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A PROPOSAL FOR RESTRUCTURING THE TAXATION OF WEALTH TRANSFERS: TAX REFORM *REDUX?*

by

EDWARD J. GAC* AND SHAREN K. BROUGHAM**

I. ABSTRACT

The Tax Reform Act of 1986 (TRA'86) provided for the most dramatic changes to the Internal Revenue Code since its inception over seventy years ago. The stated purposes of these reforms were to promote "fairness, simplicity, and economic growth." The short-term success of these measures has yet to be ascertained.

It is the position of this article that the long-term prospects for ultimate individual tax reform cannot be divorced from an eventual restructuring of the present federal wealth transfer taxation system, currently consisting of the estate, gift, and generation-skipping taxes. Genuine tax reform will remain unfinished business until such time as these transfers are fully interwoven into a reconstituted individual taxation system. It is time for an integrated system which interpolates the best elements of the newly passed income tax reforms while at the same time jettisoning the cumbersome, complicated and inefficient elements of the present wealth transfer taxes. This proposal is offered in the hope of changing the direction of future research and discussion away from the patchwork repairs of the past towards a new integrated system of taxation.

II. INTRODUCTION

Nineteen eighty-six was a year of sweeping federal tax reform. With the stated purpose of reducing complexity while increasing equity and efficiency,[1] the Tax Reform Act of 1986 (TRA'86)[2] was passed. By concentrating primarily on the income tax, the act ignored a major source of complexity, inequity, and inefficiency: the wealth transfer taxation of individuals.[3]

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[1] *See generally,* U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President* (3 v., 1984).

[2] Tax Reform Act Of 1986, Pub. L. No. 99-514 (1986), [hereinafter referred to as TRA'86].

[3] While the entire wealth transfer system, currently composed of the estate, gift *and* generation-skipping taxes, is in need of reform this paper concentrates only on the problems of the estate and gift taxes. The original attempt to deal with the problems of generation-skipping transfers in 1976 resulted in a tax which was so complex and flawed that it was repealed in 1986, retroactive to 1976! While Congress should be applauded for repealing a bad tax rather than attempting to "fix it," the tax which was adopted to replace it is not much improved in the area of complexity. The new tax will need to be evaluated in terms of its costs to society versus

The problems in the estate and gift taxes are legendary and reforms in this area are, indeed, necessary. The Treasury Department Office of Tax Policy is expected to make ongoing recommendations for changes to the wealth transfer tax structure in the coming year. In addition, at the request of the Treasury Department, the American Bar Association initiated a study of these problems.[4] Their study has resulted in a *Report on Transfer Tax Restructuring* sponsored by the American Bar Association Section of Taxation, Task Force on Transfer Tax Restructuring.[5]

The ABA Report's recommendations center around rate restructuring, clarification of the completed transfer rules, and limitation of allowable asset valuation methods. Though the report has not yet received the ABA's own *imprimatur,* several members of Congress have already cited certain elements of it in the recent debate over the Revenue Bill of 1987. Various aspects of the report will be discussed in detail throughout this article.

A key underlying assumption of both the Treasury Department and the ABA Report is the idea that the basic existing structure should be retained.[6] However, reform of the present transfer tax system will not redress its most basic flaw: it is a separate system of individual taxation. The estate and gift taxes are not, by their natures, separate from the individual income tax either in their object of taxation or in policy goals. They are historically and inherently linked.[7] Past failure to recognize this linkage has resulted in the current dual system of individual taxation which creates unnecessary complexity and unjustified compliance costs for both the taxpayer and the government.[8] The time is ripe for this linkage to be recognized through the merger and integration (hereafter called integration) of the income and estate and gift taxes.

In general, this integration could be achieved by the repeal of the estate and gift taxes and amendment of the income tax to include the receipt of all gifts and

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the revenues which it generates and the dispersion of wealth which it accomplishes. While a favorable evaluation does not appear likely, it nevertheless appears premature to advocate its outright appeal at this time. For this reason, the main focus of this paper will be on the estate and gift taxes. A limited discussion of alternatives for the generation-skipping tax is provided on pp 46-47, *infra,* text accompanying notes 119-20.

[4] Letter from then Assistant Secretary of the Treasury for Tax Policy Ronald A. Perlman to Hugh Caulkins, then Chairman of the American Bar Association Section of Taxation (Nov. 19, 1985).

[5] *Report on Transfer Tax Restructuring,* Holdsworth, scheduled for publication in the Winter, 1988 issue of THE TAX LAWYER. [hereinafter referred to as ABA Report].

[6] Indeed, steps taken by Congress over the years indicate a strong intent to keep the dual system rather than an integrated income tax system. *See also* Osgood, *Carryover Basis Repeal and Reform of the Transfer Tax System,* 66 CORNELL L. REV. 302 (1981).

[7] For a discussion of this linkage, *see* Appendix I.

[8] McNulty, *Fundamental Alternatives to Present Transfer Tax Systems,* in DEATH, TAXES AND FAMILY PROPERTY 94-95 (E. Halbach ed. 1977), "The executive, judicial, and legislative costs of administering, interpreting, and reforming these taxes are fairly large. The capital accumulation and other economic effects of such taxes may be substantial and in important respects negative. Also, huge costs of compliance or legitimate avoidance are borne by taxpayers, and tax-motivated planning involves more than transaction costs — it also produces intrusions, distortions, and apparent inefficiencies in the allocation of economic resources, not to mention inequities among taxpayers." *See also* Dobris, *Marshalling Arguments in Favour of Abolishing the Capital Transfer Tax,* 6 BRITISH TAX REV. 367 (1984).

bequests in the taxable income of the transferee. While each of these two provisions has individual merit, a proposal joining the two provisions would provide a creative and effective solution to many of the problems which would preclude the passage of either separately.[9] Though there have been calls to "leave things alone for awhile," [10] an understandable reaction to the seemingly perpetual deluge of major tax changes during the past few years,[11] the simple reality is that the tax code will not and cannot be left alone. *La forza del destino* [12] now upon us is deficit reduction through combinations of reduced governmental spending and revenue enhancement. Given the overriding need for more revenue in the post TRA'86 era, wealth transfers provide a likely arena for further tax reform.[13]

Long-term prospects for ultimate individual tax reform cannot be divorced from an eventual restructuring of the present federal wealth transfer taxation system. Such restructuring would continue to pursue the goals for which estate and gift taxes were originally enacted, generating[14] revenue while preventing dynastic accumulations of wealth,[15] and eliminate many of the inequities and inefficiencies entailed by maintaining the present dual system. The base broadening goals of TRA'86 now make integration a politically viable proposition and a logical extension of that act,[16] not a negation of it.

III. TAX POLICY PROBLEMS WITH WEALTH TRANSFER TAXES

1. Historical Quandary Over Death Taxes

Outright repeal of the estate and gift taxes has often been advocated in the past though never fully accomplished in the United States.[17] Our society's attitude

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[9] McNulty, *supra* note 8, eloquently stated the case for integration, "(Integration into the income tax) would read more understandably, yield more revenue, bear more fairly on taxpayers, administer and generally operate more simply, impose lower transaction and compliance costs, redistribute more effectively and produce a more neutral or otherwise more desirable influence on the allocation of resources."

[10] *See* Worthy, *Testimony Before the House Ways and Means Committee,* 4 AMERICAN JOURNAL OF TAX POLICY 4 (1985).

[11] The frightening fact is that, just prior to TRA'86, "over 5,000 subsections of the I.R.C. . . . have been substantially affected . . . in less than eight years." *Id.* at 5. TRA'86 contains about 1,850 separate Code amendments.

[12] "The Force of Destiny," from the opera by Giuseppe Verdi, (1813-1901), first performed 10 Nov. 1862, based on a play by Don Piave, after A.P. de Faavedra, Duke of Rivas, "Don Alvaro, O La Fuerza Del Sino" (1835).

[13] While it is certainly understandable that wholesale changes in the entire tax structure could not be done in one fell swoop, the Treasury Department's November, 1984 report to the President called for future consideration of fundamental reforms to the federal wealth transfer structure. *Supra* note 1.

[14] *See* Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income,* 91 HARV. L. REV. 1189 (1978), "It might seem that these receipt-oriented taxes would be less effective in raising revenue since the number of transferees is usually greater than the number of transferors. But the effectiveness of any transfer tax scheme in raising revenue — as well as in breaking up accumulations of wealth — depends upon its rates and exemptions." *See also* McNulty, *supra* note 8, at 98.

[15] Boskin, *An Economists' Perspective On Estate Taxation,* in DEATH, TAXES AND FAMILY PROPERTY 65 (E. Halbach ed. 1977), "My own opinion is that any attempt to reduce (substantially) inequality in the distribution of wealth via estate and gift taxation is doomed to failure, quite apart from the questions of its costs and thus its desirability."

[16] McNulty, *supra* note 8, at 96, "To tax gifts and bequests as income would be to expand the base of the income tax and to comprehend . . . these important items of accretion . . . (and) would enable (the income tax) even better to 'get at' overall ability to pay."

[17] *See generally* Dodge, *supra* note 14, at 1177; McNulty, *supra* note 8, at 94-95; Jatscher, *The Aims of Death*

towards the estate and gift taxes has always been one of ambivalence. These taxes best illustrate the inherent balancing act between the need to generate revenue and the desire to promote social goals. There is no question that a confiscatory estate tax could raise large amounts of revenue. If revenue were our only concern, then the passage of a truly confiscatory tax, such as 100 percent of all properties owned at death, would be the proper Congressional response. However, in addition to generating revenues, any tax produces ancillary economic effects, the behavioral consequences of which can not be predicted with certainty.[18] Today, few would argue that the effects of a truly confiscatory estate tax would ever be desirable.[19] Even strongly socialistic and communistic governments do not impose a true 100 percent death duty.[20]

In the United States, capitalism is based on the concept of private property, and many of our current tax laws are designed to encourage private investment and savings.[21] By its very nature, capitalism requires the accumulation of private capital, and its success is most often measured in terms of the amount of property accumulated. Furthermore, most people believe that it is natural and "good" to accumulate property with the expressed intention of providing benefits for their heirs.[22] Yet it was fear of an "unhealthy" accumulation of property and the economic and political power that it can generate, which fostered the adoption of the original estate tax. Fear of dynastic power coupled with unlimited testamentary disposition remains a legitimate tax policy concern today because of the long track record of failure to limit wealth accumulation through wealth transfer taxes.

Balancing these two goals has kept the U.S. from raising maximum revenues from the estate and gift taxes. While the economic results of a marginally confiscatory tax are less severe than the 100 percent scenario described above, an effort to raise substantially higher revenues via the estate and gift taxes will limit an individual's ability to pass wealth on to their heirs and discourage private savings and investment by entrepreneurs.[23]

This inherent conflict is not unique to estate and gift taxes. All power to tax must, in the end, be tempered by the realization that this power can also destroy.

Taxation, in DEATH, TAXES AND FAMILY PROPERTY 40-55 (E. Halbach ed. 1977); Surrey, *An Introduction to Revision of the Federal Estate and Gift Taxes*, 38 CALIF. L. REV. 5 (1950). *See also* Dobris, *supra* note 8, at 363. *However*, Graetz would hate to see these taxes repealed, ". . . (we) will have lost a great source of humor." Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L. J. 259 (1983).

[18] *See* Harris, *Estate Taxation and Needs For Capital*, 110 TR. & EST. 538-541 (1981); *see also* McNulty, *supra* note 8, at 99.

[19] *See* Dobris, *supra* note 8, at 365.

[20] It will be interesting to track any changes in the Soviet law of inheritance under the current movement towards *glasnost*.

[21] "The critical policy judgment in the law of (death taxation) . . . is the decision which locates the point at which . . . (taxes) begin to discourage investment." Shaffer, *Death, Property, and Ideals*, in DEATH, TAXES AND FAMILY PROPERTY 34 (E. Halbach ed. 1977).

[22] *See* Halbach, *An Introduction to Chapters 1-4*, in DEATH, TAXES AND FAMILY PROPERTY 5 (E. Halbach ed. 1977).

[23] *See* Boskin, *supra* note 15, at 60.

Nor will this proposal resolve the conflict between the revenue requirements and social goals of taxation. Congress seems destined to dance around these twin fires of tax policy for eternity. The proposal can, however, vastly improve the taxation of individuals by improving the income tax base, a base which will take into account, finally, these true accretions of wealth.

2. *Complexity v. Revenue*

If one is to judge the estate and gift taxes on the traditional criteria of a "good tax,"[24] that it should be equitable, efficient, and simple to administer and comply with, the estate and gift taxes are an abysmal failure. The current complexity of these laws is simply unacceptable. The ABA reform proposals, with regard to the transfer sections, provide a limited attempt to address the need for clarity and simplification.[25] While quite possibly adding to that complexity in transition, reform should set a more comprehensive course towards "fairness, simplicity, and economic growth" in the future.

Unfortunately, the cumulative effect of prior attempts to amend the law, in order to render it more equitable, has resulted in a law which is almost incomprehensible.[26] The history of the estate and gift taxes is a litany of failures, the most notable of which have been the recent attempts to correct generation-skipping[27] and stepped-up basis problems.[28]

The complexity of the estate and gift taxes is especially unacceptable in relation to its ineffectiveness as a revenue raising device.[29] Historically, the estate and gift taxes have generated about the same amount of revenue as the excise tax on cigarettes.[30] And by the time the Economic Recovery Tax Act of 1981 (ERTA)[31]

[24] The seminal work on efforts to define a "good tax" is found in A. Smith, *The Wealth of Nations* (1910) book V, chapter II, part II, "On Taxes," with reference to Smith's famous "cannons of good taxation." Other classic works in this area would include: J.S. Mill, *Principles of Political Economy* (1921) book V, chapter II and A.C. Pigou, *A Study in Public Finance* (1928) part II. A modern reference text widely used by economists is R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice* (4th Ed., 1984).

[25] *See* ABA Report, *supra* note 5, "Uniform Transfer Completion Rules" at 16-32.

[26] *See* Worthy, *supra* note 10, at 3, ". . . unfortunately the response (to 'loopholes' in the income tax) frequently has been enactment of a *proliferation of complex, sometimes incomprehensible provisions incapable of being complied with or administered in any rational fashion* (emphasis in original)." Mr. Worthy could have also been speaking of the entire federal tax system in general, or of the transfer tax system in particular.

[27] *Supra* note 2, (TRA'86) Sec.s 1431 through 1433 therein, now reflected in the Internal Revenue Code of 1986, *Tax on Generation-Skipping Transfers* (Subchapters A-G of Chapter 13, §§ 2601-2663) (1986).

[28] Stepped-up basis for inherited property was eliminated by the carryover basis provisions of P.L. 94-455, Sec. 2005, 90 Stat. 1872 (1976). These provisions, however, never became fully effective due to the complexity of I.R.C. § 1023 (1954) (*See* Sen. Rep. No. 1263, 95th Cong., 2d Sess. 213-14 (1978)). The stepped-up basis provisions were repealed by the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223, Sec. 401(d), 94, Stat. 229 (1979)).

[29] *See* Jatscher, *supra* note 17, at 40-41, "Indeed, in view of the small proportion of total receipts that these taxes contribute and the high cost of administering them, it is arguable that if the taxes were only imposed to raise revenue, they ought to be abolished." *See also* Dobris, *supra* note 8, at 369; *Final Report of the American Assembly on Death, Taxes and Family Property,* in DEATH, TAXES AND FAMILY PROPERTY 187 (E. HALBACH ED. 1977) [hereinafter referred to as American Assembly Report].

[30] *See* Appendix I.

[31] Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

is fully phased in, the revenue generated from estate and gift taxes should be significantly less than revenues from the cigarette tax. Yet the costs of planning, compliance, and enforcement have not been reduced. This problem is well illustrated in the previously mentioned ABA Report, at Exhibit B, by a long and convoluted will clause which is barely comprehensible to the practicing bar, let alone the testator. If the purposes for which the estate and gift taxes exist — the generation of revenue and the limiting of inherited power — can be accomplished in a simpler and more equitable manner, they should be.

3. *Equity*

Under capitalism, we generally view the accumulation of property as "good," an equitable reward for a "job well done." However, our attitudes towards inherited wealth seem to differ significantly from our attitudes towards earned wealth.[32] Inherited property is not viewed as a reward for a job well done; rather, it is seen as a reward for an accident of birth. Our society's belief in equality of opportunity, joined with the fear of dynastic power, led to the present laws' attempt to limit the transfer of excessive wealth by gift or bequest. The current definition of excessive is any gift of more than $10,000[33] to any nonspousal donee per year and any estate in excess of $600,000.[34] In today's search for revenue enhancement, this definition is considered by many to be overly generous.[35] In addition, these generous thresholds of taxation have resulted in a significant decrease in the number of individuals directly affected by the taxes.

The estate tax reaches a very small percentage of the nation's potential taxpayers. For deaths occurring in 1982, less than two percent of all estates were required to file a return, and, of that two percent, barely more than half actually paid any tax.[36] It is estimated that, when the effects of ERTA are fully phased in, the percentage of estates which actually pay a tax will be less than one-half of one percent.[37] Yet the impact on those estates which are taxable can be quite dramatic. The estate tax is one of the few high bracket individual taxes remaining after TRA'86.[38]

It is impossible to be certain that it is only the estates of the wealthiest which are impacted by this high bracket tax, or that the wealthiest are impacted equal-

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[32] *See* American Assembly Report, *supra* note 29, at 184; DeWind, *The Approaching Crisis in Federal Estate and Gift Taxation*, 38 CALIF. L. REV. 79-80 (1950).

[33] I.R.C. § 2503(b) (1986).

[34] I.R.C. § 2010(b) (1986).

[35] The American Assembly Report highlighted this ongoing debate, "It should be noted that there was not in this Assembly, any more than there is in American society as a whole, a consensus concerning the amount of individual wealth to be considered objectionable . . .", *supra* note 29, at 185. *But see* ABA Report, *supra* note 5, at 10, par. 4.

[36] *See* Bentz, *Estate Tax Returns, 1983*, I.R.S., Statistics of Income Bulletin, 1-12 (1984).

[37] *See* Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX LAW. 113 (1981).

[38] Compare the top brackets in 1987 for the Estate and Gift Tax — 55 percent [I.R.C. § 2001(C)(2)(d) (1986)] to the top income tax brackets under TRA'86 — 38.5 percent [I.R.C. § 1(h)(2) (1986)].

ly. George Cooper, in *A Voluntary Tax?*, posits that the estate and gift taxes are so riddled with loopholes that they are paid only by those decedents who die unexpectedly, fail to adequately plan for their death, have assets which do not easily lend themselves to manipulation, or feel a moral obligation to pay their fair share.[39] Unfortunately, the intervening years of reform have failed to correct these inequities noted by Cooper in 1979.[40] It is still not merely the smallest estates which avoid taxation nor the largest estates which pay the highest taxes.[41]

It has often been argued that the estate and gift taxes are necessary to add an element of progression to the income tax and that the high bracket can be justified on that ground alone.[42] The new bracket structure of TRA'86 seems to belie any continued justification for the tax on the basis of needed progressivity. TRA'86 has determined that progression is of lesser importance than simplicity or equity in the income tax.[43] The previous fifteen brackets have been condensed into basically three, with an ultimate reduction in the maximum rate from fifty percent to twenty-eight percent.[44] If simplicity and equity are of primary importance in the taxation of individuals, then the estate and gift taxes should also be brought into harmony with these rates. The various avoidance techniques are too complex and too expensive to create and administer. Furthermore, they are unequally availed of both within and across brackets. Neither horizontal equity, the ability to pay equally based on capacity, nor vertical equity, the progressive notion of paying more by those with a greater capacity, is properly served by the present bifurcated rate structure. In the end, a single rate structure applied to a more comprehensive measure of individual income would be more equitable.

4. *Efficiency*

For a tax to be considered efficient, it should not interfere with the workings of our market system. Again, the estate and gift taxes fail this test.[45] They interfere with the markets' ability to allocate resources efficiently in three ways. The first is in the great deal of human resources which are diverted to the conceptualizing, implementing, and managing of tax avoidance techniques which produce little, if any, societal benefit. In addition, the scarce resources of the IRS are diverted from the income tax to this area which produces little revenue.[46]

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[39] G. Cooper, A Voluntary Tax? 79 (1979).

[40] *See also* McNulty, *supra* note 8, at 94, "(federal transfer taxes) also produces . . . inequities among taxpayers depending upon whether they can avail themselves of expert advice"; Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?,* 117 Tr. & Est. 598, 674 (1978); Pedrick, *supra* note 37, at 126.

[41] Gross estates in excess of $300,000 reported in 1983 totaled only $50 billion, approximately two-thirds of a $72 billion potential base. *See* Appendix I.

[42] C. Shoup, Federal Estate and Gift Taxes 100-101 & 119-120 (1966). *But see* Dobris, *supra* note 8, at 366.

[43] It is interesting to note that the ABA report also suggests that progression is of lesser importance. It proposes a flat rate for estate and gift taxation, ABA report, *supra* note 5, at 3. *But see* Graetz, *supra* note 17, at 285, ". . . the estate tax seems far more likely to wither than to grow stronger . . . this prediction makes me fear the demise of progressive taxation in the United States."

[44] Contrast I.R.C. § 1 (1954) with I.R.C. § 1 (1986).

[45] *See* American Assembly Report, *supra* note 29, at 187.

[46] *See also* Dobris, *supra* note 8, at 367.

A second inefficiency results from the tax avoidance techniques themselves. Most involve complex trust or corporate arrangements which often serve no purpose other than the reduction of estate taxes. They tend to concentrate wealth in paper entities which preclude easy access to the market.[47] Given the progress made by TRA'86 in eliminating income tax shelters which had no economic or profit motive when evaluated sans tax savings, such strictures to economic growth in the wealth transfer system should now be assailed also.

The third major inefficiency is the way in which these taxes interfere with timely investment decisions. This phenomenon is generally referred to as the "lock in" effect; ie., keeping property off the open market so as to take advantage of the deferential tax benefits of stepped-up basis. Since properties which have appreciated in value, and are subsequently bequeathed, receive the benefits of stepped-up basis while escaping the detriments of income taxation on the appreciation, the result is a decided bias towards the holding of nonmonetary assets. In addition, this "death escape" precludes changing the form of ownership through a sale and reinvestment during later years. The tax benefits forgone by engaging in such transactions are simply too great. While this is really an inefficiency of the income tax, it plays such a significant role in estate planning that it seems appropriate to include it here.[48]

5. *Problems of the Dual System*

The current dual system of separate income and estate and gift taxes creates unnecessary complexity and unjustified compliance costs for both the taxpayer and the government. A great deal of time and money is spent by individual taxpayers with the sole purpose of reducing the impact of income and transfer taxes. Each tax requires its own specialists, and each requires the use of specialized, and often conflicting, procedures for taking full advantage of the benefits legitimately available under each. This conflict entails costly tax strategies which, albeit successfully resolved from the specialist's point of view, often results in the taxpayer's feeling of confusion and disillusionment about the entire tax system. The frustrated taxpayer bears the ultimate cost for both sides by paying either in taxes or fees. Thus, the inequities, inefficiencies, and complexities of each tax are only compounded by the other. The ABA Report very clearly illustrates the

[47] *Id.* at 367-368.

[48] While this integration proposal will significantly reduce the problem of the lock-in effect by requiring transferees to "buy" their stepped-up basis (*see* Basis, *infra.* text accompanying notes 101-105.), it will not entirely eliminate the problem since the transferor will continue to escape taxation on capital appreciation accruing before transfer. The question of the propriety of treating gratuitous transfers as realization events is extremely controversial and beyond the scope of this article. For a general discussion of the issue *see* Graetz, *Taxation of Unrealized Gains at Death: An Evaluation of the Current Proposals,* 59 VA. L. REV. 830-859 (1973)); Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth,* 19 WILLAMETTE L. REV. 42-49 (1983); Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or Death,* 50 TAXES 837-843 (1972). *See also* Brannon, *Some Economics of Tax Reform, 1986,* 39 NAT'L TAX J. 278 (1986); Graetz & McDowell, *Tax Reform for 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax,* 3 YALE L. & POLICY REV. 23 (1984); Boskin, *supra* note 15, at 66; Gutierrez, *Taxation of Wealth Transmission: Problems and Reforms,* in DEATH, TAXES AND FAMILY PROPERTY 82-83 (E. Halbach ed. 1977).

extent of this complexity by the use of a "typical" will clause which is almost two pages long.[49]

The duality of the present system has also needlessly increased complexity and administrative costs for the government. For example, the current audit division structure within the Internal Revenue Service (IRS) provides for two separate and distinct operations to review income and wealth transfer taxes. The estate, gift, and generation-skipping audit operation is categorized as a completely separate job classification and functionally operates within a separate sphere from income tax audits. Even modest intra-agency proposals for a "combined audit" at death in order to close out an individual's tax business have never really been implemented by the IRS.[50]

Other examples of improved tax administration which would result from integration are provided in what might be generally called "limiting the absurds" of tax benefits. As the structure now stands, one arm of the IRS simply often does not know what the other arm is doing. The taxpayer is often able to take advantage of this administrative ignorance. For example, under employee stock ownership plan (ESOP) provisions of the code,[51] the taxpayer receives certain benefits based on valuation placed on closely-held stock transferred to employees under an approved ESOP plan. From the income tax side, the Employee Benefit Section of the Audit Division will be charged with the initial responsibility of reviewing the value presented by the taxpayer. The key concern of the government is over valuation. Yet, when that same stock shows up on an estate tax return the issue is quickly reversed. Now, with the tax base arising from the value of included assets in the estate, under valuation becomes the central issue. Under an integrated system, the stock would be valued only once for income tax purposes and that value should be binding on all subsequent income tax transactions, with proper adjustments for lapse of time, etc.

There are numerous other scenarios such as this which point to the same essential result of inefficient tax administration and lost revenue resulting from a bifurcated individual tax structure. While many of the benefits which would result from closer cooperation within the IRS could, and should, be adopted without necessarily integrating the two taxes, the best cooperation would be facilitated by full integration of these taxes into a unified individual tax structure.

[49] ABA Report, *supra* note 5, at Exhibit B.

[50] There are some recent positive steps being taken within the audit division. In the area of reviewing fiduciary income tax returns filed by trusts, on a very limited basis, several districts are experimenting with the training of estate tax personnel to conduct audits of those returns. This may be due, in part, to the fact that fiduciary income tax reporting is one of the most under examined areas of audit review. Currently the audit percentages on fiduciary tax returns stands at about four-tenths of one percent of all returns filed (per phone conversations with audit personnel at the Denver and San Francisco District Offices of the I.R.S. during 1986). Certainly this can be improved upon in a more fully integrated personal tax structure.

[51] I.R.C. §§ 404; 1042; 2210; 6018(c) (1986).

IV. ALTERNATIVES TO THE ESTATE AND GIFT TAXES

Since 1916, a number of proposals to replace the estate and gift taxes have been advanced.[52] The primary alternatives discussed have been: [1] a federal inheritance tax,[53] [2] a periodic wealth tax,[54] [3] an accessions tax,[55] and [4] incorporation into the income tax.[56] While none has been adopted in its entirety, some of the better elements of each have been incorporated into the seventy years of ongoing amendment to the existing estate and gift taxes.

An inheritance tax is assessed on the heir, rather than the decedent's estate, and the rate of taxation is generally based on the relationship to the decedent. Elements of an inheritance tax can be found in the unlimited marital deduction[57] and the exclusion of payments for the support, education, and medical needs of dependent children from the gift tax.[58] These sections are a necessary recognition that the family relationship is not inherently a financial one,[59] but rather it is a relationship of mutual support which, at times, can involve finances. Integration should retain the current exclusions under I.R.C. Section 102 to the extent that they continue to recognize and foster the intra-family relationship elements of support, education and medical necessities. These are equitable provisions and should be maintained in any future changes.

A European-styled wealth tax attempts to measure the "worth" of an individual and bases the tax liability upon this indication of "ability to pay." The classic example of its advantages in matching tax with ability to pay is the case of the beggar and the gold hoarder.[60] They have equal tax liability under the in-

[52] ERTA, in the opinion of Pedrick, *supra* note 37, at 113, "... brought the United States to within an inch of [Reagan's] expressed campaign wish to abolish the estate and gift tax." The administration did not pursue repeal as a matter of political expediency. The fear of giving too many breaks to the "rich" was the overriding concern in the decision. Using 20/20 hindsight, it was apparent to Congress in 1986 that many of the "capital-raising" provisions of the 1981 Act, such as "fast-ACRS" for real estate, etc., were simply *too generous* and created serious revenue erosion.

[53] In 1898, the federal government imposed an inheritance tax which was upheld in Knowlton v. Moore, 178 U.S. 41 (1900); the Senate Finance Committee urged that an inheritance tax be substituted for the estate tax in 1918, SEN. REP. No. 67, 65th Cong., 3d Sess. (1918), 1939-1 CUM. BULL. 127. *Federal and State Death Taxes, A Report to the Joint Committee on Internal Revenue Taxation* (U.S.G.P.O., 1933). *See* Rudick, *What alternative to the Estate and Gift Taxes?,* 38 CALIF L. REV. at nn. 1 & 41 (March 1950).

[54] *See* Cooper, *Taking Wealth Taxation Seriously,* 34 THE RECORD 24-57 (1979); Verbit, *supra* note 40, at 677, 679-680; Jastscher, *supra* note 17, at 46-49; Isaacs, *Do We Want a Wealth Tax in America?,* 32 U. MIAMI L. REV. 23 (1977).

[55] *See generally* Bravenec & Lassila, *An Accessions Emphasis For Federal Estate and Gift Taxes,* TAX NOTES 1069 (1984); ALI, Federal Estate and Gift Taxation 446-589 (1969); Andrews, *The Accessions Tax Proposal,* 22 TAX L. REV. 589 (1967). *See also* Boskin, *supra* note 15, at 66; Jatscher, *supra* note 17, at 54-55; McNulty, *supra* note 8, at 89-93; American Assembly Report, *supra* note 29, at 187; Rudick, *supra* note 56, at 150-182; Rudick, *A Proposal for an Accessions Tax,* 1 TAX L. REV. 25 (1945).

[56] *See* Dodge, *supra* note 14; McNulty, *supra* note 8 at 95-99; American Assembly Report, *supra* note 29, at 187; Hudson, *supra* note 48, at 59.

[57] I.R.C. § 2056 (1986).

[58] I.R.C. § 2503(e) (1986).

[59] *But see* Rhodes, *Individual, Couple, or Family? The Unit of Taxation for Transfer Tax Purposes: A Shifting Focus,* 17 AKRON L. REV 607 (1984).

[60] *See* Bale, *Temporal Equity in Taxation,* 55 CAN. B. REV. 17 (1977).

come tax but unequal ability to pay. A wealth tax would remedy this inequitable situation since it would tax the hoarder on his accumulation, regardless of what the income is, while the beggar would continue to escape liability.

One strong argument in favor of retaining the estate and gift tax comes from the arguments supporting a periodic wealth tax: ability to pay is assured. The current tax is essentially a wealth tax; it simply is not periodic, except as relates to gifts.[61] The estate and gift tax, however, seems to share more of the disadvantages of the wealth tax than its better elements. Both entail the problems of valuation, liquidity, and discovery.[62]

An accessions tax, like the inheritance tax, is assessed on the heir rather than the decedent's estate and is generally assessed at a progressive rate which favors transfers among closely related parties. The accessions tax proposed by Andrews[63] incorporated many of the elements of a consumption tax which foster savings and is considered by many to better incorporate the concept of ability to pay than either a wealth or income tax. An accessions tax looks to the situation where taxpayers with equal economic income have unequal tax liabilities due solely to the fact that one is unlucky enough to have to earn his income while the other is fortunate enough to receive his as gift or bequest.

An accessions tax accumulates all gratuitous transfers received during a taxpayer's lifetime and imposes a progressive tax on them. It is this accumulation requirement, as well as its shift in the incidence of taxation to the transferee, that has probably prevented its acceptance in the wealth transfer area. If and when the notion of accessions based taxation is accepted, it is most likely to happen at the income tax level with taxation of estate and gifts collaterally caught in the new web. A variation on this theme is found in Aaron and Galper's *Assessing Tax Reform*.[64] That plan is entitled "The Cash Flow Income Tax" and is "based on the principle that all income should be taxed once in the course of a taxpayer's lifetime."[65] That tax would be imposed on all consumption plus transfers to others through gifts or bequests.[66]

The fourth alternative to the estate and gift taxes, its integration into the income tax, takes an approach which is similar to the accessions tax. The incidence of taxation would be shifted to the recipient. Unlike the accessions tax, however, this approach would not accumulate the transfers. Rather, it would merely include all gifts and bequests which were received during the current period in the current taxable income of the transferee. A primary reason why this suggestion has

[61] *Id.* at 8. *But see* Jatscher, *supra* note 17, at 48 . . . "The differences between a death tax and a periodic tax on net wealth are so substantial that I do not believe a death tax can be supported as a substitute for the other."

[62] *See* Cooper, *supra* note 54, at 33-43; Isaacs, *supra* note 54, at 39-46.

[63] *See* Andrews, *supra* note 55.

[64] H. Aaron & H. Galper, Assessing Tax Reform 66-107 (1985).

[65] *Id.* at 66.

[66] *Id.*

failed to be adopted in the past is that this rather simple approach has almost always been advanced in conjunction with a call to radically change the income tax.[67] It has most often been tied to the adoption of an accessions or a consumption tax.

The concept of integrating the estate and gift taxes into the income tax, not as a separate tax on transfers, but as an item of taxable income to the transferree, deserves reexamination during the present climate of ongoing tax reform. Such a provision would be a bona fide extension of the base broadening efforts of TRA'86, and could be accomplished in a relatively easy and straightforward manner. This change would more closely match the "official" incidence of taxation with the "emotional" incidence, and would eliminate many of the inequities and inefficiencies which result from the duality of the present system of individual taxation.

V. OUTLOOK FOR REFORM OF ESTATE AND GIFT TAXES

Prior attempts to reform the existing estate and gift taxes have mainly taken the form of closing loopholes.[68] However, rather than merely closing existing loopholes, these reforms have most often generated more complex techniques of tax avoidance. This is a concern with the approach taken in the ABA Report.[69] That report does include a number of real reforms such as a flat tax rate,[70] portability[71] between spouses of a new and higher exemption,[72] and a number of other positive proposals such as those which clarify what constitutes complete versus incomplete transfers.[73] The ABA Report's basic problem is that it assumes the continuation of the present dual track individual federal tax system. As worthy as the ABA proposals are, seventy years of fixing is enough. Gratuitous transfers of wealth have never been properly included in any comprehensive plan for the taxation of individuals.

Some of the key arguments against repeal are these: [1] transfer taxes limit the extent to which wealthy parents can confer unearned advantages on their children,[74] [2] transfer taxes provide not only a back up to, but also an element

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[67] *Id. But see* Dodge, *supra* note 14; Bale, *supra* note 60, at 13.

[68] *See* Halbach, *An Introduction To Chapters 5 & 6,* in DEATH, TAXES AND FAMILY PROPERTY 69-70 (E. Halbach ed. 1977), "The tragedy of the history of American transfer taxes to date is that we have paid the price of change without the benefits of real improvement, even with respect to those desired qualities about which there is a consensus."

[69] *Supra* note 7.

[70] *Id.* at 3.

[71] *Id.* at 3.

[72] *Id.* at 5.

[73] *Id.* at 16-32.

[74] Or at the minimum, the tax is perceived to limit those advantages. Continuing this perception is considered a worthy purpose in and of itself. *See* Dobris, *supra* note 8, at 378, ". . . statistics and empirical studies are less important than perceptions." *See also* Gutierrez, *supra* note 48, at 84; Graetz, *supra* note 17, at 259; Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VIR L. R. 1209-1212 (1983); Worthy, *supra* note 10, at 2; Rhodes, *supra* note 59, at 607; Robinson, *The Federal Wealth Transfer Taxes — A Requiem,* 1 AMER. J. TAX POLICY. 39 (1982).

of progressivity in, the income tax, [3] charities would lose a major source of funds, and [4] the deficit makes the elimination of any revenue source unwise at this time.

In response to the first objection, interesting studies by John A. Brittain suggest that inherited wealth is of limited importance to this question.[75] The advantages which the children of the wealthy enjoy are primarily the result of better educations, more propitious marriages, and noncapital advantages in the form of "pull."[76] These social issues can be better addressed through improved opportunities in education and job markets, not through the tax laws. If our concern is really one of limiting the transfer of wealth-related power rather than limiting the transfer of economic advantages, then any tax which favored the dispersion of accumulations, such as the breaking up of *excessive* concentrations of wealth,[77] would be preferable.[78]

As to the second argument, that the estate and gift taxes are necessary to correct flaws in the income tax, our response is to agree that there are flaws in the income tax. We disagree, however, that the present estate and gift taxes can correct these flaws, or even that they should be used to accomplish that purpose.[79] The flaws of the income tax should be addressed and amended through the income tax laws, not through a dual system of taxation.

In response to the third argument, charitable bequests at death *are* a major source of revenues for many worthwhile organizations,[80] although one is tempted to reconsider this supposition in light of that highly publicized air conditioned doghouse for Jim and Tammy Bakker's pet.[81] However, the argument that charities

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[75] *See* J. Brittain, The Inheritance of Economic Status (1977); Boskin, *supra* note 15, at 63, "Will a decrease in bequests decrease inequality? I very much doubt it"; Jatscher, *supra* note 17, at 52, "Not all wealth is inherited, and therefore even if all inheritances were confiscated by the state the distribution of wealth in American society would still be unequal . . ."; Verbit, *supra* note 40, at 677. *See also* J. Brittain, Inheritance and the Inequality of Material Wealth (1978).

[76] *See* Brittain, The Inheritance of Economic Status, *supra* note 75, at 29-34.

[77] The income tax, with its "pay as you go" element is intrinsically better suited for pursuit of this goal. It would give real teeth to the notion of checks on unhealthy accumulations of wealth due to its annual accounting. This timing structure would be far superior to the present dual system in which the taxpayer need only account to the government once in a lifetime, or in an effective generation-skip, only twice in three lifetimes. Annual accounting should also enhance compliance.

[78] *See also* Jatscher, *supra* note 17, at 54, "The anti-concentration aim calls for a death tax tailored to the circumstances of the recipient rather than those of the decedent . . ."; Boskin, *supra* note 15, at 66, "Another potential improvement would be to move away from the estate (transferor-oriented) tax to a transferee-oriented tax."

[79] *But see* Surrey, *supra* note 17, at 6.

[80] Even though private giving reported in 1977 accounted for only 22 percent of charities' receipts (and slightly less than 20 percent of that amount came from bequests) all private receipts are essential to maintain the independent status of most charities and, according to Salamon & Clotfelter, "anything that threatens private giving threatens the very essence of the private (charitable) sector." *See* Salamon & Clotfelter, *Will the Tax Act Hurt Charitable Giving?*, 120 TR. & EST. 8-9 (1981). In addition, charitable contributions reported on 1983 estate tax returns totaled $2.5 billion (Bentz, *supra* note 36), a not insignificant amount.

[81] The House Ways and Means Subcommittee on Oversight held hearings in the fall of 1987 to review the federal tax law relating to tax-exempt organizations as response to the scandals surrounding certain television ministries.

would lose this revenue source if the estate and gift taxes were repealed is not necessarily valid. Decedent contributions seem to arise primarily from the decedents' wishes to contribute to their fellow man rather than a wish to reduce estate taxes.[82] The relative stability of past estate tax rates has made the price elasticity of charitable bequests difficult to investigate.[83] Future research in this area should be facilitated by the annually decreasing rates of ERTA.[84] Until such research becomes available, preferential treatment for these contributions should be continued. Their favored status under the estate and gift taxes could easily be accommodated through integration in the income tax, which already provides incentives for charitable giving.[85]

As to the fourth argument, repeal is not likely to be easily accomplished in this age of Draconian deficits. The ever constant struggle of vested interest groups, both in and out of the government, to increase or decrease, respectively, their piece of the "tax pie," makes it very difficult to ask Congress for repeal of any tax without an equitable means of raising replacement revenue. No matter how bad the tax or how small the revenues, the deficit prohibits serious consideration of any proposal which would even marginally lower federal revenues. Coupling repeal of estate and gift taxes with an inclusion of gratuitous transfers in the taxable income of the transferee could meet this revenue requirement. Through manipulation of the exclusion amounts, Congress could assure that the integration proposal was revenue neutral or even revenue enhancing if it so desired. The integration proposal advocated by this paper, and detailed in the following section, is not merely a loophole plugging approach to transfer tax reform. It offers an opportunity to substantially simplify the taxation of individuals while solving many of the problems associated with other reforms. If is also provides another reasonable avenue for deficit reduction, so be it.

VI. INTEGRATION OF ESTATE AND GIFT TAX INTO THE INCOME TAX

1. *Introduction*

Many issues arise from a plan to integrate estate and gift taxes into the in-

[82] *See* Tidd, *Tax Act May Not Hurt Charitable Giving*, 120 TR. & EST. 16 (1981). *See also* Friedman, *The Law of Succession in Social Perspective*, in DEATH, TAXES AND FAMILY PROPERTY 24 (E. Halbach ed. 1977); Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 1002-1006 (1970) *But see* Salamon & Clotfelter, *supra* note 80, at 10.

[83] There is virtually no analysis in this area according to Salamon & Clotfelter, *supra* note 80, at 9. *But see* Boskin, *Estate Taxation And Charitable Bequests*, 5 J. PUBLIC ECON. 27-56 (1976); Feldstein, *Charitable Bequests, Estate Taxation, And Inter-generational Wealth Transfers*, in RESEARCH PAPERS, sponsored by the Commission on Private Philanthropy and Public Needs, v. III, Special Behavioral Studies, Foundations and Corporations, U.S. Department of the Treasury, 1485-1500 (1977); Barthold & Plotnick, *Estate Taxation and Other Determinants Of Charitable Bequests*, 37 NAT'L. TAX J. 225-237 (1984); Watson, *A Note On The Effects of Taxation On Charitable Giving Over The Life Cycle And Beyond*, 99 QRTLY. J. ECON. 639-684 (1984).

[84] I.R.C. § 2001 (1986).

[85] Since the decedent will no longer need to retain assets until death to receive maximum advantage by reducing the high bracket estate tax, rather than the lower income tax rates, it might induce the wealthy to accelerate the timing of their gifts. *See* Dodge, *supra* note 14, at 1209.

come tax. This paper postulates integration of the best elements of prior studies[86] and offers alternatives in areas where potential problems exist. It is *not* intended to be a detailed prescription for tax reform, nor is it an attempt to rewrite the code in these pages. It is an attempt to remind Congress that its commitment to fundamental tax reform which began with TRA'86 should be continued. It is time for tax reform *redux*.

2. *Incidence of Taxation*

The proposed procedure to integrate the two taxes is relatively straightforward. It centers on the repeal of three code sections: Sections 2001 and 2501 which impose the estate and gift taxes on the transferor and Section 102 which excludes gifts and bequests from the taxable income of the transferee. Obviously, the actual mechanics will be far more complex. But repeal of these sections *will shift* the incidence of taxation from the transferor to the transferee. While this is a radical departure from historical tax policy, it has the advantage of finally matching the "official" incidence of taxation to its "emotional" incidence. Most lay taxpayers already believe that gifts and bequests are included in taxable income. From the media, taxpayers have learned that most forms of windfalls, such as lottery winnings and the Nobel Prize, are taxed as income.[87] The "person on the street" sees the equity in taxing "windfalls" to the same extent as wages, i.e., both make them better off, both are income. It is quite often with gleeful surprise that the taxpayer learns from their friendly neighborhood tax return preparer that they can exclude gifts and bequests.

Nor does the average taxpayer recognize an estate as a separate taxpaying entity. Even those who have the sophistication to handle the probating of a will argue that they, not the estate, have paid the tax. By the time the estate tax return is filed, title and possession of the property have often passed; the property is "theirs;" "they" write the check; it is "their" bank balance which decreases. Integration into the income tax will only match the official incidence of taxation to the one who already emotionally and ultimately bears the tax.[88]

3. *Exclusions*

The income tax will need to be amended so that reasonable amounts of gifts and bequests would continue to escape all taxation. The need for such exclusions from income is obvious. As a practical matter they are necessary for administrative convenience: we do not want to have to attach 1099's to every birthday present nor to have to invite the IRS to join Santa at the chimney each December. Nor would the reform have a prayer of passage unless it assured that the lower economic

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[86] *See* ABA Report, *supra* note 5; Andrews, *supra* note 55; Dodge, *supra* note 14; Aaron & Galper, *supra* note 64.

[87] I.R.C. § 61(a) and § 74(a) (1986).

[88] *See* Jatscher, *supra* note 17, at 47, "Death taxes normally have either no effect or only a small effect on the owners of the wealth and are borne instead by the heirs of the owners."

classes would not be subject to the tax. A reasonable exclusion should also be adopted to prevent the imposition of an undue burden on the economic classes which will be affected by the changes. Along these same lines, the ABA Report proposes a three tier level of exclusions.[89]

Reasonable amounts for exclusion will need to be set by Congress after careful balancing of revenue versus equity. The 1981 changes to the annual gift exclusion have simply allowed for too much revenue loss. This is especially true for large families.

At least in the short term, the new exclusions should approximate the amounts which would result if the current exclusions available to the transferor (under estate and gift taxes) were apportioned among the potential transferees (under the income tax). While no transition can be painless, this will minimize transition problems by making the taxable results under the reform proposal more closely match the existing results. If the tax consequences do not significantly change, existing estate plans should not need to be significantly changed. In addition, all effective dates should be prospective rather than in any way retroactive. The detrimental effects of retroactive provisions on tax planning have long been a thorn in the side of tax practitioners.

Over the long run, however, we do not advocate a straight allocation of the transferor's exclusions to the transferee. We do not believe that each recipient should be able to exclude $10,000 per year from each separate donor nor do we favor splitting the $600,000 unified credit equivalent between the existing heirs, which could result in a sole heir excluding $600,000 while each of twelve heirs excludes only $50,000 apiece. If the primary goals of tax reform are simplicity, equity, and efficiency, then the exclusions must be determined at the *transferee* level, not the transferor. To enhance simplicity, the reform should not require the taxpayer to look to any other taxpayer to determine tax liability; each taxpayer should stand alone.[90] To enhance equity, taxpayers who receive equal gratuitous amounts should receive equal tax treatment. Their tax liability should not depend on their good fortune in having lots of donative sponsors or their dubious fortune in having many equally loved siblings. Exclusion should be limited to a specific amount per transferee, regardless of its source.

However, the present special treatment provided by income tax Section 102 which excludes certain intrafamily transfers from taxation should be preserved. These provisions, particularly the exclusion of 100 percent of all transfers between

[89] *Supra* note 5, at 10, "Gift Tax Annual Exclusion," paragraphs A through E (inclusive). These provisions would provide for a $100 *de minimis* per donee exclusion, a $10,000 annual per donee exclusion, and an overall $30,000 annual cap per donor. Certain gifts to charities, spouses, and political organizations would not be subject to the $30,000 cap.

[90] An exception should, of course, be made for "serial deaths." In the unfortunate situation where the same properties could pass through the income tax base of more than one person due to intrafamilial deaths occurring within one or two years of each other, an appropriate credit system should be adopted. This credit could be patterned, in part, after existing I.R.C. § 2013 (credit for tax on prior transfers).

spouses[91] and the exclusion of parental transfers in discharge of obligations for support, schooling, and medical expenses are a necessary recognition of the special relationship within families. These transfers, which also are currently excluded from taxation under estate and gift taxes, should continue to be excluded from taxation under an integration proposal. This treatment is consistent with the proposals of the ABA Report.[92] The ongoing administrative problem is how to distinguish between gifts and payments which are parental obligations of support such as for school and medical expenses. The present rules which seek to provide these distinctions need to be clarified in any event due to the TRA'86 changes with regard to the imposition of the "kiddie tax."[93]

4. Rates

A beneficial aspect of this proposal would be the elimination of the present differential rate structure between income and wealth transfer. It would also end most cumulative computations with regard to wealth transfers. These benefits would be consistent with the spirit of simplification initiated in 1986. Gratuitous transfers should merely be included in the current year's taxable income with no provision for special taxation of these amounts. They are income; they will be taxed at the applicable income tax rate.

While the provisions of an accessions tax, which accumulates gifts and bequests received throughout the transferee's lifetime and taxes them at progressive rates, could substantially improve equity among taxpayers,[94] the losses in simplicity could far outweigh the enhanced equity. Since TRA'86, progression simply is not the major factor it once was. Regardless of the year, or years of receipt, the rate would vary only between fifteen percent and thirty-three percent,[95] barring Congressional rate tampering. The record keeping requirements entailed by an accessions tax, along with the necessity of delaying the closing out of each individual income tax return, would be a substantial impediment to simplicity. The

[91] In most instances the marital exclusion would be unnecessary for bequests since the widow/widower is permitted to file a joint return for the year of death. The need would arise only when the bequests were received in a subsequent period. The income tax exclusion for inter vivos spousal gifts, and subsequent bequests, is consistent with the filing of a joint return. The income of the taxing unit has not increased. *See* Dodge, *supra* note 14, at 1193.

[92] ABA Report, *supra* note 5, at 11.

[93] TRA'86 established special rules for the taxation of income of a minor child. If a child under 14 years of age has income derived from property transferred from a parent (parental-source unearned income), the bill taxes the unearned income to the child at the parents' marginal tax rate, if at least one parent is living at the end of the tax year. I.R.C. § 1(i) (1986).

[94] *But see* Dodge, *supra* note 14, at 1191, "The income tax proposal has the advantage of only measuring present ability to pay rather than basing tax rates on questionable assumptions about past use of capital." *See also* McNulty, *supra* note 8, at 93, "If one wishes to take into account overall taxpaying ability, including income, one naturally looks for other tax structures. These might include a periodic, comprehensive wealth tax *or an income tax that includes donative receipts in its base (emphasis added);* Hudson, *supra* note 48, at 53-54, "Indeed the income tax approach is an improvement over the accessions tax in that the income tax is measured by the recipient's *present* ability to pay.

[95] I.R.C. § 1 (1986).

cumulative aspects of an accessions tax should *not* be included in the proposed integration of the estate and gift taxes into the income tax. Each tax year should stand alone; current income should be taxed in the current period; each year's tax return should be complete unto itself.

To enhance efficiency, there should be no preference for one type of gratuitous transfer over another. This goal was partially attained in the present system when the separate estate and gift taxes were integrated in 1976.[96] Integration was accomplished by the use of a unified credit, a single tax rate, and inclusion of all post 1976 taxable gifts in the estate tax calculations.

This unifying process should now be carried to its next logical and evolutionary stage of integration into the "mainstream" of federal taxation: the income tax structure. The main focus of wealth transfer taxation could then be shifted from the unified credit towards selecting the proper annual exclusions. These exclusions would be selected by Congress on the basis of balancing the tax policy goals of equity, fairness, and administrative simplicity against the real and present need to enhance revenues. As for transfers at death, we should spread bequests out as though they were received as gifts. This could be accomplished rather easily by simply adopting a form of forward averaging for any bequests which were received.[97]

A forward averaging provision, if adopted, would not only enhance efficiency by equalizing the treatment of gifts and bequests but also alleviate many liquidity problems which might result from "bunching."[98] The forward averaging provision should not, however, be made available for gifts. Since these are discretionary transfers, if one does not wish to incur bunching, one does not need to accept the gift.[99] In addition, certain "hardship" provisions such as Section 6166 could be effectively carried over from the present estate tax law.[100]

5. Basis

Sections 1014 and 1015 of the income tax have long created a divergent and disjointed treatment of income tax basis arising out of wealth transfers. Section 1015 gives the donee a carryover basis in gifts whereas Section 1014 gives the recipient a fair market value (FMV) basis in bequests. The process of tax reform has long wrestled with this inconsistent treatment, but prior attempts to amend

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[96] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[97] *See example,* Appendix II.

[98] For an example of how forward averaging is currently being applied to the taxpayers' benefit, *see* I.R.C. § 402(e) (1986) (10-year averaging for lump sum distributions from certain qualified employee plans). However, since progression has been greatly reduced under TRA'86, the problem of bunching has also been greatly reduced.

[99] *See*Dodge, *supra* note 14, at 1190.

[100] I.R.C. § 6166 (1986), "extension of time for payment of estate tax where estate consists largely of interest in closely held business."

this inefficient and inequitable situation have failed.[101] This integration proposal offers a unique opportunity to significantly reduce the two-sided basis problem. Since the taxpayer will include the FMV of all gifts and bequests in taxable income, the taxpayer is entitled to a FMV basis in all properties so received. The taxpayer is, in effect, "buying" a FMV basis.

This is an equitable and workable solution which incorporates the better elements of the carryover basis amendment[102] while avoiding its complex bookkeeping requirements. Since we propose taxing the FMV of gratuitous transfers, not appreciation, there is little need to discover the transferor's basis. In addition, there will be no need to value all property as of the date of enactment to assure that only prospective gains are being taxed.[103] Nor will this proposal entail the complex transition rules of carryover basis.[104] Just as the decision to tax 100 percent of capital gains was adopted without transition by TRA'86, the decision to tax 100 percent of gratuitous transfers can be adopted without transition allowances. TRA'86 reduced the tax rates on ordinary income to justify the 100 percent inclusion of capital gains. This integration proposal will repeal the estate and gift taxes, justifying the 100 percent inclusion of gratuitous transfers at the lower income tax rates.

While some will argue that this involves "double taxation" of the transferor's basis, these arguments are without merit. Currently the FMV of the property, which includes the basis, is subject to the estate and gift taxes. This proposal simply replaces those taxes with an income tax levied on the transferee.[105]

As to spousal transfers, Section 1041(b)(2), which gives the transferee-spouse a carryover basis in properties so received should be retained. Since 100 percent of all spousal transfers will continue to be excluded from the income tax, the transferee should not be entitled to a FMV basis. The spouse simply has not "bought" a new basis. As to nonspousal transfers which escape income taxation (those which fall below the exclusion amounts), these properties should also receive a carryover basis in the hands of the transferee. Legitimate economic considerations outweigh the sacrifice in administrative simplicity. Only *taxed* nonspousal transfers should receive a FMV basis.

6. *Transfers in Trust*

In very simplistic terms, under the present law, ideally all transfers of cor-

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[101] For a discussion of these problems refer to note 28, *supra*.

[102] *Id.*

[103] *See* Lewis, *Taxing Unrealized Gains: The Nettle and the Flower,* 4 REV. TAX'N. INDIVIDUALS 19-21 (1981).

[104] P.L. 94-455, *supra* note 28.

[105] *See* Dodge, *supra* note 14, at 1188, ". . . double taxation (of gifts and bequests) has existed since 1916 . . . the income tax proposal concerns only the form of 'double taxation.' Moreover, double taxation is not undesirable if it is consistent with the underlying purposes of the particular tax system." Perhaps a more appropriate nomenclature here would be to avail ourselves of a "second taxing opportunity" on a second "transaction" involving the same property.

pus to a trust are taxed to the grantor under the estate and gift taxes just as though they were direct transfers to the beneficiaries. Inter vivos transfers are subject to the gift tax if they are completed transfers, while incomplete inter vivos and all testamentary transfers are included in the decedent's estate.[106] The income from the corpus is generally taxed to the beneficiaries if it is distributed to them or to the trust if it is retained.[107]

The ABA Report's proposed rules for the clarification of the complete versus incomplete transfer[108] would substantially simplify one of the most complex issues in the taxation of transfers to trusts. These rules substantially simplify the timing of wealth transfer taxation, and this proposal strongly advocates their complete examination.

Two prior proposals which offered alternatives to the present estate and gift taxes were Aaron and Galper's cash flow income tax[109] and Andrews' accessions tax.[110] While both had many fine points to recommend their adoption, their treatment of transfers in trust would not be appropriate for inclusion in an income tax alternative to the estate and gift taxes. Both deferred taxation of all transfers in trust until either the corpus or the income was subsequently distributed to the beneficiaries. The cash flow income tax further delayed taxation until such time as the beneficiary consumed the transfer. While this exclusion of all transfers in trust from current taxation had merit under Aaron and Galper's tax proposal, it is not equitable treatment under either the current income or an alternative accessions tax.[111] The current tax liabilities of two individuals who receive equal amounts of gratuitous transfers should not differ simply because one receives his transfer in the form of outright ownership while the other receives his in the form of a beneficial trust interest. If this deferral of taxation on all transfers in trust were adopted no one would ever again intentionally receive an outright transfer of any amount which exceeded the exclusion provisions.[112] The inefficiencies and inequities which currently exist in the estate and gift taxes would be magnified, not diminished.

[106] I.R.C. § 2031 (1986).

[107] *See primarily* I.R.C. §§ 641 and 661 (1986).

[108] *See* ABA Report, *supra*, note 5, at 16.

[109] *See* Aaron & Galper, *supra* note 64. *But see* Graetz & McDowell, *supra* note 48, at 11 note 30, "proposal for a consumption tax which (Aaron & Galper) label a 'lifetime income tax.' "

[110] *See* Andrews, *supra* note 55.

[111] *See also* Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 682 (1977). *But see* Andrews, *supra* note 55; Dodge, *supra* note 14; and McNulty, *supra* note 8.

[112] *Contra*. Dodge, *supra* note 14, at 1184, "Clearly, (trusts) merely serve the ends of individuals; here they serve to facilitate gratuitous transfers. Taxation of entities can therefore be justified only as a means of counteracting the deferral of tax that results naturally from the economic function of (these) entities." However, we feel 'counteracting the deferral of tax' which can result not only from trusts' 'economic function' but also from their 'fiscal function' — the pure deferral of tax liability — is sufficient justification for denying exclusion from income taxation for transfers of corpus to trusts. *See* Alexander, *supra* note 111, at 658-65; Rudick, *supra* note 56, at 168-171; Westfall, *supra* note 82, at 1006.

The most equitable treatment for transfers of corpus to trusts would be to ignore the trust completely and tax all such transfers as though they had been constructively received by the beneficiary. Since a gift or bequest would be considered income if received directly by an individual, it should also be considered income if received indirectly via trust. The transfers should be attributed to the beneficiaries and taxed to them currently.

This "pure conduit" approach was, in fact, recently proposed for fiduciary taxation of grantor trusts.[113] The proposal would have attributed all trust income, regardless of whether it had been retained or distributed, to the beneficiaries. Tax would have then been imposed on the trust using the applicable individual income tax rate. The proposal was, however, soundly rejected because of the enormous problems of attribution from multibeneficiary trusts and the insurmountable complexities which would have resulted from the need to combine the information from multiple trusts to determine the tax liability of even one.[114] In light of these very practical objections to this economically sound concept, we cannot advocate that the pure conduit approach be adopted as a binding provision in any reform proposal.

We do, however, advocate an *elective pure conduit approach* to integrate the estate and gift taxes into the income tax. To improve equity in the income tax, all gifts and bequests should be included in the current income of the person who receives them.[115] To preclude the creation of multiple trusts which could use the exclusion provisions to escape all taxation, the exclusions from income should not be made generally available to trusts. Their use should be limited to individuals.

Since this treatment would discriminate against transferees who have legitimate human needs for receiving all gifts and bequests in trust (transferees such as minors or others in need of professional management), individuals should be given an *elective* provision to treat all trusts to which they are a beneficiary as pure conduits. This would allow individuals to use their personal exclusions at the trust level but not generally impose complex attribution or record keeping costs. Most plans which create trusts for personal rather than avoidance reasons use only one or two simple trusts to accomplish their goals. If multiple trusts were involved, however, the individual or guardian could evaluate the benefits of receiving the personal income exclusion against the increased costs

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[113] *See* Barnett, *Tax Reform by Frankenstein*, 25 TR. & EST. 10, 12 (1986).

[114] *See* Barnett, *id.*, at 22; Ritchie, *Tax Reform: R_x for a Headache*, 25 TR. & EST. 22 (1986).

[115] In addition to the inequities of deferral cited previously (note 111, *supra*), failure to include these receipts in the taxable income of the trust would result in the trust obtaining a zero basis in the property. This would prohibit the trust from taking any depreciation charges against income earned while the property was retained by the trust (*See* Dodge, *supra* note 14, at 1195). This result is inequitable. Individuals who received property via trusts would eventually pay taxes on distributed trust income which had not been reduced for depreciation. This would result in a higher tax liability for individuals who earn income in trust as opposed to individuals who earn income via outright ownership.

of conduit treatment. If multiple trusts are involved, competent financial advisors are sure to be close at hand.

As to the taxation of the income from trusts, the current rules which generally tax distributed income to the beneficiaries and undistributed income to the trust should be continued[116] in spite of their inequities. This would alleviate many potential transition problems by continuing to closely approximate postreform results to prereform tax liabilities. However, to preclude the use of multiple trusts solely to decrease tax liability, while not discouraging the legitimate use of trusts, the rate of tax on income which is not distributed should be the maximum individual rate.[117]

To alleviate any potential discrimination which the imposition of the maximum rate might engender, the pure conduit election could be extended to the taxation of the income from trusts. Again, individuals could weigh the benefits of the provision against its administrative costs.

While the pure conduit elections, like so many benefit provisions in the tax code, are intended to prevent inequitable results, no attempt should be made to limit their application. The election should be available to all since its results will only match, not improve upon, the results which would have resulted had the transfer not been made in trust. The pure conduit election, if adopted, should be considered a "method of accounting." [118] This will preclude adoption on a piecemeal basis solely to reduce taxes in any one given year.

7. *Generation-skipping Transfers*

One means of incorporating the goals of the generation-skipping tax into an integration proposal is to simply ignore it. The present separate tax on the transferor could remain in place, virtually unchanged, until its effects have been more closely evaluated.[119] Or, in the alternative, the present tax could be allowed to become, in fact, what it has in reality been all along — an *excise tax* on the privilege of transferring property beyond the reach of wealth taxation in the next generation.[120] A retained generation-skipping tax, regardless of form, could be required to be reported and paid to the IRS via the transferor's annual income tax return, just like the self-employment tax. Of course these alternatives would result

[116] *See generally* I.R.C. of 1986, Subchapter J of Chapter 1, "Estates, Trusts, Beneficiaries, and Decedents," § 641 through 691 (1986).

[117] The most equitable rate would be 33 percent, or the current top rate, to prevent manipulation solely to avoid the phasing out of personal exemptions which was provided for by TRA'86. *See* I.R.C. § 1 (1986).

[118] I.R.C. § 446 (1986).

[119] *See* authors' comments on the problems with the present tax at note 3, *supra*. For an alternative treatment for generation-skipping transfers *see* Aaron & Galper, *supra* note 64, at 95, ". . . we suggest that a special tax be imposed every thirty years on the assets of trusts created after 1976." Trusts whose only remaindermen are the spouse or children of the creator would be exempted from the tax.

[120] All of the current transfer taxes, the estate, gift *and* generation-skipping taxes are essentially excise taxes on the privilege of transferring property. *See* Gutierrez, *supra* note 48, at 72.

in maintaining, not eliminating, a limited version of the present dual system.[121] However, if outright repeal of the current generation-skipping tax is impractical at this time, perhaps continuance of a limited dual system is not unreasonable.

If one wanted to continue to pursue the goals of the generation-skipping tax, but also to eliminate the dual system, the tax could be integrated into the income tax along with estate and gift taxes. One way in which integration could be accomplished would be to simply eliminate the individual income tax exclusion for all gifts or bequests which were received from persons more than one generation prior.

8. Charitable Contributions

The discussions surrounding the passage of TRA'86 made it clear that any constriction of "tax favors" for charities could not be accomplished easily. Nor do those discussions support the contention that the public desires to limit charitable contributions, especially in this time of decreasing governmental support of eleemosynary activities.[122]

To facilitate the acceptance of the integration proposal it is suggested that the current rules be left intact, though perhaps, strengthening IRS review of institutions' qualification for charitable status. The income tax rules should still apply to inter vivos gifts to charities. The current split interest estate tax rules[123] which govern testatmentary gifts to charities should also be retained. If a gift is made by the estate directly to the charity, it will never be received by a taxable heir and, therefore, will continue to pass free of tax. In addition, this proposal should provide a liberal disclaimer provision which would more readily foster transfers to charitable organizations by heirs who wish to avoid the income tax consequences.

If, however, the heir wishes to donate property which was received via bequest, there should be a reasonable period, for example six months, during which time the inter vivos gift limitations of Section 170(b)(1) are suspended. During this period the amount of the contribution should be limited to the FMV received, thus achieving a netting of the two transfers to obtain a zero tax liability on the donated bequest. The taxpayer should also be given the option to elect out of this netting provision in circumstances where the FMV had appreciated during the "six month period." The taxpayer making this election, however, must be will-

[121] The duality of the system would be limited since the generation-skipping tax applies to a very limited number of individuals. Only those who can afford to transfer in excess of $1 million beyond the next generation are subject to it. *See also* Shaffer, *supra* note 21, at 33-34 . . . "While tax policy makers in Washington concoct arcane regulations for the prevention of 'generation skipping' . . ., lawyers in the field report they rarely find a client who is interested in skipping generations. Many lawyers say they would find the suggestion immoral; their clients, apparently, agree."; Alexander, *supra* note 111, at 676, "It might be assumed that there would be a definite correlation between the size of the estate and the use of trusts skipping two or more generations, but there is actually surprisingly little direct correlation of this character"; Verbit, *supra* note 40, at 674.

[122] *See* Salamon & Clotfelter, *supra* note 80, at 8, 14; Rudick, *supra* note 56, at 179.

[123] I.R.C. §§ 2055(e)(1) and (2) (1986).

ing to subject this appreciated gift to the normal inter vivos gift limitations of Section 170(b)(1). Double benefits would not be appropriate.

The heir should also be given the option, in a very limited set of circumstances, of paying the federal income tax on bequests with a "payment in kind." This would encourage the conservation of national treasures which otherwise might have to be sold to meet tax liabilities. Similar proposals have worked well in other countries and are worthy of consideration.[124]

9. *Insurance*

Currently, insurance proceeds are subject to the estate and gift tax if they are received by the estate, if the decedent had an incidence of ownership in the policy at the time of death, or if the decedent had transferred an incidence of ownership within three years of death for less than full and adequate consideration.[125] Otherwise, insurance proceeds are received tax free by the beneficiary.

To be equitable, under an integration proposal, these proceeds should be treated no differently from other amounts which one receives as the result of the death of another. There is no justification for preferential treatment which favors insurance over any other form of investment.[126] However, this proposal, while recognizing the inherent inequities and inefficiencies which it is advocating, favors adopting the current estate and gift tax insurance provisions in the income tax.[127] Adoption of this provision is advocated because of the simple fact that any proposal which suggested the immediate inclusion in taxable income of all insurance proceeds would be doomed.[128]

If proceeds which would not have been subject to the estate tax were suddenly to become taxable, it would require the reappraisal and restructuring of almost all existing estate plans. The disruption would simply be too severe. This integrated plan should be formulated to disrupt current estate plans as little as possible in order to minimize transition problems. If tax consequences do not significantly change, existing estate plans should not need to be significantly changed. Chances for adoption are greatly enhanced.

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[124] Recent comparative examples can be found in France and the U.S. The French government recently opened the new Picasso Museum in Paris. The art collection is made up mostly of Picasso's estate holdings which were transferred to the government in payment of death duties. Compare the estate of William Harrah, the late casino owner from Reno, Nevada. His automobile collection, surely one of the most historically significant of our time, had to be "gutted" in order to pay federal estate tax. Had the U.S. had a "payment in kind" procedure in place at the time of Harrah's death, his collection might well have been preserved for the public at large. What we gained in short-term revenue has been more than offset by the long-term loss of a significant historical collection which cannot be replaced. *See also* Verbit, *supra* note 40, at 680.

[125] I.R.C. §§ 2035 and 2042 (1986).

[126] *See* Dodge, *supra* note 14, at 1200; Rudick, *supra* note 56, at 179.

[127] It is interesting to note that the ABA Task Force on Transfer Tax Restructuring also struggled with the issue of insurance and failed to reach a consensus, ABA Report, *supra* note 5, at Exhibit E.

[128] To borrow a phrase from Brannon, *supra* note 48, at 279, "The indications are that our tax law in the future should be designed after consultation with public relations experts."

Furthermore, in any discussion of the taxability of insurance, political reality must dictate. A proposal to tax insurance proceeds in the income of the beneficiary is sure to arouse the ire of the vocal and powerful insurance lobby. Their concerted effort to thwart this provision could jeopardize the entire integrated plan and preclude passage of other provisions which, if adopted, could immediately simplify and improve the taxation of individuals. Witness the end result of attempts to tax insurance policy accumulations in TRA'86 wherein the insurance lobby won out.

This paper strongly advocates a reappraisal of the preferential treatment which is given to insurance proceeds but reluctantly acknowledges that the integrated plan should retain the current estate and gift tax rules in this area. The proceeds should be included in the income of the beneficiary only if those proceeds would have been subject to tax in the decedent's estate: if they are received by the estate, if the decedent had an incidence of ownership in the policy at the time of death, or if the decedent had transferred an incidence of ownership within three years of death for less than full and adequate consideration. Any reappraisal of the taxation of insurance proceeds should be deferred until after the integrated plan has been adopted or rejected on its policy merits.

10. Liquidity Problems

The current estate tax makes special provision for liquidity problems which can arise in the situation where the property bequeathed is a family farm or a closely held business.[129] The special treatment of these properties is not unique to the estate tax. However, it is neither equitable nor efficient. If the primary goals of tax reform are the enhancement of equity and efficiency, a proposal to integrate the estate and gift taxes into the income tax should not advocate the continuance of this preferential treatment.

Benefits to alleviate liquidity problems should be made available to all taxpayers depending upon their need, not the form of property they receive.[130] Inclusion in the income tax base of multiple heirs, who would be subject to lower and less progressive rates than the decedent under the estate tax, would assist in alleviating most liquidity problems.[131] In situations where greater relief is indicated, such as where current tax liability would exceed some multiple of prior average tax liability, installment payments could be made available.

11. State Taxes

One of the first major obstacles to the adoption of a federal estate tax was the objections of the states, who had considered death taxation to be their private do-

[129] I.R.C. §§ 303, 1040, 1223(11), 2032A, 6161(a)(2), 6163, 6166, 6324B, 6601(j) (1986).

[130] *See* Dobris, *supra* note 8, at 377; Gutierrez, *supra* note 48, at 81. *See also* Graetz, *supra* note 17, at 285, ". . . for some owners of small business and farms, their clout far outweighs their actual stake in the general estate tax policies."

[131] Forward-averaging, if adopted, could also tend to alleviate liquidity problems. *See* Rates, *supra* text accompanying notes 94-100.

main.[132] From this earlier position of primary importance, the states have more recently shown little interest in this area of taxation. Many have provisions only to take advantage of the credit which is allowed to them under the present federal tax.[133] However, one should not assume that they would silently overlook a reform which denied preferential treatment for even these marginal sources of state revenue.

While the integration into the income tax could easily continue the present system of allowing a credit against federal taxes, the adoption of the proposal could also offer an opportunity to the states to significantly streamline their own tax systems. Many states have income tax laws which mirror the federal tax. If inclusion of gifts and bequests in the income tax base of the transferee is adopted at the federal level, it would also be "picked up" at the state level. Since state income taxes are already deductible under the federal income tax, no special provision would then have to be adopted. The benefits of eliminating the dual system at the federal level might also be passed along to the states — a possible selling point.

12. *Funeral and Administrative Expenses*

These expenses are currently deductible from the estate and, thereby, currently escape taxation.[134] This equitable treatment should continue under the proposed integration. If the expenses are paid by the estate prior to dispersal to the heirs, the amounts will not be received by the heirs and, therefore, will never be taxable to them. If, however, the payment of these expenses is made by the heirs, Section 2053 should be adopted into the income tax to allow them to be netted against the heirs' taxable receipts. This will assure that these necessary expenses continue to be paid with before-tax dollars.

13. *Tax Practitioners*

A favorable response from tax practitioners is essential to the success of any reform proposal. There have been numerous recent examples where economically sound tax bills have failed to be passed primarily because of adverse response by this respected community.[135] If an integration proposal is adopted, the transition period will, of course, be difficult. The tax professional, however, must bear in mind that the transfer tax laws will likely be changed. The profession will again

[132] The major part of the revenue generated by the original estate tax was shifted to the states by the use of credits (Revenue Act of 1942 § 301(b)) which, in effect, allowed the states to tax the first $40,000. For a historical review of early federal death tax legislation, *see generally* Paul, Taxation In The United States (1954). *See also* Surrey, *supra* note 17, at 5; DeWind, *supra* note 32, at 79; Groves, *Retention of Estate and Gift Taxes by the Federal Government*, 38 CALIF. L. REV. 28 (1950).

[133] I.R.C. § 2011(b) (1986). *See also* examples in Cal. Rev. & Tax §§ 11301 and 13302 (1983) and N.Y. Tax Law §§ 951 through 963 (1983).

[134] I.R.C. § 2053 (1986).

[135] *See* Barnett, *supra* note 113, at 10.

be facing a period where the results of the simplest planning techniques cannot be known with certainty. It would be far better to undergo this kind of disruption for changes which can result in a simpler and more equitable structure than to continue the present system of patchwork "reforms" which result in a system which is ever more incomprehensible.

Integration has the advantage of using an existing tax with which the tax professional is already intimately knowledgeable: the income tax. It also incorporates most of the current transfer tax provisions which we have come to rely on as gospel: the unlimited marital deduction, the unlimited charitable contribution, the taxation of insurance proceeds, the taxation of transfers in trusts, the exclusion of smaller estates and gifts, etc. These advantages are substantial. They would smooth the transition period and allow at least some measure of confidence in dealings with clients. The tax professional should not mistake novelty for complexity,[136] but must consider the possibility that the integration of the estate and gift taxes into the income tax could represent an opportunity for true reform.

VII. CONCLUSION

The growth and development of modern tax policy is not dissimilar to the evolution of the biological species. Only through repeated efforts, and sometimes sad failures, can we get closer to the ideal. This ideal in tax policy should fairly balance the revenue needs of the taxing entity against the deleterious effects of any tax. As with evolution, mature tax policy development can be painfully slow. Historic opportunities for fundamental change come all too rarely. In the past, many of the basic changes have come about due to the revenue needs generated by armed conflagrations. Our country's present battleground is in the international marketplace. We are fighting a new and bigger economic war now, a war which we may never win as long as we are burdened with a nearly $3,000,000,000,000.00 deficit. Our economic stability and security is inexorably tied to deficit reduction. This reduction must, at least in part, be facilitated through revenue enhancement. These new revenue impositions must reflect the lessons of history. They must be "fair, understandable, and efficient."

The present dual individual federal tax structure has long proven itself to be neither fair, understandable, nor efficient. The current season of fundamental tax reform, started with TRA'86, now provides our government with a unique window of opportunity. An opportunity to "pull the plug" on a patient who, for too long, has been artificially kept alive by patchwork measures.

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[136] *See* Halbach, *supra* note 22, at 69-70, "Novelty must not be confused with complexity. The possibility of having a truly better and simpler tax structure in the long run should be given great weight in assessing the potential for constructive change in this field, even if the price is a challenging period of transition"; McNulty, *supra* note 8, at 100, ". . . even today (our present transfer taxes) have so much litigation and dissatisfaction, that a shift to some new structure may not be as disadvantageous as it would at first seem . . . (Integration) merits . . . serious consideration instead of the endless tinkering and complexifying tax 'reform' efforts that have so preoccupied us in recent years."

By finally integrating wealth transfers into the "mainstream" of income taxation, our government can create the best of both worlds: a tax which will not only raise more revenue within the parameters of modern definitions of a "good" tax, but also retain the better elements of the present wealth transfer tax system.

A well designed plan of integrated income taxation would also balance the legitimate interests of protecting certain intrafamily transfers and charities while yet revitalizing some of the original underlying policy justifications for the estate tax. Because the income tax is subject to annual reporting and review, the concerns for "unhealthy" accumulations of wealth can be more readily and efficiently addressed than they are now.

The benefits to be derived from a truly integrated income tax are worthy of further consideration and discussion. The wealth transfer tax structure would cease to be the nagging poor relation of the income tax. TRA'86 began the process of returning to both economically and procedurally sound tax policy. The time is ripe for Congress to finish the job. The worthwhile goals of wealth transfer taxation should now be accomplished through the income tax.

VIII. APPENDIX I

Linkage between the Income and Estate Taxes

The income and estate taxes have traversed a common path through the annals of federal tax policy. Prior to 1913 the primary sources of federal revenues were tariffs and excise taxes. Income and estate taxes were enacted as temporary measures primarily to finance wartime expenditures. Though never enacted jointly, the estate tax was always adopted shortly after the income tax and repealed at about the same time that the income tax was being declared unconstitutional. The sole purpose of each was to raise revenue. And each was abandoned when the revenue need ceased. World War I, however, marked a dramatic change in this policy. Neither the income tax nor the estate tax was repealed after that war.[137]

Tax policy had changed. Congress, rather than concentrating on the temporary needs of the impending war, sought a more consistent and permanent means of raising revenues in the future. Ratification of the Sixteenth Amendment in 1913 reflected this policy change. It enabled the enactment of a permanent individual income tax that same year. This was followed by the enactment of a permanent estate tax in 1916.[138]

[137]

War	*Estate Tax*	*Income Tax*
Undeclared	1797-1802	—
Civil War	1862-1870	1861-1872
Spanish American War	1898-1902	1894-1895
World War I	1916-	1913-

Sources, J. Pratt, J. Burns, & W. Kulsrud, et.al., Individual Taxation 4-6 (1987 ed. 1986); Bentz, *supra* note 36.

[138] Revenue Act of 1918, P.L. 64-271, 39 Stat. 756 (1916). The modern gift tax was adopted by the Revenue Act of 1932, Pub. L. No. 72-154, §§ 501-532, 47 Stat. 245 (1932).

While both are linked through their roles as permanent sources of revenue, they are not equally effective in fulfilling those roles. The estate tax has never been a major source of revenue. Except for a brief period during the 1930's, the estate tax has never generated more than two percent of federal tax revenues — slightly less than the revenues generated by the excise tax on cigarettes.[139] In contrast, the individual income tax has become the federal government's primary source of funds accounting for almost fifty percent of all tax receipts.[140] The income tax's emergence has been primarily due to its own enormous growth as measured in terms of percent of GNP.[141] In spite of renewed interest in excise and corporate income taxes as sources of increased revenues, the individual income tax will continue to be the primary revenue raiser while the estate tax will continue to be an insignificant nuisance.

World War I marked another significant change in federal tax policy. Congress no longer viewed either the income or estate tax solely as a source of revenue. Each was adopted to meet social as well as revenue goals. These social goals were as inherently linked as the revenue needs which had triggered their use in the past. They were both adopted to accomplish a limited measure of wealth redistribution.[142] The income tax was intended to prevent the undue accumulation of wealth while the estate tax was intended to prevent the intrafamilial transfer of undue accumulations.[143]

While both were again linked through their roles in wealth redistribution, they were not equally effective in fulfilling those roles. The estate tax has never been an effective a tool for preventing the transfer of undue accumulations of wealth since only a very small portion of the potential base is redistributed. It was estimated that private wealth in the United States totaled almost $9 trillion in 1982.[144] It was also estimated that top wealth holders accounted for approximately $2.4 trillion of that amount.[145] Approximately three percent of private wealth in

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[139] Pedrick, *supra* note 37, at 114.

[140] *See* Musgrave & Musgrave, *supra* note 24, at 316-317.

[141] GROWTH OF INDIVUDAL INCOME TAX re OTHER TAXES AS PERCENT OF GNP

Year	*Total Fed Taxes as % of GNP*	*Excise Taxes % of Fed. Tax*	*Excise Taxes % of GNP*	*Estate Taxes % of Fed. Tax*	*Estate Taxes % of GNP*	*Income Tax % of Fed. Tax*	*Income Tax % of GNP*
1902	2.3	47.6	1.095	1.0	0.023	0.0	0.000
1913	1.7	45.6	0.775	0.0	0.000	0.0	0.000
1922	4.6	24.4	1.122	4.1	0.189	5.6	1.178
1979	20.6	4.3	0.886	1.2	0.247	8.8	10.053

Source: Musgrave & Musgrave, *supra* note 24, at 316-317.

[142] Bentz, *supra* note 36, at 3.

[143] It is interesting to note that one of the early supporters of the estate tax for "anti-wealth" purposes was Andrew Carnegie, WEALTH, 149 N. AM. REV. 653, 659-660 (1889). It has even been asserted that it is the lower economic classes, not the wealthy, which object most strongly to any attempts to increase the tax. *See* Verbit, *supra* note 40, at 682.

[144] 1982 is the most recent year for which complete information is available. Schwartz, *Preliminary Estimates of Personal Wealth, 1982: Composition of Assets*, I.R.S., Statistics of Income Bulletin 1-7 (1984-1985).

[145] *Id.*

the United States can be expected to pass through estates in any one year.[146] This would result in an estimated potential tax base of $72 billion for 1982 deaths. Total tax revenues from estate tax returns filed in 1983 for 1982 deaths totaled approximately $5 billion,[147] resulting in slightly less than seven percent of the potential base being redistributed.[148]

Gross estates in excess of $300,000 reported in 1983 totaled only $50 billion dollars,[149] approximately two-thirds of our $72 billion estimated base. While we can not be sure whether this discrepancy is the result of an error in our estimation, the use of the myriad avoidance techniques, or outright evasion it is, nonetheless, troublesome. Comparison of tax liabilities to the smaller reported tax base of $50 billion, however, results in wealth redistribution rising to ten percent. This tax indeed accomplishes a "limited" wealth redistribution. Even ten percent is hardly a significant dent in the accumulations of the wealthy.[150]

While the effectiveness of the income tax is less easily analyzed, its social goals having been so dramatically expanded beyond the redistribution discussed here, a consensus could no doubt be reached that it is significantly more effective than the estate and gift taxes.[151]

In addition to being linked in their roles as permanent revenue sources and redistribution tools, the income and estate taxes are inherently linked in their object of taxation — the individual. While all taxes are ultimately borne by individuals, the income and estate and gift taxes have the most widely recognized impact, by far. Few of us give much consideration to, or spend much time planning for, excises and tariffs or even the payroll tax. We may lament their reported increases and notice their increased impact on our wallets, but we seldom take any direct action. Such is not the case with either the income or estate and gift taxes. A great deal of time and money is spent by individuals with the sole purpose of reducing the impact of these two taxes. And the fact that they are two taxes — the duality of the present system — has aggravated that impact.

IX. APPENDIX II

To illustrate how forward averaging of bequests could be implemented, the following example is offered.

[146] R. Musgrave & P. Musgrave, *supra* note 24, at 490.

[147] *See* Bentz, *supra* note 36, at 1-12.

[148] If one includes the $2.5 billion of charitable contributions reported on all 1983 estate and gift tax returns, *id.*, the amount diverted from the wealthy increases to $7.5 billion dollars and the percentage diverted improves to slightly more than 10 percent. However, it is unlikely that these charitable contributions are the result of the estate tax and would most likely continue without its incentives.

[149] *See* Bentz, *supra* note 36, at 1-12.

[150] *See* Boskin, *supra* note 15, at 63, "Since total national wealth is many trillion dollars, the paltry few billion dollars raised annually by estate taxes cannot by its revenue raising alone accomplish very much in the way of altering the wealth distribution." Isaacs, *supra* note 54, at 24, ". . . our estate and gift tax laws have wholly failed in their purpose . . . to reduce or even check extraordinary concentrations of wealth."

[151] *See* Jatscher, *supra* note 17, at 51 . . . "In the United States the federal income tax also erodes concentrations of wealth . . .".

Assume that in addition to $150,000 of taxable income from other sources, Individual A received an inheritance of $1 million from his father, a second inheritance of $600,000 from his aunt, and a gift of $21,000 from his mother during 19XX. Further, assume that Congress had determined that each individual was entitled to exclude $20,000 of gratuitous transfers from taxable income each year, and that the appropriate period to apply to forward averaging was ten years.[152]

Based on these assumptions, the tax liability for Individual A for 19XX could be determined as follows:

		Tax Income	*Tax Liability*
1. Compute normal tax liability without bequests:			
Income from other sources		$ 150,000	$ 42,000
Taxable gift in current year		21,000[a]	5,880
Total (without bequests)		$ 171,000	$ 47,880
2. Compute tax on "net forward gifts":			
Net forward gifts	$140,000[b]		
at appropriate rate	28%[c]		
one years' increase	$ 32,800		
times ten years	x10		
Tax on net forward gifts			328,000
3. Total tax liability for 19XX			$ 375,880

A) Since Individual A has received an inheritance of more than $20,000 in the current year, no portion of the exclusion is available for gifts. Thus the entire $21,000 gift from his mother will be included in the current year's income. This treatment is necessary to prevent a spate of death bed gifts which could result in each heir receiving a $20,000 gift exclusion *and* ten $20,000 "forward gift" exclusions in any one year. (See note b, following).

B) The inheritances which totaled $1.6 million dollars would be averaged over ten years resulting in a "forward gift" of $160,000 per year which would qualify for the "forward year's" annual exclusion of $20,000 and result in a "net forward gift" of $140,000.

C) If Individual A had not reached the maximum rate of twenty-eight percent, or was in the period where the "surcharge" of an additional five percent to phase out exemptions applied, the appropriate "mixed rate" should be used.

[152] The $20,000 personal exclusion was chosen since it is the amount which *a couple* could currently transfer to *each* of their children or grandchildren without incurring the current gift tax. The ten year forward averaging period was chosen since it would result in excluding $200,000 of bequests (ten $20,000 personal gift exclusions) from *each* of the typical *decedent's* three (2.7) children and closely match the $600,000 exclusion which is currently provided by the estate tax. These amounts are not intended to be used as guidelines; they were merely chosen for illustrative purposes. The revenue implications of the interaction of the exclusion amounts and the lower income tax rates would need to be closely investigated before Congress determined the appropriate amounts.