. Having recharacterized one generation-skipping transfer as two conventional transfers, the proposals then subject each of the two transfers to transfer taxation.³² This recharacterization of one generation-skipping transfer into two "normal" transfers is precisely the approach taken by the 1976 generation-skipping tax with respect to intervening life estates and powers.³³

As amended by the Tax Reform Act of 1986, chapter 13 taxes direct skips as well as transfers in which a member of an intervening generation has an interest in or power over the transferred property.³⁴ The Act also eliminates the incorporation of the estate and gift tax progressive rate structure into the generation-skipping tax, using instead a simpler, nonprogressive rate structure.³⁵ This change in rates allows the generation-skipping tax to be imposed without reference to a deemed transferor and without explicit

wealth down to their families. That is, if they want to use trusts, they can use trusts. If they want to pass assets directly to grandchildren they can do that. And the tax system will not affect that judgment.

...
... [I]t is frequently argued that if the property is transferred in a direct skip from grandparent to grandchild, there is only one transfer. So there should only be one tax. This argument has an intuitive appeal perhaps, but misses the essential point. And that is that imposition of a [generation-skipping tax] on direct skips is necessary for the transfer tax system to work properly.

*Generation-Skipping Transfer Tax: Hearing Before the House Comm. on Ways and Means, 98th Cong., 2d Sess. 7-8 (1984) [hereinafter *Generation-Skipping Transfer Tax Hearing*] (statement of Ronald A. Pearlman).*

Those testifying at the Hearing included: Ronald A. Pearlman, Acting Assistant Secretary, Tax Policy, Department of the Treasury; Harry L. Gutman, Professor of Law, University of Pennsylvania, and Reporter, American Law Institute Project on Generation-Skipping Transfers; Marshall L. Zissman, Senior Trust Counsel, First National Bank of Chicago, on behalf of American Bankers Association; Malcolm A. Moore, Chairman, Estate and Gift Tax Committee, American College of Probate Counsel; Jackson M. Bruce, Jr., Chairman, Section of Real Property, Probate and Trust Law, American Bar Association.

Representatives of the ALI and the American Bankers Association made similar comments to the Committee. See *id.* at 35-36 (statement of Professor Harry L. Gutman); *id.* at 269 (statement of Marshall L. Zissman).

30. See I.R.C. §§ 2601, 2611(a)(2), 2622 (1986).

31. See J. PECHMAN, *FEDERAL TAX POLICY* 239 (4th ed. 1983); Bloom, *The Generation-Skipping Loophole: Narrowed, But Not Closed, By the Tax Reform Act of 1976*, 53 WASH. L. REV. 31, 33-38 (1977); Dodge, *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. PA. L. REV. 1265, 1267-71 (1977).

32. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 119 (supplement to statement of Professor Harry L. Gutman); *id.* at 253 (Treasury proposal).

33. See Verbit, *supra* note 5, at 718-19.

34. See I.R.C. §§ 2601, 2611(a)(3), 2612(c) (1986).

35. See *id.* §§ 2601, 2611(a)(1)-(2).

recharacterization of generation-skipping transfers into multiple, nonskip-ping transfers. Despite these changes, the structure of chapter 13 is fundamentally unchanged: generation-skipping taxation is justified as filling holes in the estate and gift tax provisions, and operation of the tax is based upon the taxation that would result if multiple, normal transfers in fee replaced the generation-skipping transfer.³⁶

II. RECONSIDERING THE GENERATION-SKIPPING PROBLEM

A. Cascading Life Estates

Consider first the paradigmatic generation-skipping problem: a devise to the child for life, then to the grandchild in fee. Conventional wisdom considers such a multigenerational transfer to be an avoidance device because two generations of beneficiaries after the transferor enjoy the devised property although only a single federal transfer tax is imposed.³⁷ Under this analysis the child is the tax-favored beneficiary because the federal government imposes no federal transfer tax when the child dies.³⁸

This analysis, however, is flawed: a federal transfer tax is imposed on the child. Assume, for example, that the devise consists of \$100,000 in long-term bonds paying a fixed ten percent interest each year. Assume further that the child is sixty years old at the time of the devise so that the discounted value of his life estate, determined actuarially, is about \$75,000.³⁹ The value of the grandchild's remainder, therefore, equals about \$25,000.

Upon the child's death none of the corpus of the devise, that is, no part of the bonds, is includible in the child's estate.⁴⁰ The interest payments the child received from those bonds, however, are includible in the child's taxable estate under the general estate tax inclusion rule of section 2033.⁴¹ Thus, if the child survives for precisely his actuarially predicted 14.5 years, his estate will include some \$145,000 of interest received during his life. If the child invests that amount during his life, a total of about \$300,000 will be included in his taxable estate. Thus, the child pays a transfer tax.

To be sure, had the child received the bonds in fee, his gross estate would have been greater than this includible amount by \$100,000. On the other hand, the child did not enjoy all the benefits of fee ownership. Had interest rates declined so that the value of the bond rose, only the remainder-beneficiary, the grandchild, would have profited from the increase.⁴² The child

36. See H.R. REP. NO. 426, 99th Cong., 1st Sess. 825-26 (1985).

37. See, e.g., G. COOPER, A VOLUNTARY TAX? 57-58 (1979) (generation-skipping trusts offer tax avoidance advantage); J. PECHMAN, *supra* note 31, at 236 (before 1977 the trust eliminated intermediate taxation); Bloom, *supra* note 31, at 33-34 (transfer tax not imposed at intervening level); Dodge, *supra* note 31, at 1266 (property owner avoids tax at intermediate level).

38. R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION ¶ 12.01[1], at 12-3 (5th ed. 1983).

39. See Treas. Reg. § 20.2031-7(f) (Table A) (1983).

40. *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 59-63 (1942).

41. I.R.C. § 2033 (1986).

42. Cf. Abrams, *A Reevaluation of the Terminable Interest Rule*, 39 TAX L. REV. 1, 25-26 (1983) (similar issue in context of transfer tax marital deduction).

surely enjoyed much of the value of ownership of the bonds, and his gross estate will reflect about three-quarters of fee simple ownership. The child, however, did not enjoy all the rights of fee simple ownership, and so the child's estate appropriately does not include the full value of the corpus.

The child's estate arguably will not be increased by the value of the life estate if the property consists of a homestead⁴³ or other property that does not produce income. Even in such a case, however, equivalent value will be included in the child's estate because by living cost-free in the devised homestead, the child will have saved the housing costs that, but for the devise, would have diminished his estate.⁴⁴ These savings effectively will increase the child's transfer tax base unless the child consumes them during life.

What if the child does consume these savings? Has the child's action improperly eroded the transfer tax base? The value of the life estate was in the child's transfer tax base, but the child removed it in the only tax-free way possible, by consuming it. A taxpayer can always lessen his transfer tax liability by increasing his consumption; the very nature of a transfer tax permits no other result.⁴⁵

Consider the case in which the child's life estate is in income-producing property, but assume that the child fully consumes the income during life. Professor Surrey analyzed this situation as follows:

[I]f an individual had a taxable estate of \$10,000,000 and left it outright to his two children equally, the estate tax under the rates [applicable prior to 1976] would have been about \$6,000,000 and his children would each have received \$2,000,000. Assuming that the children then lived on the income from their inheritances without consuming principal, each of their estates would have paid an estate tax of about \$750,000 when the property passed to their children, so that the latter would, in total, have inherited \$2,500,000 of their grandparent's wealth. On the other hand, the grandparent could have left his estate in trust, the income going to the children with the remainder to the grandchildren. Under this arrangement, his estate would still have paid the estate tax of \$6,000,000, the same as in the first case, but the estate tax on the death of the children would have been entirely avoided. The grandchildren would therefore have inherited \$4,000,000 of that grandparent's wealth.⁴⁶

Professor Surrey's analysis is deficient in that he has compared the tax consequences of two very dissimilar devises: the devise of property to a child versus the devise to a child of an income interest from that property. To be sure, in each case it is assumed that the child consumes the interest income and nothing more. In the outright transfer of ownership, however, the child had the potential for additional consumption.⁴⁷

43. See Stephens & Calfee, *supra* note 5, at 449.

44. See Abrams, *supra* note 42, at 17-18.

45. See *id.* at 17-18 & n.106.

46. S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, *supra* note 13, at 894.

47. For the very wealthy, the potential for consumption, including the power to determine who in the next generation may consume, is probably more significant than actual consumption. See *infra* text accompanying note 45.

Is this potential for consumption meaningful? Suppose that each child in the case of the outright devise had been willing to commit irrevocably to consuming no more than the income interest from the devised property. In that case, each child could have used some of the devise to purchase a single life annuity. The child could have immediately given the remainder of the devise to the grandchildren, perhaps in the form of a trust accumulating all income until the death of both children. If these steps had been followed, then the amount subject to transfer tax as to each child would have been reduced from the value of the corpus of the property to the value of the grandchild's remainder. By forgoing the potential for additional consumption, thereby forcing the remainder interest to skip their generation, the children could thus have reduced their transfer taxation substantially. If the remainder interest truly skips a generation, the generation-skipping fight should not be about inclusion of the corpus in the intermediate generation's estate but only about taxation of the generationally remote beneficiary's remainder interest.

Further refining the comparison to capture all the elements of the life estate reveals that only the value of the remainder skips a generation. If the grandparent devises property outright to his children, then the children have the discretion to purchase an annuity. If the children receive only a life estate, they have no such discretion. The arrangement that best captures all the characteristics of a life estate, yet that involves only fee simple interests, is the devise of an annuity by a grandparent to his children, with the remainder of the grandparent's estate placed in trust, the corpus and all accumulated income from the trust to be divided among the grandchildren upon the death of the last child.⁴⁸

With this bifurcated devise each child will enjoy and include in his gross estate only so much of the devise as remains unconsumed at death, as well as any other property owned by the child and not consumed during life. Furthermore, the remainder devised to the grandchild is equivalent to a direct skip of the actuarially determined value of the remainder at the time of the grandparent's death. Surely the portion devised to each child in the form of a lifetime annuity would be free of all generation-skipping tax. Since a devise of a life estate to the children followed by the remainder to the grandchildren is the economic equivalent of this bifurcated devise, no generation-skipping tax should be imposed on the actuarially determined portion of the trust devised to each child. Thus, the only generation-skipping issue presented by a devise including an intervening life estate is whether the actuarially determined value of the remainder interest should be subject to an extra tax. Stated differently, should the implicit direct skip be taxed twice?

B. Powers of Appointment

Before considering the propriety of subjecting a direct skip to a generation-skipping tax, consider the other generation-skipping arrangement cap-

48. See Verbit, *supra* note 5, at 722-23 & n.107.

tured by the 1976 law, the generation-skipping trust with powers over the trust given to members of an intervening generation.⁴⁹ Do such arrangements pose a transfer tax problem? Consider a devise of property that remains in trust for the life of the child, then goes to the surviving grandchildren in fee. The child receives a power to accumulate interest or distribute it among the grandchildren during life and also receives a testamentary power to appoint the trust corpus among grandchildren. In this case, the intervening generation, the child, has no interest in the devised property but has powers over it.

Should such a devise be subject to a generation-skipping tax? Consider first a tax that does not tax direct skips. The instant devise consists of a direct skip augmented by an intervening power; if the intervening power does not trigger the generation-skipping tax, the devise will be subject to only a single estate tax. Imposing a generation-skipping tax on this devise amounts to saying that the child's power over the trust corpus is sufficiently akin to ownership to justify a second tax, a tax that would be payable had the child received the corpus in fee.

Determining when powers over property should be taxed as ownership of property is a question that arises in connection with all transfer taxes, not just with a generation-skipping tax. Current law equates a power over property with ownership for purposes of imposing estate and gift taxes only if the power rises to the level of a general power of appointment as defined by section 2041(b)(1)⁵⁰ of the federal estate tax law. Should such a definition be imported into a generation-skipping tax?

The answer is "no" for the surprising reason that such a definition would be redundant; if taxable powers are uniformly defined for the federal estate, gift, and generation-skipping taxes, and assuming that the generation-skipping tax does not apply to simple direct skips, then the generation-skipping tax is wholly superfluous. Any power over property created in an intervening generation will either be taxed as outright ownership under the estate and gift taxes or else the power will fail to rise to the level of a taxable power, and the intervening generation will therefore avoid all estate, gift, and generation-skipping taxes.

The gift of property in trust for the benefit of a grandchild with the child having the power during life to distribute or accumulate interest is an example. Under current law the power that the child has over the trust property does not rise to the level of a general power of appointment,⁵¹ and the child will not be treated as owner of the trust for federal estate or gift tax purposes. If the generation-skipping tax used the same definition of a taxable power, then this power given to the child would also escape taxation under the generation-skipping tax. On the other hand, if the definition of a taxable power were changed for estate and gift tax purposes to include the child's power, then the value of the trust corpus would be includible in the child's

49. I.R.C. §§ 2611-2614 (1982) (repealed 1986).

50. I.R.C. § 2041(b)(1) (1986); *see id.* § 2514(c); *supra* note 2.

51. *See supra* note 2.

taxable estate, unless the corpus were subject to the gift tax during the child's life. With this redefinition of taxable powers, no generation-skipping tax is needed because the estate and gift taxes would capture the child's power over the property. Indeed, this example as well as the prior one should serve to prove that, if direct skips are not subject to a generation-skipping tax, then the power of appointment provisions of the federal estate and gift tax laws, governing the transfer taxation of powers over property, are the only generation-skipping provisions needed; no additional taxing structure should be added.⁵²

If the 1976 generation-skipping tax did not tax direct skips, why was it enacted? First, it imposed an additional tax on intervening life estates and similar terminable interests given to intervening generations. Such transfers include implicit direct skips in the form of the interest given to remote beneficiaries, and, to the extent the generation-skipping tax caught such interests, the 1976 law did tax direct skips.⁵³ Second, the 1976 law imposed a tax on transfers in which an intervening generation was given almost any power over property, even powers not rising to the level of general powers under estate and gift tax provisions.⁵⁴ It does not make sense to have two definitions of taxable powers, with a lesser threshold applicable to powers held by intervening generations.

As defined by estate and gift tax law, a taxable general power of appointment is one exercisable in favor of the power holder, creditors of the power holder, the estate of the power holder, or creditors of the estate of the power holder.⁵⁵ If the class of potential beneficiaries excludes these four categories, the exercise, release, or lapse⁵⁶ of a power of appointment will impose no federal estate or gift tax liability upon the power holder. In one sense this definition of a taxable power is very restrictive: to avoid inclusion to the holder, a power must not be exercisable in a way that allows the holder to consume or sell the property, either directly or indirectly. For most taxpayers ownership of property is important for the consumption opportunities such ownership presents. From this perspective, nontaxable powers are those in which the key ingredient of ownership, consumption, is lacking.

Rules and definitions used in the transfer taxes, however, should not be drafted with an eye toward most taxpayers, for in excess of ninety-nine percent of all taxpayers are not subject to these taxes.⁵⁷ The grist of the federal

52. See Verbit, *supra* note 5, at 724-25 (condemning exceptions to estate and gift tax power of appointment provisions for powers subject to an "ascertainable standard" and for "5 and 5" rule in case of lapsed powers).

53. See *supra* text accompanying notes 37-48.

54. See I.R.C. § 2613(d)-(e) (1982) (repealed 1986).

55. I.R.C. § 2041(b)(1) (1986) (estate tax); *id.* § 2514(c) (gift tax); see Note, *Taxation: Special Powers of Appointment and Transfer Taxation—It Is the Courts' Move*, 34 OKLA. L. REV. 907, 909-12 (1981).

56. Under the "5 or 5" rule of §§ 2041(b)(2) and 2514(e), the lapse of a general power of appointment is treated as a taxable release only to the extent that the property which could have been appointed exceeds the greater of \$5,000 or 5% of the trust corpus.

57. "[T]he estate tax . . . will cover no more than three-tenths of one percent of decedents dying in 1987 and thereafter." S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, *supra* note 13, at 12. Of the 2,000,000 people expected to die in 1988, only 25,800 (1.29%) will have

estate and gift tax mill is the class of very wealthy taxpayers, and Congress should design that mill with an eye toward this class. For the very wealthy, property is more than consumption: property is power.⁵⁸ This power is the power to say who will enjoy the property next, the power to devise and disinherit. It is the power to choose among charitable organizations and perpetual monuments on college campuses. For the very wealthy a nontaxable special power of appointment may include all the essential attributes of outright ownership,⁵⁹ and the failure to tax such special powers has engendered substantial criticism.⁶⁰

Why did the Tax Reform Act of 1976 bring with it a "Tax on Certain Generation-Skipping Transfers" rather than a tightening of the definition of a general power of appointment? Professor Casner's study for the ALI in 1969 rejected a rewriting of the powers of appointment provisions. The study asserted that liberal provisions allowing powers of appointment to escape taxation gave needed flexibility to multigenerational arrangements.⁶¹ Yet if one accepts this argument in favor of nontaxable flexibility, and remembers that only the case of a generation-skipping tax that excludes simple direct skips from its reach is under consideration, the generation-skipping tax is nothing but an amendment to the power of appointment provisions that redefines the taxability of powers held by an intervening generation. Does such an amendment make sense?

An amendment to the power of appointment provisions such as this does not make sense because the relationship of donor and donee generations has no effect under current provisions of the estate and gift taxes. Some powers over property ought to be taxed as ownership, and reasonable persons can disagree over where the line distinguishing taxable powers from nontaxable powers should be. Once that line is drawn, however, no reason exists for

estates large enough to be subject to the federal estate tax. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 19 (statement of Ronald A. Pearlman).

58. See G. COOPER, *supra* note 37, at 14-15.

59. See W. PEDRICK, DEATH, TAXES AND THE LIVING 47-48 (1980); *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 31-32 (statement of Harry L. Gutman).

60. E.g., Hess, *The Federal Taxation of Nongeneral Powers of Appointment*, 52 TENN. L. REV. 395, 416-17 (1985).

61. ALI RECOMMENDATIONS, *supra* note 26, at 18. The study noted:

Powers of appointment in a transfer that creates a succession of limited beneficial interests give a flexibility to the arrangement that permits adjustments to meet changed conditions. A rigid and inflexible plan of successive limited interests is likely to be inadequate to meet the conditions of the future under which it will operate. The present transfer tax law is quite liberal in the controls the owner of a limited interest can be given without causing him to be treated as the owner of the appointive assets for transfer tax purposes.

This liberality contributes to the generation-skipping problem But a tightening of the power-of-appointment rules to cause the powerholder to be treated as the owner of the appointive assets in more situations than at present would simply tend to drive property arrangements into the more rigid mold, if the more rigid mold avoided the burdens of transfer taxation. Therefore, the generation-skipping problem should not be resolved by drawing a different line than now exists in the power-of-appointment area.

Id.; see also Leach, *Powers of Appointment And The Federal Estate Tax—A Dissent*, 52 HARV. L. REV. 961 (1939) (flexible powers of appointment enable wise distributions of family funds and use of such flexible powers should not be penalized by tax).

drawing a second line for intergenerational transfers. Whether the touchstone of ownership should be potential for consumption or power is debatable, but surely the reasons put forward one way or the other are insensitive to generational concerns. So long as a system of transfer taxation exists as to direct transfers, generationally blind transfers with intervening powers present an issue that should be the concern only of the estate and gift tax powers of appointment provisions.

Accordingly, if Congress decides that direct skips should not be subject to a generation-skipping tax, the generation-skipping problem boils down to rethinking the definition of a taxable power of appointment. On the other hand, Congress might determine that direct skips should be subject to a special generation-skipping tax. If Congress so decides, how substantial a problem is created by a direct skip coupled with a power given to a member of an intervening generation? The answer, surprisingly, is that the problem disappears entirely.

Reconsider the devise of property for the benefit of a grandchild with substantial powers over the trust corpus given to the child. If direct skips are subject to a generation-skipping tax, the trust corpus will be subject to the generation-skipping tax independent of the child's powers. Thus, powers given to intervening generations need have no impact on the design of a generation-skipping tax that imposes a tax on simple direct skips.

III. DIRECT SKIPS AND GENERATION-SKIPPING TAXATION

The analysis presented above makes clear that the generation-skipping problem is not one of plugging loopholes in the estate and gift taxes; neither transfers with an intervening life estate nor transfers with intervening powers present a generation-skipping problem beyond that posed by the simplest generation-skipping transfer, the direct skip. Accordingly, imposing a generation-skipping tax on direct skips cannot be justified, as a necessary corollary of a generation-skipping tax generally aimed at more complex transfers, despite assertions by the Treasury,⁶² the ALI,⁶³ and the drafters of the Tax Reform Act of 1986⁶⁴ to the contrary. Direct skips are the core of the generation-skipping issue, and if they are to be taxed, the justification for doing so must be faced squarely.

It is often asserted that direct skips are available only to the very wealthy because most taxpayers cannot afford to disinherit a generation.⁶⁵ Since direct skips substitute for two or more transfers that do not skip generations, some argue that double taxation of direct skips is necessary to make the

62. *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 5-7 (statement of Ronald A. Pearlman).

63. *Id.* at 31-34 (statement of Harry L. Gutman).

64. *See supra* text accompanying note 36.

65. *See* G. COOPER, *supra* note 37, at 56-57; *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 6-7 (statement of Ronald A. Pearlman); *see also* U.S. TREASURY DEPARTMENT, *supra* note 25, at 388-89 (tax system allows wealthy to skip taxation every generation, but discriminates against those of modest wealth, who must pay taxes every generation).

transfer tax system neutral among taxpayers.⁶⁶ This plea for tax neutrality presupposes that direct skips are sufficiently similar to a series of outright nonskipping transfers to warrant multiple imposition of the transfer taxes. Yet, a direct skip certainly is not identical to a series of nonskipping transfers: a taxpayer who wishes to minimize transfer taxation under current law is forced to use a generation-skipping trust or its equivalent, regardless of personal circumstance or preference.⁶⁷ Such loss of freedom is important, especially in the context of excise taxes such as the estate, gift, and generation-skipping taxes, because a taxpayer can always avoid an excise tax by forgoing the privilege upon which the tax is based.⁶⁸ One way to avoid a toll is to refuse to cross the bridge. If a taxpayer devises property to his grandchild in one fell swoop rather than in two transfers, from taxpayer to child to grandchild, has the taxpayer evaded the toll or eschewed the bridge?

A frequent justification for imposing a tax on direct skips is that double taxation of direct skips ensures periodicity of transfer taxation regardless of the form of a taxpayer's gift or devise;⁶⁹ yet, the estate and gift taxes are not periodic or generational taxes. With limited exceptions gratuitous transfers are subject to the federal estate and gift taxes without regard to the relative generations of donor and donee.⁷⁰ A direct skip, because it is a gratuitous transfer, will be subject to the federal estate or gift tax without the encouragement of any generation-skipping tax.

Professor Verbit has argued that current transfer taxes do not embody a periodicity concept.⁷¹ No provision of current law, not even the current generation-skipping tax, provides for the imposition of a transfer tax every generation.⁷² The taxation of every generation is not a principle, but instead "an empirically derived observation."⁷³ To be sure, the estate tax is applicable every generation, but only because "the estate tax is levied on transfers made at death. The fact that death also marks the end of a generation is coincidental."⁷⁴ Furthermore, no particular relationship exists between the gift tax and generational taxation.

Representatives of the American College of Probate Counsel and of the

66. *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 5 (1984) (statement of Ronald A. Pearlman); see H.R. REP. NO. 426, 99th Cong., 1st Sess. 825-26 (1985).

67. The use of a trust may restrict subsequent tax minimization opportunities. For example, the annual per donee gift tax exclusion, the charitable deduction, and aggressive investment strategies all become more difficult to exploit once a family fortune is placed in trust. See Verbit, *supra* note 5, at 726-27.

68. See *Bromley v. McCaughn*, 280 U.S. 124, 136-38 (1929); *Blodgett v. Holden*, 275 U.S. 142, 146-47 (1927).

69. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 6-7 (testimony of Ronald A. Pearlman); U.S. TREASURY DEPARTMENT, *supra* note 25, at 388-89.

70. The following provisions have a generational flavor: I.R.C. § 2013 (1986) (credit for tax on prior transfers); *id.* § 2056(a) (estate tax marital deduction); *id.* § 2523(a) (gift tax marital deduction).

71. Verbit, *supra* note 5, at 727-28.

72. See I.R.C. § 2613(b)(6) (1982) (repealed 1986) (grandchild exclusion of \$250,000 per deemed transferor); *id.* § 2613(e) (limited power to appoint among lineal descendants of grantor excluded from definition of a taxable power).

73. Verbit, *supra* note 5, at 727.

74. *Id.*

American Bar Association's Real Property, Probate, and Trust Law Section voiced opposition to taxing direct skips.⁷⁵ While neither organization unequivocally opposed such a tax, each urged the Congress to consider carefully any decisions to enact so radical a departure from current law. Mr. Jackson Bruce was correct when he testified that "a tax on direct skips discards the concept of an excise tax on the privilege of the transfer of ownership in favor of a concept of generational periodicity."⁷⁶

The only possible justification for a generation-skipping tax applicable to direct skips is that transfer taxes should be periodic—not that they are periodic, but only that they should be. Professor Casner, for example, expressed this view as reporter for the 1969 ALI project on federal estate and gift taxation.⁷⁷ The House Committee on Ways and Means also suggested generational periodicity as a worthy goal of the transfer tax system as part of the 1976 reform leading to the first generation-skipping tax.⁷⁸

Nevertheless, no one has ever made a proposal suggesting true periodicity in the transfer taxes. Such a proposal would, for example, need to exempt from estate and gift taxation all gratuitous transfers made between members of the same generation, such as between brothers and sisters. Without a substantial overhaul of the estate and gift taxes, imposition of a generation-skipping tax on direct skips would not ensure true generational periodicity in the transfer tax system. Rather, imposition of this tax would ensure that a transfer tax must be paid on property at least once every generation.

Perhaps such a minimum frequency proposal is defensible. To the extent that a goal of transfer taxation other than the raising of revenue exists, that goal is to prevent large concentrations of wealth from passing from generation to generation.⁷⁹ Imposition of a wealth tax will ensure that large concentrations of wealth are dispersed, either voluntarily through consumption or involuntarily through taxation. The more frequent the imposition of the wealth tax, the greater effect it will have.

An estate tax is simply a wealth tax imposed once each generation. If the estate tax is thought of not as a transfer tax but rather as a periodic wealth tax, then imposition of the estate tax at least once a generation will ensure that the distribution effects of the estate tax cannot be minimized by ingenious transfers. Indeed, from this perspective both the gift tax and a genera-

75. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 294-95 (statement of Malcolm A. Moore); *id.* at 282-83 (statement of Jackson M. Bruce, Jr.).

76. *Id.* at 285 (statement of Jackson M. Bruce, Jr.); see also *id.* at 45 (statement of Harry L. Gutman) (proposed revisions bring direct skips under generation-skipping tax plan and impose tax no matter how many generations are skipped).

77. ALI RECOMMENDATIONS, *supra* note 26, at 26. "A transfer tax system should not only provide relief against the imposition of the tax too frequently (the previously-taxed-property problem) but should also prevent too infrequent impositions of the tax." *Id.*

78. See H.R. REP. NO. 1380, 94th Cong., 2d Sess. 46-47, reprinted in 1976 U.S. CODE CONG. & ADMIN. NEWS 3356, 3400-01.

79. See, e.g., B. BITTKER & E. CLARK, FEDERAL ESTATE AND GIFT TAXATION xxiv-xxvi (5th ed. 1984); Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L. REV. 1, 19-21 (1983); Verbit, *supra* note 5, at 700; see also Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 269-73 (1983) (arguing that role of federal estate tax is to increase progressivity of federal taxes).

tion-skipping tax on direct skips can be seen to backstop the estate tax considered as a periodic wealth tax.

Is the estate tax best viewed as a periodic wealth tax? That, it seems, is what the current debate concerning the generation-skipping tax ought to be about. Professor Verbit, at least, thinks that the fact that the estate tax functions as a periodic wealth tax is only coincidental.⁸⁰ Others see a stronger connection.⁸¹ It is not the intent of this Article to substantially further this debate. Instead, this Article has shown that the generation-skipping tax debate should reorient itself and focus on the direct skip as the core problem. However the debate is resolved, a simple legislative solution can be implemented.

IV. SIMPLIFYING THE GENERATION-SKIPPING TAX

The form of a generation-skipping tax turns on its treatment of direct skips. If direct skips are not subject to more than the estate and gift tax, a generation-skipping issue arises only when a donor transfers property to a generationally remote beneficiary and gives power over the property to a member of an intervening generation. As indicated above, this problem is really only one facet of the more general problem associated with the transfer taxation of powers of appointment, and the proper solution to both problems is to redefine taxable powers of appointment in a sufficiently broad way.⁸²

On the other hand, if direct skips are to be the subject of a special generation-skipping tax, then Congress needs to create a new transfer tax structure. Direct skips can be valued by reference to actuarial and present-value tables, whether the skips are explicit, such as an outright devise from grandparent to grandchild, or implicit, such as a transfer by a grandparent to a child in trust with income to the child for life, then the corpus to a grandchild in fee. Timing questions arise, but they can be answered. The only serious problem in implementing a tax on direct skips concerns the tax rate. If the tax has more than one rate, a taxpayer's direct skips must be aggregated before the tax liability can be determined, and to account for the endless variety of trust arrangements, compromises must be made. A description of these issues and one possible resolution is given at the end of this Article.

A. Tax-Free Direct Skips: Rethinking Powers of Appointment

If direct skips are not subjected to a generation-skipping tax, then generation-skipping transfers with powers given to members of intervening generations, with or without intervening interests, present a possible abuse of the transfer tax system. The proper resolution, however, is not to enact a generation-skipping tax but rather to broaden the definition of a taxable power of appointment for estate and gift tax purposes. As that definition currently

80. See *supra* text accompanying notes 71-74.

81. See ALI RECOMMENDATIONS, *supra* note 26, at 26.

82. See *supra* text accompanying notes 49-61.

stands, a power over property is equivalent to outright ownership only if the power can be exercised in a way that effectively permits direct or indirect beneficial enjoyment of the property by the power holder.⁸³ Such a power is called a general power of appointment.⁸⁴

One circumstance exists in which a power not rising to the level of a general power of appointment is taxed as the equivalent of ownership: a power retained by the transferor rather than vested in another is taxed as the equivalent of ownership. Under sections 2036 and 2038 if a transferor of property retains almost any power to affect the beneficial enjoyment of transferred property or its income, the property will be included in the transferor's estate as if no transfer had been made.⁸⁵ These provisions respond to the reality that, for vast sums of money, power rather than potential for consumption is the cornerstone of ownership. The question arises whether a similar standard should be introduced into the definition of taxable powers held by third parties. If a transferor's power to affect beneficial enjoyment is akin to ownership, should that power be treated differently if it is created in a third party?⁸⁶

In 1942 Congress substantially broadened the definition of a taxable power of appointment.⁸⁷ Under that definition all powers were taxable with two major exceptions: (1) a power exercisable only in favor of the creator's spouse, the creator's lineal descendants, spouses of such descendants, and charitable organizations, and (2) a power to appointment within a restricted class if the power was held by one having no beneficial interest in the property.⁸⁸ Even this modest attempt at broadening the definition of taxable powers failed, as Congress retroactively repealed the 1942 provisions in 1951.⁸⁹ Part of the problem with the 1942 definition of a taxable power was the arbitrary exception for powers exercisable in favor of the grantor's descendants. By far the greater difficulty, though, lay with the application of the 1942 provisions to powers created prior to their enactment.⁹⁰

83. See *Morgan v. Commissioner*, 309 U.S. 78, 81 (1940).

84. See *supra* note 2.

85. I.R.C. §§ 2036, 2038 (1986). The common law gloss that powers subject to an ascertainable standard are beyond the reach of the statute has considerably diminished the reach of §§ 2036 and 2038. See *Jennings v. Smith*, 161 F.2d 74, 77-79 (2d Cir. 1947); *Estate of Budd v. Commissioner*, 49 T.C. 468, 473-75 (1968). This judicially created exception to §§ 2036 and 2038 has engendered substantial criticism. See, e.g., B. BITTKER & E. CLARK, *supra* note 79, at 198 ("assumptions on which [the doctrine] is founded are dubious"); Pedrick, *Grantor Powers and Estate Taxation: The Ties That Bind*, 54 NW. U.L. REV. 527, 537-42 (1959) (grantor wants to make decisions without fear of future litigation); Peschel, *The Impact of Fiduciary Standards on Federal Taxation of Grantor Trusts: Illusion and Inconsistency*, 1979 DUKE L.J. 709 (criticizes approach for not recognizing degree of control supplied by other powers). The powers of appointment provisions of the estate and gift tax explicitly incorporate the "ascertainable standard" exception. See I.R.C. §§ 2041(b)(1)(A), 2514(c)(1) (1986).

86. See Griswold, *Powers of Appointment and the Federal Estate Tax*, 52 HARV. L. REV. 929, 958 (1939).

87. Revenue Act of 1942, ch. 619, § 403, 56 Stat. 798, 942-44. See generally Hess, *supra* note 60, at 401-09 (historical development of the estate tax).

88. Revenue Act of 1942, ch. 619, § 403, 56 Stat. 798, 942-44.

89. Powers of Appointment Act of 1951, ch. 165, § 2, 65 Stat. 91, 91-93 (1950).

90. See Buck, Craven & Shackelford, *Treatment of Powers of Appointment for Estate and Gift Tax Purposes*, 34 VA. L. REV. 255, 266-69 (1948).

Powers of appointment thus have had no history, good or bad, of being taxed as the equivalent of ownership. Such a history exists with regard to sections 2036 and 2038 as they apply to powers retained by transferors, however, and no great dissatisfaction has surfaced with respect to these provisions. Unfortunately, even this history tells little of the potential viability of a broad definition of taxable powers of appointment, because the judicial decisions under sections 2036 and 2038 have substantially reduced the statute's efficacy.⁹¹ If powers of appointment are to be taken, and taxed, seriously, then all discretionary powers affecting the beneficial enjoyment of property must be taxed, unlimited by exceptions for permissible appointees⁹² or for restrictive standards.⁹³

Broadening the definition of taxable powers may force transfers into narrow and less flexible forms,⁹⁴ but in reality no modification of the taxing system forces any taxpayer to adopt any form of transfer. To be sure, the creation of discretionary powers will likely decrease if the powers are taxed as the equivalent of ownership, but that decrease will simply reflect the inevitable consequence of eliminating a tax loophole. Despite the protests of estate planners to the contrary,⁹⁵ equating powers to affect the beneficial enjoyment of property with outright ownership reduces tax avoidance but not wealth transfer flexibility.

Discretionary powers given to commercial fiduciaries, however, might warrant different treatment.⁹⁶ Taxing the holder of a power over property as the property's owner makes sense if the holder may enjoy the benefits of ownership that come with discretion over the beneficial enjoyment of the property. In the case of a commercial fiduciary not having a beneficial interest in the property, a power of appointment is unlikely to be exercised in a way that confers substantial benefit, psychic or otherwise, to the power holder. Accordingly, the potential for abuse usually associated with powers over property is not present, and the power holder should escape taxation.

Of course, just the opposite result should obtain if the power holder is a relative or other nonprofessional fiduciary. In that case, the potential for abuse is present; regardless of how the holder exercises the power, discretion over the beneficial enjoyment of the property gives the holder the ability to use the power to obtain many of the benefits of outright ownership.⁹⁷ Thus, the power holder should be taxed on exercise of the power. Similarly, because a failure to exercise a power is equivalent to exercising it in favor of the

91. See G. COOPER, *supra* note 37, at 98-100; *supra* note 85.

92. Compare I.R.C. § 2613(b)(5)(A) (1982) (repealed 1986) (\$250,000 grandchild exception in former generation-skipping tax) with *id.* § 2613(e)(1) (exception for powers limited to class of grantor's lineal descendants of generation younger than powerholder's generation).

93. See *supra* note 85.

94. See ALI RECOMMENDATIONS, *supra* note 26, at 18-19.

95. Craven, *Powers of Appointment Act of 1951*, 65 HARV. L. REV. 55, 61 (1951).

96. Cf. I.R.C. § 2613(e)(2) (1982) (repealed 1986) (powers of independent trustees). The 1942 powers of appointment provisions expanding the definition of a taxable power contained a "fiduciary" exception for power holders having no beneficial interest in the property. Revenue Act of 1942, ch. 619, § 403, 56 Stat. 798, 942-44.

97. See *Estate of Yawkey v. Commissioner*, 12 T.C. 1164, 1170 (1949).

taker in default, a termination of a power to affect beneficial enjoyment should be also taxed as a taxable transfer.

B. Taxing Direct Skips: One Possible Answer

A decision to tax simple direct skips obviates the need to tax powers over property, but introduces two new issues: (1) when should the tax on generation-skipping transfers be imposed, and (2) at what rate should simple direct skips be taxed? The second of these issues has no easy answer.

No timing issue exists for the simplest of direct skips, namely transfers such as those from grandparent to grandchild in fee with no intervening delay. For such transfers the only opportunity for a generation-skipping tax to apply is at the time of transfer.⁹⁸ A more complex conveyance including implicit direct skips, though, can offer at least two plausible opportunities for imposition of a generation-skipping tax. For example, consider the devise of property in trust by the grandparent for the benefit of the child for life and then to the grandchild in fee. The grandchild's interest in the trust can be estimated at the time of the devise, and a tax could be imposed immediately on that estimated value.⁹⁹ On the other hand, taxation could be deferred until the grandchild actually takes possession of the remainder. The latter method of taxation minimizes horizontal inequities between taxpayers arising from actuarial fluctuations; that is, it minimizes the danger of taxing different members of the same generation differently. For that reason this method is the preferable choice.

If the generation-skipping tax has a flat rate, then taxation at time of transfer will, *ex ante*, equal taxation at time of receipt. For example, if the trust corpus is \$100,000 and the child is sixty at the time of the devise, then the child's life expectancy is about 14.5 years, making the grandchild's actuarially determined interest in the trust about \$25,000.¹⁰⁰ At any constant rate of taxation the present value of a tax on \$25,000 today equals the present value of a tax on \$100,000 in 14.5 years.¹⁰¹ Thus, whether taxation occurs at the time of transfer or at time of receipt should make no difference to the federal fisc.

For more complex arrangements actuarial estimation of the value of a direct skip becomes impossible. For example, consider a devise in trust with income payable to either the child or the grandchild, as the trustee decides, and with the remainder going to whomever of the grantor's descendants the trustee appoints by will. Neither the value of the grandchild's income interest nor the likelihood of the remainder going to a generationally remote descendant of the grantor can be estimated with any degree of reliability. Accordingly, taxation should be deferred until the trust income or corpus is

98. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 16 (statement of Ronald A. Pearlman).

99. The gift of a remainder interest is taxed in this way under current law. See Treas. Reg. § 25.2512-9 (as amended in 1984).

100. See Treas. Reg. § 20.2031-7(f) (Table A) (1983).

101. See *Abrams*, *supra* note 42, at 23 n.114.

distributed to the grandchild or some other beneficiary. So long as all amounts are taxed as they are distributed and at a constant tax rate, no tax is avoided by this mechanism.

No generation-skipping proposal, however, incorporates a uniform rate.¹⁰² In particular, because transfer taxes are considered extraordinary impositions appropriately reserved for the very wealthy,¹⁰³ all transfer taxes, including the current generation-skipping tax as well as all proposed generation-skipping taxes, include a substantial zero bracket.¹⁰⁴ For example, the effective zero bracket for the estate and gift taxes is \$600,000.¹⁰⁵ The zero brackets for the proposed new generation-skipping taxes are considerably larger,¹⁰⁶ as is the zero bracket for the post-1986 generation-skipping tax.¹⁰⁷

If a generation-skipping tax incorporates only two rates, one of which is zero, and if imposition of the tax is deferred until generationally remote beneficiaries of the transferor receive the devise, then the zero bracket must be adjusted for the time value of money in order to prevent inequity. Consider the following simple devise: a grandparent places \$600,000 in a trust that will accumulate all income for fifteen years, then the trust income and corpus go to a grandchild in fee. Further assume that the zero bracket amount for the generation-skipping trust is \$600,000. If the annual interest rate is 10%, the grandchild should receive approximately \$2,500,000 in fifteen years. The present value of the grandchild's gift is only \$600,000 because the grandparent gave the grandchild the economic equivalent of an outright gift of the entire trust corpus.¹⁰⁸ Because the grandparent has made the economic equivalent of an outright devise of \$600,000, the transfer should be taxed like an outright devise.¹⁰⁹ Taxing the actual devise either more or less than an outright devise of \$600,000 in cash will impose an extra toll on the form of transfer taxed at the higher rate, thereby implicitly favor-

102. Under former law a generation-skipping tax liability was determined by reference to the transfer tax bracket of the deemed transferor, thereby incorporating the multibracket rate schedule of I.R.C. § 2001(c) (1986). See I.R.C. § 2602(a) (1982) (repealed 1986). The Treasury proposal includes a \$1,000,000 exemption (in effect a \$1,000,000 zero bracket) as well as a general tax rate of 80% of the maximum estate tax rate. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 17, 18-20 (statement of Ronald A. Pearlman). The ALI proposal includes a credit of \$417,000 (the equivalent of an \$834,000 zero bracket) as well as a general tax rate of 50%. See *id.* at 73 n.4, 87-88 (statement of Harry L. Gutman).

103. See S. REP. NO. 144, 97th Cong., 1st Sess. 124, reprinted in 1981 U.S. CODE CONG. & ADMIN. NEWS 105, 226; S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, *supra* note 13, at 12.

104. See *supra* note 102.

105. For decedents dying after Dec. 31, 1986, the transfer tax unified credit is \$192,800. I.R.C. § 2010(a) (1986). The exemption equivalent of such a credit is, under current rates, \$600,000. See H.R. REP. NO. 201, 97th Cong., 1st Sess. 154-55 (1981).

106. See *supra* note 102.

107. As amended the generation-skipping tax law includes a general \$1,000,000 zero bracket, I.R.C. § 2631(a) (1986), as well as a \$2,000,000 exemption for direct skips to grandchildren made prior to Jan. 1, 1990. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(3), 100 Stat. 2085.

108. The grandchild has, in effect, received both the income interest and the remainder interest in the trust corpus. The aggregate value of these interests necessarily equals the fair market value of the trust.

109. A basic premise of the transfer taxes is that economically equivalent transfers should be taxed alike. See *Abrams*, *supra* note 42, at 1-2 & n.4; *Hudson*, *supra* note 79, at 3-4.

ing one form over the other. No reason exists for the tax system to show favoritism, so the two forms should be taxed alike.

If the generation-skipping tax is imposed at time of transfer, then no tax will be due because the value of the generation-skipping transfer does not exceed the grandparent's zero bracket amount. On the other hand, if imposition of the tax is deferred until receipt of the devise by the grandchild, and if the zero bracket amount does not account for the time value of money, then a positive tax liability will result. Indeed, although the discounted value of the grandchild's gift is independent of the duration of the trust,¹¹⁰ the generation-skipping tax will be dependent on the duration of the trust unless proper adjustment is made to the zero bracket amount.¹¹¹

Fortunately, the proper adjustment is not difficult to make. If taxation occurs at the time of receipt rather than at the time of transfer, the zero bracket amount should be increased by an interest factor dependent on both the statutory discount rate and the time between transfer and receipt. The proper formula is not difficult to compute or to apply.¹¹² In the above example properly adjusting the zero bracket amount to account for the time value of money shelters the grandchild's entire devise from taxation. Because an outright skip of \$600,000 would have been tax-free, and because the grandchild received the equivalent of such an outright skip, the transfer to the grandchild should also be tax-free.¹¹³

If the generation-skipping tax has more than one nonzero bracket, accounting for the time value of money is considerably more complex. A multiple rate structure, such as that present in the income tax and also, to a lesser extent, in the estate and gift taxes, responds to a need for a progressive tax rate structure. That need diminishes, however, as the zero bracket in-

110. See *supra* note 108.

111. Cf. Isenbergh, *Simplifying Retained Life Interests, Revocable Trusts, and the Marital Deduction*, 51 U. CHI. L. REV. 1, 7-8 (1984) (discussing "bracket effect" of taxing a remainder interest).

112. Let t' be the time when the transfer is made by the transferor, and let t'' be the time when property is received by the transferee. If the annual interest rate (i.e., discount factor) is i , the unused zero bracket of the transferor should be increased by the factor $(1+i)^{(t''-t')}$. Alternately, one could adjust (i.e., reduce) the taxable value of the property received by the transferee to account for the time value of money. If property of value v is received at time t'' , taxation using the unadjusted zero bracket, amount would be appropriate if the value of property were deemed to be $v/(1+i)^{(t''-t')}$.

113. Rather than set a time-adjustable zero bracket, the Tax Reform Act of 1986 provides that the first \$1,000,000 contributed to a generation-skipping trust or trust equivalent is exempted from tax. I.R.C. § 2631(a) (1986). Thus, if a trust is funded with \$1,000,000, no distribution from the trust will be subject to tax under chapter 13. If more than \$1,000,000 is contributed to the trust, each distribution is bifurcated into a taxable and nontaxable component. See *id.* §§ 2631-2632. For example, if the trust is funded with \$1,500,000, then only 1/3 of each trust distribution will be taxable.

By exempting both the \$1,000,000 trust corpus as well as all interest on it, this rule creates the equivalent of a time-adjustable zero bracket. In the case of an over-funded trust, however, the new statutory rule may produce unacceptable results. Consider the trust funded with \$1,500,000 and assume that both the child and grandchild of the trust grantor are beneficiaries. If the child receives one-third or more of the trust distributions, no generation-skipping tax should be imposed on any distribution to the grandchild; yet, under the new law, one-third of each distribution to the grandchild will be taxable. See *id.* § 2642(a)(2).

creases. Indeed, the generation-skipping tax should target only the wealthiest taxpayers, and, for such taxpayers, progressivity in the tax rates makes little sense. Neither the ALI nor the Treasury Department propose more than a single nonzero bracket for the generation-skipping tax.¹¹⁴

Because a generation-skipping tax liability can arise after the death of the transferor, the tax liability must be borne by the transferred property, and thus, implicitly, by the transferee, rather than by the transferor.¹¹⁵ In addition, if the tax has a zero bracket, the tax liability arising from a generation-skipping transfer cannot be computed without reference to all other generation-skipping transfers made by the taxpayer. If a single transferor establishes multiple trusts having generation-skipping potential, applying the transferor's zero bracket on a first-come, first-served basis will impose the heaviest tax burden on those beneficiaries receiving distributions last. To protect against possible unfairness some mechanism should exist to allocate the transferor's zero bracket among the multiple generation-skipping trusts.

One solution, adopted by the Treasury proposal, is to allow the transferor to allocate the zero bracket among his or her generation-skipping transfers.¹¹⁶ This allocation, like the apportionment of state death taxes among devisees, should be of no concern to the federal government. In each case the transferor must decide what portion of each transfer should pass unmolested by taxation and what portion should pay the transfer toll. In other words, such allocations are simply part of the mechanism by which a taxpayer divides the after-tax value of his property among various donees.

To be sure, a transferor might misallocate the zero bracket. For example, suppose *T* transfers property in trust for the benefit of a child and grandchild. If the entire corpus and all interest is distributed to the child, for example, because of the grandchild's untimely death, any generation-skipping zero bracket allocated to this trust will go unused. The problem, however, only arises if a taxpayer makes multiple generation-skipping transfers and if those transfers are sufficiently complex to cause the transferor to misjudge the relative interests of the beneficiaries. In such cases any hardship caused by misallocation of the zero bracket can fairly be said to have been caused by the transferor and not by the transfer tax system.

V. THE CURRENT PROPOSALS: WHAT WENT WRONG

A generation-skipping tax excluding direct skips from its reaches is redundant: outside the direct skip arena, whatever generation-skipping problems that exist should be corrected through the powers of appointment provisions of the estate and gift tax law.¹¹⁷ In addition, subjecting direct skips to the generation-skipping tax merely requires that transfers to remote beneficiaries

114. See *supra* note 102.

115. Cf. *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 136-37 (statement of Harry L. Gutman) (ALI discussion of proposed generation-skipping tax credit after death of transferor).

116. See *id.* at 251-52.

117. See *supra* notes 83-97 and accompanying text.

be taxed as such beneficiaries receive distributions of cash or other property.¹¹⁸ If either form of a generation-skipping tax can be implemented so easily, why are the proposals so complex?

The answer can be traced to why we have proposals for a generation-skipping tax in the first place. Both the Treasury and the ALI argue in favor of a generation-skipping tax as a backstop to the estate and gift taxes.¹¹⁹ They see the paradigmatic generation-skipping transfer as a series of cascading life estates, which is the modern variant, as much as is possible, of the traditional fee tail. The Treasury and ALI seek to recharacterize and tax such transfers as if the property passes from generation to generation in fee simple absolute.¹²⁰

In the case of cascading life estates this recharacterization is not difficult; each life tenant becomes the deemed transferor vis-à-vis the next beneficiary. Such recharacterization, however, subjects the entire property to the generation-skipping tax even though only a portion of the property, the actuarially determined value of the remainder-beneficiary's interest, skips a generation.¹²¹ In other words, when the recharacterization is easy, it is also inappropriate.

The crux of the generation-skipping issue is the direct skip, and such transfers do not easily fit into this recharacterization mold. For example, who is the intermediate transferor in the case of an outright transfer from grandparent to grandchild? The ALI "resolves" this dilemma of its own creation by (1) recharacterizing the transfer as if it had been made in trust and followed by a complete distribution of the trust corpus to the actual beneficiary, and (2) treating the fictional trust as the donee of a taxable gift from the transferor and as the maker of a taxable gift to the actual beneficiary.¹²² These two fictional transfers are then subject to the gift tax. If the generationally remote beneficiary's interest follows a life estate, a different result obtains. The property is again subject to a double tax, but in this case one of the taxes is imposed at estate tax rates because the recharacterized transaction includes a deemed testamentary transfer by the intermediate beneficiary.¹²³ Because effective gift tax rates are as much as one-third less than effective estate tax rates,¹²⁴ employing both sets of rates in one generation-skipping tax produces horizontal inequity. For example, a devise by a grandparent to a child for life and then to a grandchild in fee incurs a generation-skipping tax based on the higher estate tax rates, while a direct transfer to the grandchild of the value of his remainder interest will be taxed at the lower gift tax rates.

The treatment of multigenerational skips causes further unnecessary com-

118. See *supra* notes 98-116 and accompanying text.

119. See *supra* note 29.

120. *Id.*

121. See *supra* notes 37-47 and accompanying text.

122. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 80 (statement of Harry L. Gutman).

123. See *id.* at 95.

124. See *Abrams*, *supra* note 42, at 21 n.113.

plexity. The proposals try to recharacterize transfers to very remote beneficiaries as a series of simple generation-skipping transfers, transfers that are then further recharacterized as a series of nonskipping gifts or devises.¹²⁵ At each level the proposals struggle to determine whether the fictional transactions are more like testamentary transfers subject to the estate tax, or more like lifetime transfers subject to the gift tax. In fact, though, direct skips, whether of one or several generations, are unlike testamentary or lifetime transfers of an intermediate generation deemed transferor. Once that concept is accepted, multigenerational direct skips can be taxed in the simple geometric way.¹²⁶

The problem is not that the drafters at the ALI or the Treasury have recharacterized poorly, but instead that they chose to recharacterize at all. All generation-skipping transfers can be analyzed as a combination of intervening terminable interests, intervening powers, and direct skips. Intervening terminable interests are adequately addressed by the existing transfer taxes. Intervening powers present no difficulties of their own: if the generation-skipping tax exempts direct skips, then the powers of appointment provision should address intervening powers; if the generation-skipping tax applies to direct skips, then intervening powers become irrelevant. Taxation of generation-skipping transfers is the taxation of direct skips, and direct skips cannot be fitted into the recharacterization mold dominating the current proposals.

The debate on the propriety of a generation-skipping tax should focus on taxation of direct skips. If imposition of a wealth tax at least every generation is appropriate, then a new tax on direct skips is needed. If not, then a reexamination of the estate and gift tax powers of appointment provisions is needed. In no event, though, should we continue to treat the generation-skipping issue as a loophole in the current transfer tax system to be filled with complexity and confusion.

125. See *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 96 (statement of Harry L. Gutman).

126. For example, if the generation-skipping tax on direct skips is 50%, and ignoring the possible application of a generation-skipping zero bracket, a double skip should be taxed at a rate of 75%, a triple skip at a rate of 87.5%, etc. The Treasury proposal does not tax multiple direct skips more harshly than single direct skips because a contrary approach allegedly would be "exceedingly complex." *Generation-Skipping Transfer Tax Hearing*, *supra* note 29, at 20-21 (statement of Ronald A. Pearlman).