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INTRODUCTION

In 1976, with comparatively little advance notice, Congress substantially revised the United States federal estate and gift tax laws, necessitating in most situations the alteration of existing wills and estate plans.[1] In 1981, in the Economic Recovery Tax Act, Congress again revised federal estate and gift tax laws and another review of wills and estate plans is in order.[2] This Article will provide a brief summary of the various changes which were made by the Economic Recovery Tax Act of 1981 and then make a detailed analysis of most of those changes and their impact upon estates and estate planning. There will, however, be no detailed discussion of the special use of valuation changes.

Although some of the 1976 changes could be considered quixotic—for example, the orphans' deduction and the minimum marital deduction—in most cases the changes involved had real substance. The most significant, lasting change of the 1976 reforms was the unification of the estate and gift taxes. The new 1981 estate and gift tax regime retains that change. Prior to 1976, the gift tax rates had been three-quarters of the estate tax rates, and in computing estate taxes no consideration was given to prior gifts, no matter how extensive. The 1976 changes quite properly recognized the interconnection between lifetime and death transfers and applied a single rate schedule. The change considered lifetime transfers in determining the proper rate of tax to be applied to testamentary transfers. Carryover basis, an equally significant 1976 reform—a repeal of the rule which stepped-up the basis of all assets passing through a decedent's estate so that any capital gains which had accrued but had not been realized were forgiven—did not survive the concerted onslaught which was mounted against it and was repealed in 1978.[3] The 1976 Act also introduced, primarily

1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525 [hereinafter cited as Tax Reform Act of 1976].

2. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 [hereinafter cited as ERTA].

3. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299.

for the benefit of farmers, the special use valuation of section 2032A. This section permitted the undervaluation of farm property so long as certain conditions were met, all of which were designed to see that the land continued to be farmed. This is a provision which the 1981 changes expanded.[4] The 1976 reforms also included tinkering with the rules reflecting jointly held property, which have now been further changed by the 1981 Act.[5]

The 1981 changes, generally not effective until 1982, and in important cases phased-in over several years, have many interesting aspects, but the most significant are these:

(1) The introduction in 1982 of an unlimited estate tax and gift tax marital deduction so that one spouse may transfer totally tax-free all of his or her assets to the other.[6] The reasons it will almost always be wise from a tax standpoint to utilize these provisions will be examined below.

(2) The adoption of a new form of marital deduction trust which permits the decedent to specify the disposition of the marital property at the death of the surviving spouse.[7] This change will make the use of the 100% marital deduction feasible.

(3) An increase, phased-in over six years, of the unified estate and gift tax credit to $192,800 (the equivalent of a $600,000 exemption) from a unified credit of $47,000 (the equivalent of a $175,625 exemption).[8] This change is expected to have the effect of dramatically reducing the number of estates which are obligated to file returns or pay estate taxes, but whether this will actually occur only time and inflation will tell. It will also change estate planning practices.

(4) The reduction over a four year period of the top estate and gift rate to 50% from 70%.[9] The phase-in of the unified credit over six years and the reduction of the top rates over four years means that existent planning is not yet obsolete, but new planning will be necessary to deal with the phase-in.

(5) The increase of the gift tax per donee exclusion to $10,000

4. I.R.C. § 2032A(b) (1982), *amended by* ERTA, *supra* note 2, at § 421.
5. I.R.C. § 2040 (1982), *amended by* ERTA, *supra* note 2, at § 403(c).
6. I.R.C. § 2056 (1982).
7. I.R.C. § 2056(b)(7) (1982).
8. I.R.C. §§ 2010, 2505 (1982).
9. I.R.C. § 2001(c)(2) (1982).

from \$3,000.[10] This means that a married couple can give \$20,000 to each of their children and grandchildren every year tax-free. These transfers will not be included in the estate tax base.

(6) Property held by spouses jointly with the right of survivorship will be deemed, after 1981, to be owned half by each, irrespective of the source of the contribution used to acquire or improve the property.[11] The complex 1976 joint marital property scheme has been repealed.[12] The unlimited marital deduction made a change in the joint property rules unnecessary as a practical matter, but there was no reason not to simplify those rules in light of the conclusion by Congress that marital property is not "his" or "hers," but "theirs."

Although there were many other changes made in the estate and gift taxes in the 1981 legislation, those enumerated above are the most significant and, in contrast to certain features of the 1976 legislation, quite simple and straightforward. Yet with these relatively simple changes, Congress has fashioned an estate and gift tax regime which drastically alters estate planning. It changes estate planning not only in the tax sense, but raises new personal issues for husbands and wives to wrestle with as they think about the ultimate disposition of their property. Do the tax advantages of equalization of estates outweigh the practical consequences? To what extent should bequests to children, for example, be postponed in light of the unlimited marital deduction? Tax advantages aside, is it sensible to transfer \$20,000 a year to a child?

I. The Changes in Brief

A. *Increased Unified Credit*

The Economic Recovery Tax Act of 1981 enlarges the unified estate and gift tax credit to \$192,800 from \$47,000, the equivalent of a \$600,000 exemption, over six years beginning in 1982 as set forth below:[13]

10. I.R.C. § 2503(b) (1982).
11. I.R.C. § 2040(b) (1982).
12. I.R.C. § 2040(c)(1) (1976), *repealed by* ERTA, *supra* note 2, at § 403(c)(3)(A).
13. I.R.C. §§ 2010, 2505 (1982).

Year	Amount of Credit	Equivalent Exemption
1982	$ 62,800	$225,000
1983	$ 79,300	$275,000
1984	$ 96,300	$325,000
1985	$121,800	$400,000
1986	$155,800	$500,000
1987 and beyond	$192,800	$600,000

The unified credit for nonresident aliens was left at $3,600.[14]

The Act, as might be expected, revises the estate tax filing requirements to tie them into the increased unified credit. As is presently the rule, the filing requirement is reduced by the sum of any adjusted taxable gifts made by the decedent after December 31, 1976, and by the amount of any specific gift tax exemption under prior law which may have been used by the decedent with respect to gifts made after September 8, 1976, and before January 1, 1977.

B. *The Reduction in the Top Estate and Gift Tax Rate*

Under the Act, the maximum estate and gift tax rate is reduced by five percentage points a year over a four year period (to 50% from 70%) beginning in 1982.[15]

C. *Unlimited Marital Deduction and the New Exception to the Terminable Interest Rule*

Under the new law, the 50% marital deduction (with the $250,000 minimum estate tax and $100,000 minimum gift tax marital deduction) has been altered to permit an unlimited estate and gift tax marital deduction.[16] Thus, one spouse can transfer an unlimited amount of property tax-free to the other spouse, and estates may be freely equalized. Consistent with this change, transfers of community property are now eligible for the marital deduction.[17]

In addition, the Act introduces a new kind of terminable interest which qualifies for the marital deduction. The new interest—"qualified terminable interest property"—has the effect of

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14. I.R.C. § 2102(c)(1) (1982).

15. I.R.C. §§ 2001(c)(1), 2502(a) (1982).

16. I.R.C. § 2056(c)(1)(A) (1976) (imposing a 50% limitation), *repealed by* ERTA, *supra* note 2, at § 403(a)(1)(A).

17. I.R.C. § 2056(c)(1)(C) (1976) (providing for a community property adjustment), *repealed by* ERTA, *supra* note 2, at § 403 (a)(1)(A).

permitting the spouse who predeceases to avail him or herself of the unlimited marital deduction and at the same time specify precisely how the remainder interest is to pass on the death of the surviving spouse.[18] Qualified terminable interest property will permit some post-mortem estate planning by allowing election to be made by the executor at the time the estate tax return of the decedent is filed.

Because of the changes in the marital deduction and the possible effect on pre-existing wills, Congress provided, consistent with its approach to the minimum marital deduction in the 1976 changes,[19] that the old law will continue to apply to wills executed prior to 30 days after the date of enactment, if not subsequently amended to indicate specifically an intent to adopt the unlimited marital deduction. The new law will apply, however, to all wills with respect to which the governing state enacts a law which construes the reference to the old formula to encompass the new.[20] The Act was signed into law on August 13, 1981, and became effective 30 days thereafter. Therefore, the new law will apply to wills executed on or after September 12, 1981.

D. *Joint Property*

Somewhat submerged in the marital deduction changes, but important in its own right, is a major change with respect to joint property.[21] It will be recalled that for many years section 2040 provided that property held jointly with a right of survivorship was includable in the estate of the first to die, except to the extent the survivor could demonstrate what he or she had contributed to the acquisition of the property. In 1976, Congress revised this scheme to introduce the concept of a qualified joint interest.[22] Then, in 1978, it provided for treating material participation in a farm or other business by the surviving spouse as a contribution to joint property.[23] The qualified joint interest concept permitted a husband and wife, by electing to have a transfer into joint names

18. I.R.C. § 2056(b)(7) (1982).
19. Tax Reform Act of 1976, *supra* note 1, at § 2002(d)(1).
20. ERTA, *supra* note 2, at § 403(e)(3).
21. I.R.C. § 2040(b)(2) (1976), *amended by* ERTA, *supra* note 2, at 403(c)(1).
22. I.R.C. § 2040(b)(2) (1982).
23. I.R.C. § 2040(c) (amended by Act of Nov. 6, 1978, Pub. L. No. 95-600, 92 Stat. 2763), *repealed by* ERTA, *supra* note 2, § 403(c)(3)(A).

treated as a gift, to exclude one-half the value of jointly held property from the estate of the first to die.

Under the new law these provisions, which in the case of material participation were quite complicated, were repealed, although the qualified joint interest terminology was retained. Under section 2040(b), joint property held by husband and wife is included in the estate of the first to die only to the extent of one-half of the value of the property.

E. *The Per Donee Exclusion, the Education and Medical Exclusion, and the Annual Payment of Gift Tax*

Under the Act, the annual gift tax per donee exclusion is increased to $10,000 from $3,000.[24] Thus, a couple who elects to split gifts may transfer $20,000 a year to an unlimited number of donees without paying any gift tax or having the transfers considered for purposes of computing the estate tax. Furthermore, the Act provides, in effect, an unlimited exclusion for amounts paid as tuition to a recognized educational organization or for medical care, as such amounts are not deemed to be gifts.[25] Finally, the Act restores the requirement that gift tax returns be filed annually rather than quarterly as is now required after a certain threshold.[26] Gift tax returns are due, beginning in 1982, on April 15. This is the same time that the income tax return of a taxpayer filing on a calendar year basis is due. If there is an extension of time granted for income tax purposes, it also applies for gift tax purposes. However, in the year of death the annual gift tax return is required to be filed on the date for filing the donor's estate tax return (including extensions), if that is earlier than April 15 (or any extended date).

F. *Transfers Made Within Three Years of Death*

Since 1916, when first enacted, the federal estate tax law has either presumed that any transfer made within two (later three) years of death was made in contemplation of death and, therefore, should be included in decedent's gross estate to prevent the avoidance of estate tax, or the inclusion has been mandated, irrespective of intention. However, changes made by the Revenue Act of 1976

24. I.R.C. § 2503(b) (1982).
25. I.R.C. § 2503(e) (1982).
26. I.R.C. § 6075(b) (1982).

substantially reduced the significance of transfers made within three years of death, although section 2035 was continued in the law and inclusion was made mandatory.[27] Under the unification of the estate and gift taxes which was adopted in 1976, any lifetime transfer made before or within three years of death is considered in determining the total life and death transfers of the decedent, and also in determining the estate tax which will be finally levied upon the assets passing at his death (because of the inclusion of gifts made during one's life in the estate tax base, a credit is allowed against the estate tax for any gift tax paid).

The net effect of the unified system was that in the case of a transfer made within three years of death, only the appreciation of the property between the date of the gift and death was subject to a tax which would not otherwise be imposed. In other words, the mere transfer itself was treated as a transfer which had to be considered in determining the total life and death transfers of the decedent and in fixing the tax imposed, although it would be considered only to the extent of the value at the time of the gift. The practical effect of section 2035 after 1976 was, therefore, to require the additional inclusion of the amount of appreciation of the property since the gift.

In the Economic Recovery Tax Act of 1981, Congress concluded that except in a few limited situtations there was no longer any point in including property transferred within three years of death in the decedent's gross estate. It recognized that the only impact of such a rule was to include appreciation; the value of the property itself was already being included under the general rules relating to the unified transfer tax. Thus, the old rule was largely repealed, effective January 1, 1982. However, the old rule will continue to apply with respect to gifts of life insurance and property which, if held at death, would be includable in the gross estate pursuant to sections 2036, 2037, 2038, and 2041. Moreover, Congress determined that gifts made within three years of death should be included in the decedent's gross estate to determine the estate's eligibility for favorable redemption, valuation and deferral provisions (under sections 303, 2032A, and 6166). This rule was intended to preclude deathbed transfers designed to qualify the es-

27. Tax Reform Act of 1976, *supra* note 1, at § 2001 (a)(5) (codified at I.R.C. § 2035 (1980)).

tate for favorable treatment. Whether these changes will result in an undue complication of the law remains to be seen.

Perhaps the most significant aspect of the change is its impact on income taxes. The effect for income tax purposes of including property in the gross estate is that the property receives a step-up in basis to fair market value at the date of the decedent's death (or the alternate valuation date, if that were elected). The beginning rate on the first dollar of taxable estate will be 37% and the maximum capital gains rate is reduced to 20%. However, despite the lower income tax rate, the value of the exclusion of appreciation from estate tax will not always be greater than the value of the step-up in basis for income tax purposes that would result from inclusion. As will be explained in the detailed discussion below, the estate tax cost of inclusion may be less, especially in cases of gifts of appreciated property, than the potential capital gains tax liability with respect to the property.

G. *Basis of Property Acquired from a Decedent*

Under the Act a special rule is adopted beginning in 1982 which provides that the basis step-up rules of section 1014 will not apply with respect to appreciated property acquired by the decedent through a gift within one year of his death if the property passes, directly or indirectly, from the donee-decedent to the original donor or the donor's spouse.[28] The purpose of this provision is to preclude deathbed transfers to a prospective decedent where the property would be returned to the donor, hopefully with a stepped-up basis as a result of its passing through the estate of the decedent.

H. *Disclaimers*

The Act modifies section 2518 relating to disclaimers, added to the gift tax statute by the Tax Reform Act of 1976. The 1981 change provides that the timely transfer of property to the person who would have received it had an effective disclaimer been made under applicable local law shall be deemed to be an effective disclaimer for federal estate and gift tax purposes, assuming the other requirements for a qualified disclaimer are met. Section 2518 has

28. I.R.C. § 1014(e) (1982).

engendered a considerable amount of controversy and a good deal of scholarly writing. For reasons expressed in the detailed discussion below, it is doubtful whether this change will do much to eliminate the problems of section 2518.

I. *Current Use Valuation of Certain Property*

Under present section 2032A, real property, which ordinarily must be included at fair market value at its highest and best use, may, in the case of family farms and real estate used in closely held businesses, be included at its current use value if certain conditions are met. However, the gross estate may not be reduced by more than $500,000 as a result of this provision.

The provisions of section 2032A would appear to have more to do with practical politics than with tax policy. Moreover, they serve to establish beyond peradventure that complexity—which polemicists argue is to be eschewed in any provision that can be regarded as burdening a taxpayer (like the generation-skipping tax)—is not a factor to be considered in a pro-taxpayer provision.

There are numerous articles which explain present section 2032A, and someone with more strength than the present author will describe in detail the seventeen technical changes made in this provision (as counted in a Joint Committee on Taxation staff summary) which have assumed a variety and complexity that almost overwhelm the estate tax itself.[29] In the House report, a substantial portion of the discussion relating to the estate and gift tax changes is devoted to the current use valuation provision.[30] No further attention will be given to section 2032A in this Article.

J. *Extension of Time for Payment of Estate Tax Attributable to Interests in Closely Held Businesses*

Those provisions contained in old sections 6166 and 6166A of the Internal Revenue Code were related and more justifiable. For reasons not readily apparent at the time, Congress in 1976 decided to leave intact section 6166A, a provision which originated in the

29. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, 241-54 (Comm. Print 1981).

30. H.R. REP. No. 201, 97th Cong., 1st Sess. 165-79 (1981) [hereinafter cited as H.R. REP. No. 201].

Small Business Tax Revision Act of 1958[31] as section 6166, and to provide additional relief with respect to the payment of estate taxes on closely held businesses in a new, separate section designated section 6166. The current Act wisely repealed one of these overlapping provisions, section 6166A.[32] It also substantially liberalized the provisions of section 6166.[33] These changes will be described in a bit more detail below, but the most significant is reducing to 35% the requirement of present section 6166 that the closely held business interest must comprise at least 65% of the adjusted gross estate.[34]

K. *Charitable Contributions of Art Works*

The Act provides a limited change with respect to estate and gift tax deductions in the case of transfers of copyrightable works of art. Under present law, where a charitable transfer is of an interest which is less than the donor's entire interest in property, no charitable deduction is allowed unless the gift is made in certain specified forms.[35] An original work of art and a related copyright are considered interests in the same property. Therefore, under present law, no charitable deduction is allowed for the transfer of an original work of art to charity if the copyright is retained or transferred to someone other than a charity.

The Act amends sections 2055 and 2522 to provide that where a donor or decedent makes a charitable contribution of a copyrightable work of art after 1981, the work of art and its copyright will be treated as separate properties.[36] Thus, a charitable deduction will be allowed for a transfer of the work of art to a charity even though the copyright is not simultaneously transferred.

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31. Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, § 206(a), 72 Stat. 689, 1606, *repealed by* ERTA, *supra* note 2, at 422(d).

32. ERTA, *supra* note 2, at § 422(d).

33. ERTA, *supra* note 2, at § 422(a).

34. *See generally* Kahn, *Closely Held Stocks—Deferral and Financing of Estate Tax Costs Through Sections 303 and 6166*, 35 Tax Law. 639 (1982).

35. I.R.C. §§ 2055(e)(2), 2522(c)(2) (1982).

36. I.R.C. §§ 2055(e)(4), 2522(c)(3) (1982).

L. *The Orphans' Deduction*

The orphans' deduction, introduced in the Revenue Act of 1976, is repealed in the case of decedents dying after December 31, 1981.[37]

M. *Generation-Skipping Tax*

The Tax Reform Act of 1976 introduced a tax on so-called generation-skipping transfers designed to prevent estate tax avoidance by the creation of a trust which extended over several generations. However, a limited transitional rule exempts from the generation-skipping tax trusts created by wills or revocable trusts in existence on June 11, 1976, if two conditions are met: first, such wills and trusts could not be amended after that date to create or increase the amount of any generation-skipping transfer, and second, the testator or trust-grantor must die before January 1, 1982.[38] Accordingly, under this provision, a generation-skipping tax would be imposed in the case of all decedents dying on January 1, 1982, or thereafter, irrespective of when the generation-skipping transfer was made.

Under the Economic Recovery Tax Act of 1981, the transitional rule has been extended one year.[39] The generation-skipping tax will accordingly not apply in the case of pre-June 12, 1976, wills and trusts, provided that they are not amended to increase the generation-skipping amount and the testator or trust grantor dies before January 1, 1983. This does not change the present application of the generation-skipping tax to all wills and trusts presently being prepared and existing generation-skipping trusts created by wills or inter vivos deeds after June 11, 1976.

II. THE CHANGES IN DETAIL

A. *Legislative History*

Because the Economic Recovery Tax Act of 1981 had a somewhat unusual procedural history, it will be helpful to set out how the legislation developed.

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37. Tax Reform Act of 1976, *supra* note 1, at § 427(a) (codified at I.R.C. § 2057 (1977)), *repealed by* ERTA, *supra* note 2, at § 427(a).

38. Tax Reform Act of 1976, *supra* note 1, at § 2006(e).

39. ERTA, *supra* note 2, at § 428.

The original proposals of President Reagan were introduced in the House of Representatives on March 10, 1981, as H.R. 2400.[40] The bill was a comparatively simple one as the President's proposals were limited to rate reduction, changes in depreciation and the extension of the at-risk rules to the investment tax credit. The Reagan administration had expressed a strong desire that there be a so-called "clean bill" which could move rapidly through Congress.

Neither the House Ways and Means Committee nor the Senate Finance Committee shared this predilection for a clean bill, and the Finance Committee was eager, probably for political reasons, to push the Ways and Means Committee to early action. Both the Senate and House began developing bills that were substantially broader than the Reagan administration indicated it would like, although the President recognized that he had no real alternative but to accept the congressionally popular provisions of these bills and ultimately withdrew his objections.

The Senate bill[41] developed essentially along Republican lines since the Republican party was in control of the Finance Committee, whereas the House bill[42] was essentially a Democratic bill, the Democrats being in control of the Ways and Means Committee. This state of affairs led to the following parliamentary maneuvers: On June 9, 1981, Representatives Barber Conable and Kent Hance introduced H.R. 3849,[43] a bill which represented the administration's modified position which accepted many relief provisions it had initially fought. Thereafter, the Ways and Means Committee reported its bill, H.R. 4242,[44] on July 24, 1981, and on the same day Representatives Conable and Hance introduced H.R. 4260,[45] which was in most respects identical to the bill developed by the Finance Committee. In a vote taken on July 29, 1981, the House voted to substitute the text of the second Conable-Hance bill for the text of the Ways and Means Committee bill, and then to adopt H.R. 4242 as amended. On July 6, 1981, the Senate voted to attach

40. H.R. 2400, 97th Cong., 1st Sess., 127 CONG. REC. H831 (daily ed. Mar. 10, 1981).
41. H.R.J. Res. 266 (Comm. on Finance), 97th Cong., 1st Sess. (1981).
42. H.R. 4242, 97th Cong., 1st Sess. (1981).
43. H.R. 3849, 97th Cong., 1st Sess., 127 CONG. REC. H2783 (daily ed. June 9, 1981).
44. H.R. 4242, 97th Cong., 1st Sess., 127 CONG. REC. H4761 (daily ed. July 24, 1981).
45. H.R. 4260, 97th Cong., 1st Sess., 127 CONG. REC. H4761 (daily ed. July 24, 1981).

its bill as an amendment to House Joint Resolution 266,[46] relating to the budget, and proceeded on August 3, 1981, to adopt the House Joint Resolution as amended.

The conference committee therefore had to deal with virtually identical legislation. In a marathon series of meetings, the relatively minor differences between the House and Senate bills were rapidly resolved, and the Economic Recovery Tax Act of 1981 was forwarded to President Reagan for his signature. The President signed the Act on August 13, 1981.

B. *Increased Unified Credit*

1. *In general.* As indicated above, the unified credit has been dramatically increased, although the increase is phased-in over six years so that the immediate impact was not that great. However, the ultimate increase to $600,000 from an effective exemption of $175,625 will produce major changes in revenues and planning techniques.

Under pre-1982 law, approximately 8% of those who died in the United States each year were required to file an estate tax return.[47] One can assume that this change will have the effect, when fully implemented, of very substantially reducing the number of estate tax returns. The change was estimated to have less than a $5,000,000 impact on receipts in 1982, but by 1986 the revenue loss was estimated to be $3,834,000,000.[48] No estimate was given for the revenue loss in 1987 and beyond when the credit goes to $192,800.

2. *Legislative history.* One difference between the Senate and House approach to the unified credit was that the House proposed increasing the unified credit over a six year period, whereas the Senate proposed a phase-in over five years.[49] The House ver-

46. H.R.J. Res. 266, 97th Cong., 1st Sess., 127 CONG. REC. S7274 (daily ed. July 8, 1981).

47. The 1982 World Almanac lists the following number of deaths for 1978, 1979, and 1980 respectively: 1,927,788, 1,906,000, and 1,986,000. THE WORLD ALMANAC AND BOOK OF FACTS 954 (1982). The 1981 Statistical Abstract of the United States states that the following number of estate tax returns were filed in 1978, 1979, and 1980 respectively: 160,000, 159,000, and 148,000. BUREAU OF CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 256 (102d ed. 1981). Accordingly, about 8% of all decedents have estate tax returns filed on their behalf.

48. H.R. REP. No. 201, *supra* note 30, at 155.

49. *Id.* at 154-55; S. REP. No. 144, 97th Cong., 1st Sess. 124-25 (1981) [hereinafter cited as S. REP. No. 144].

sion prevailed. The Ways and Means Committee report, echoed by the Finance Committee report with one exception, indicated the reason for the increase in the unified credit was inflation and the need to provide relief for estates containing farms, ranches, and small businesses.[50] The stated rationale was that the $47,000 credit was intended to exempt small and moderate sized estates from estate and gift taxes, but inflation had been pushing such estates and gifts into higher brackets. The two reports also state that the amount of the credit was inadequate to provide relief to farms and small businesses and an increase was necessary so that estates would no longer be forced to dispose of family businesses to pay estate or gift taxes.

The Finance Committee report makes two statements not contained in the report of the Ways and Means Committee. First, it articulates the inflation rationale a bit more strongly by stating that "inflation has increased the dollar value of property and, therefore, the transfer tax burdens, without increasing real wealth."[51] This has, of course, occurred, but one may speculate as to whether that is the real reason behind the drive of farmers and small businessmen for estate tax relief. My limited experience suggests that in many areas of the country there have been dramatic increases in real wealth. The value of holdings in real estate have rapidly increased in many parts of the country far beyond the effects of inflation. Thus, individuals who had always conceived of themselves as being of relatively modest means, suddenly discovered that they had estates of $1,000,000 or more. No doubt they were not pleasantly surprised to discover that, on their death, the government would take what they regarded as a significant portion of the estate through taxes. Empirical studies indicate that the demise of the family farm is continuing apace, but that estate tax burdens have had little to do with this phenomenon.[52] Much more

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50. H.R. REP. No. 201, *supra* note 30, at 155.

51. S. REP. No. 144, *supra* note 49, at 124.

52. *See, e.g.*, 5 N. HARL, AGRICULTURAL LAW § 41.02 (1982); Chapter 6, Tax Policy, of Department of Agriculture, A Time to Choose: Summary Report on the Structure of Agriculture 91, 92 (1981):

> In 1976, the taxation of estates was substantially revised. . . . Farm interests argued that farm-operator families could not realize these higher values on which estates were taxed without selling the land or removing it from farming. . . . The Congress accepted this argument despite the fact that most purchases of farm land were by farmers, at market value, for use as farms.

significant is the movement away from the farm by offspring of farmers, the spread of suburbs so that farm land suddenly becomes too valuable for agricultural pursuits, and changes in farm economics which require substantially more land for economical farming, thus making smaller farms obsolete.[53]

The second interesting statement in the Finance Committee report is, "[H]istorically, one of the principal reasons for estate and gift taxes was to break up large concentrations of wealth."[54] It has been persuasively argued that this is not true, and that estate and gift taxes have historically been associated with the need for revenue during wars.[55] Only in the 1930s was an attempt made to mobilize these taxes to produce a more even distribution of wealth. Furthermore, based on the evidence available, it seems relatively clear that whatever the purpose of our present estate taxes, they have no significant effect on the distribution of wealth. Wealth is even more concentrated today than it was in the 1930s.[56] There is, however, no suggestion in the Finance Committee report that the Committee is abandoning this assumed historic reason, even though its action in reducing the top rates to 50% from 70% seems inconsistent.

3. *The practical significance of the increase.* As previously noted, when the increased unified credit is fully phased-in it will dramatically reduce the number of estates filing estate tax returns. This presumably will have some marginal effect upon those attorneys specializing in estate administration, although these estates will still have to be administered. In many cases a state estate or inheritance tax return will be prepared and, in any event, the actual problems of administration require significantly greater time and energy than the preparation of the federal estate tax return. Therefore, comparatively little impact can be expected on the bar.

As to prospective decedents, inflation and real increases in wealth may substantially offset the impact of the increased unified credit. A dollar doubles in about seven years at a 10% compound

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See also N. Harl, Influencing the Structure of Agriculture Through Taxation 6 (Oct. 30, 1980) (unpublished paper).

53. *See* N. HARL, AGRICULTURE LAW, *supra* note 52, at § 41.02.

54. S. Rep. No. 144, *supra* note 49, at 124.

55. Moran, *Estate and Gift Taxation: The Case for Repeal*, XIII TAX NOTES, Aug. 17, 1981, at 339.

56. *Id.* at 340.

rate, so that an estate of $1,200,000 today (and tax-free in 1987) should conservatively become an estate of $2,400,000 in 1990, putting aside the effects of inflation, and assuming all income and growth is retained. Furthermore, as will be explored more fully in connection with the reduction in rates and the effect of the unlimited marital deduction, the combination of the unified credit, the unlimited marital deduction, and the reduction in the top estate tax rate to 50% makes the extremely wealthy the major beneficiaries from the new estate and gift tax regime.

The increase of the unified credit to permit $600,000 to pass tax-free means that with proper planning no tax will be paid on an estate of $1,200,000. Using the unlimited gift tax marital deduction, the estate can be split $600,000 to husband and $600,000 to wife, so that irrespective of who dies first, full use can be made of both unified credits. The transferor of the $600,000 to equalize estates would probably place the property in trust, income for life to the surviving spouse, with the usual 5%, $5,000 invasion permitted and an unlimited power of invasion in a friendly trustee. The remainder would be left to the objects of the couple's bounty. Although this formulation makes the property owned by the first to die available as a practical matter to the surviving spouse, the surviving spouse's estate will be only $600,000 and fully exempt by reason of the unlimited credit. However, as will be explored below in the discussion of the unlimited marital deduction, the tax cost of not equalizing either during life or at death is not that great, and non-tax considerations may suggest it not be done.

4. *The practical significance of the phase-in.* The phase-in of the increase in unified credit will necessitate will clauses which take account of the phase-in. Assume a testator with $1,200,000 in property who, despite the unlimited marital deduction, proposes to leave half of his property to his wife in a standard marital deduction trust and the other half in trust, income for life to her, remainder to their children. When the unified credit is fully phased-in, the net effect of this disposition will produce total estate tax exemption. Six hundred thousand dollars will be subject to tax in both the husband's and wife's estate, but any tax will be completely eliminated by their unified credits. Yet, when the unified credit produces only a $275,000 exemption, as it will in 1983, a somewhat different disposition may be indicated. For example, one might wish to consider taking somewhat greater advantage of the

marital deduction in order to produce an exemption in the first estate. However, because increased use of the marital deduction will make more property subject to tax in the estate of the surviving spouse, one would obviously wish to reduce to a minimum the amount of marital deduction property and retain in the first estate only that amount necessary to utilize as much of the unified credit as is available in the estate of the first to die. Furthermore, besides leaving $600,000 in the estate of the first to die, one should also leave a sufficient amount so as to pay all deductible administration expenditures. The handling of state death taxes will be discussed below.

A will clause to achieve such a disposition is as follows:

RESIDUARY MARITAL DEDUCTION CLAUSE:

FIFTH: All the rest, residue and remainder of my estate, both real and personal and wheresoever situate, including any property over which I may have a power of disposition by Will or otherwise, I give, devise and bequeath as follows:

I. If my spouse, [name], shall survive me, I direct my Executor to divide my residuary estate into two parts. Part A [the portion qualifying for the unlimited marital deduction] shall be determined by a fraction, the numerator of which shall be the maximum estate tax marital deduction allowable in determining the federal estate tax on my estate (excluding any generation-skipping transfers deemed part of my gross estate pursuant to section 2602(c)(5)(A) of the Internal Revenue Code of 1954, as amended), reduced by the value of all other property interests forming a part of my gross estate which qualify for such marital deduction and which property interests shall have passed to my spouse in any other manner, and further reduced by the amount, if any, necessary to reduce my taxable estate to the largest amount that will, after taking into account all deductions allowable in determining my taxable estate and the unified credit and the credit for state death taxes (provided that the credit for state death taxes shall be taken into account only to the extent that it does not result in an increase in state death taxes otherwise payable), result in no federal estate tax on my estate. The denominator of the fraction shall be the value of my residuary estate. Part B [the taxable portion] shall be the balance of my residuary estate. In making these determinations, the values as finally determined in the federal estate tax proceeding shall control. Part A and Part B shall share proportionately in any increase or decrease in the value of the property comprising such residuary estate.

There shall not be allocated to Part A any asset or the proceeds of any asset (a) which does not qualify for the marital deduction, or (b) with respect to which a credit shall be allowable for estate or death taxes paid to any foreign country or any of its possessions or subdivisions, except that assets described in clause (b) may be so allocated to the extent that assets other than those hereinbefore described are not sufficient.

I dispose of said parts as follows:

A phase-in clause is also appropriate where the estate is under $1,200,000. For example, once the unified credit is fully phased-in, the proper disposition from a tax standpoint in an estate of $800,000 would be to ensure that $600,000 is includable in the estate of the first to die (which would be exempt from tax by reason of the unified credit), and that only $200,000 is subject to tax in the estate of the second. It would be sensible to use the unified credit fully in the estate of the first to die even if it means that some of the unified credit in the estate of the second to die goes unused. Such a disposition protects against the effects of inflation, which may push the surviving spouse's estate to higher levels, and takes account of the possibility of increases in value due to wise investments, inheritances, gifts, and so on. Survival until 1986 by the spouse who retains $600,000 in assets to be taxed will produce virtual exemption, and in 1987, total exemption. However, in such a case in 1983, for example, only $275,000 should be kept in the estate of the first to die. The clause set forth above would achieve this effect.

C. *Reduction in Top Rate*

1. *In general.* The Act reduces the top estate and gift tax rate to 50% from 70%, although the reduction is phased-in.[57] Under the phase-in provision, the top rate drops to 65% in 1982 for estates of over $4,000,000, to 60% in 1983 for estates of over $3,500,000, and to 55% in 1984 for estates of over $3,000,000. In 1985 the new top rate of 50% is applicable to estates of over $2,500,000.

2. *Legislative history.* The proposal to reduce the top estate tax rate to 50% from 70% originated in the House bill[58] and was not contained at all in the Senate Finance Committee's bill.[59] The Ways and Means Committee's justification was that present estate and gift tax rates could result in more estate and gift taxes on highly successful enterprises, closely held corporations, and family businesses than their owners could afford without disposing of the

57. I.R.C. §§ 2001(c)(1), 2502(a) (1982).
58. H.R. Rep. No. 201, *supra* note 30, at 156.
59. S. Rep. No. 144, *supra* note 49.

businesses. In order to prevent forced sales of such businesses, the Committee believed that a rate reduction was appropriate. The Committee also stated that it believed the reduction of the top rate to 50% was consistent with its decision to reduce the maximum rate of income tax to 50%.

3. *The soundness of the revised rate schedule.* Under the present rate schedule, the rates begin at 18% for a taxable estate of not over $10,000 and increase at intervals to a rate of 32% where an estate is over $150,000, but does not exceed $250,000. These rates do not apply in any case because the unified credit of $47,000 offsets the tax otherwise imposed on the first $175,625 of the estate. Thus, as a practical matter, the first bracket for an estate is 32% under present law. Under the present schedule an estate of $2,500,000 is in the 49% bracket and an estate over $2,500,000 and less than $3,000,000 is in the 50% bracket. After $3,000,000 the rates continue their climb and reach 70% in estates of over $5,000,000. When the reduction in rates is fully phased-in, an estate of $2,500,000 will be in the 49% bracket, whereas all estates of over $2,500,000 will be in the 50% bracket.

The effect of the rate change will sharply compress the rates, especially when the reduced top rate is coupled with the increased unified credit. See Chart 1 below, which compares the effective rates under the present schedule with the effective rates in 1987:

CHART 1

1981 RATE SCHEDULE

Size of Estate	Tax	Effective Rate	Tax Less Unified Credit	Effective Rate
$20,000,000	$13,050,800	65.3%	$13,003,800	65%
$10,000,000	$ 6,050,800	60.5%	$ 6,003,800	60%
$ 5,000,000	$ 2,550,800	51%	$ 2,503,800	50%
$ 2,500,000	$ 1,025,800	41%	$ 978,800	39.2%
$ 2,000,000	$ 780,800	39%	$ 733,800	36.7%

1985 RATE SCHEDULE WITH AND WITHOUT 1987 UNIFIED CREDIT

Size of Estate	Tax	Effective Rate	Tax Less 1987 Unified Credit	Effective Rate
$20,000,000	$ 9,775,800	48.9%	$ 9,583,000	47.9%
$10,000,000	$ 4,775,800	47.7%	$ 4,583,000	45.8%
$ 5,000,000	$ 2,275,800	45.5%	$ 2,083,000	41.6%
$ 2,500,000	$ 1,025,800	41%	$ 833,000	33.3%
$ 2,000,000	$ 780,800	39%	$ 588,000	29.4%

1985 RATE SCHEDULE WITH 1987 UNIFIED CREDIT AND STATE DEATH TAX CREDIT

Size of Estate	Tax Less 1987 Unified Credit	Tax Less 1987 Unified Credit and State Death Tax Credit	Effective Rate
$20,000,000	$9,583,000	$6,916,200	34.6%
$10,000,000	$4,583,000	$3,517,200	35.2%
$ 5,000,000	$2,083,000	$1,691,400	33.8%
$ 2,500,000	$ 833,000	$ 694,200	27.8%
$ 2,000,000	$ 588,000	$ 478,400	23.9%

Since the unified credit when fully phased-in will exempt the first $600,000 of an estate, an estate of $601,000 will be in the 37% bracket. If the estate is sufficiently within the 37% bracket to utilize the credit for state death taxes, the effective rate of credit on $600,000 is .0273, so the overall effective rate is reduced to 34.27%. The 50% rate will be available for estates of $2,500,000 and over. One may question the advisability of this rate structure. While the use of a unified credit rather than an exemption makes the rate schedule on its face look more progressive than it in fact is, an individual with an estate of $750,000 may very well wonder why he should pay tax at a top rate of 39% when his neighbor with a $20,000,000 estate pays a top rate of 50%. Although the spread of effective rates is far greater than 11 points (it is 40.5 points, the difference between a 7.4%, $55,500 tax on $750,000, and 47.9%), it is not clear that this will console the $750,000 taxpayer. These considerations suggest a spreading of brackets so that the 50% rate is not reached until $10,000,000. Moreover, under the rate table as revised by the Act, decedents with estates between $2,000,000 and $2,500,000 have a particular grievance. The rate table rises from 37% in two point intervals to 45% for a $2,000,000 estate, but then immediately jumps to 49% for an estate between $2,000,000 and $2,500,000. Once the $2,500,000 threshhold is reached, the rate goes up one percentage point to 50%.

One may question whether the 50% maximum will survive. This is especially so in view of the Finance Committee statement in connection with the unified credit that the estate tax has historically been intended to break up concentrations of wealth. As noted above, this is not a provision which the Senate Finance Committee, typically more estate tax reduction oriented than the Ways and Means Committee, initiated. One may suspect that the advocacy of this provision by the House had more to do with politics than with deep felt conviction. The House justification for limiting the tax on "highly successful closely held corporations and family businesses" because the present tax was more "than their owners could afford without disposing of the businesses" seems a bit hollow when it is recognized that under then-existing law a rate in excess of 50% was not reached unless the estate was more than $2,500,000. One sees the primary beneficiaries of this change as individuals with estates of $10,000,000 or more. For a $10,000,000 estate, there is a $1,275,000 estate tax reduction and for a $20,000,000 estate, a $3,275,000 reduction (ignoring the effect of the unified credit). The fact that these reductions will be welcomed by the heirs of such a decedent does not weaken the possibility that the change will have almost no effect on successful, closely held businesses and farms.

In light of all these considerations, one would anticipate that there would be further revisions in our estate and gift tax rates within the next few years. Alternatively, the reductions in revenue occasioned by the 1981 Act, acting on what is already a very small contribution to federal revenues, produces a potent argument for complete repeal of the estate and gift tax.[60]

From the perspective of the estate planner, the reduction in the top rate should have comparatively little significance. There is little or no doubt that clients will be just as reluctant to pay 50% of their estate to the federal government as they are to pay 70%. It can therefore be anticipated that planning for larger estates will continue at its present level even with the unlimited marital deduction, and one would anticipate that the use of trusts by the wealthy will not diminish to any significant degree, especially if the generation-skipping tax is repealed.

D. *Unlimited Marital Deduction*

1. *In general.* The marital deduction for estate and gift tax purposes, which was first introduced into the law in 1948[61] as part of the income tax changes made at that time dealing with the problems created by the tax advantages of community property, was not changed in any significant manner until 1976. As is well

60. *See* Moran, *supra* note 55.
61. Revenue Act of 1948, ch. 168, § 361, 62 Stat. 110, 117-21.

known, an unlimited gift tax marital deduction was adopted in 1976 for transfers between spouses for the first $100,000 of taxable gifts.[62] No deduction was allowed for the next $100,000, and thereafter a deduction was allowed for 50% of interspousal transfers. The estate tax marital deduction, which had been previously limited to one-half of the adjusted gross estate, was changed to permit a marital deduction equal to the greater of $250,000 or one-half of the adjusted gross estate. In effect, the estate tax marital deduction permitted an unlimited marital deduction to the extent of $250,000. There was a provision adjusting the estate tax marital deduction where the unlimited $100,000 gift tax marital deduction had been used and not offset by the transfer of an additional $100,000 not eligible for the deduction.[63]

2. *Legislative history.* Both the Senate Finance Committee and the House Ways and Means Committee adopted the unlimited marital deduction, although the reasons given for the proposal were somewhat different. However, the Senate bill did not contain provisions creating the new concept of qualified terminable interest property and permitting such property to qualify for the marital deduction.

The Senate report simply states that a husband and wife should be treated as one economic unit for the purpose of estate and gift taxes as they generally are for income tax purposes, and therefore no tax should be imposed on transfers between a husband and wife.[64] It would not seem to be quibbling to point out that a husband and wife are not uniformly treated as a single economic unit for income tax purposes. First, they are treated as a single economic unit only if they elect that treatment by filing a joint return. Second, couples in community property states are not treated as a single economic unit, and the tax treatment of husband and wife in common law jurisdictions is more intended to equate their treatment to the results in community property jurisdictions than it is to treat them as one economic unit. Third, this rationale was undercut by the Economic Recovery Tax Act of 1981 itself, as it adopted a provision designed to mitigate the so-called marriage penalty.[65]

62. I.R.C. § 2523(a)(2) (amended by ERTA, *supra* note 2, at § 403(b)(1)).
63. I.R.C. § 2056(c)(1)(B) (repealed by ERTA, *supra* note 2, at § 403(a)(1)(A)).
64. S. REP. No. 144, *supra* note 49, at 127.
65. ERTA, *supra* note 2, at § 103 (codified at I.R.C. § 221 (1982)).

The Ways and Means Committee statement was much more elaborate, grounding its adoption of the unlimited marital deduction on something it referred to as the "widow's tax."[66] The Committee claimed the widow's tax results when a decedent bequeaths his entire estate to his surviving spouse.[67] Half the estate is subject to tax and, when the surviving spouse later transfers the property, the entire amount is subject to estate taxes. Thus, the cumulative effect of this form of transfer is to subject the property of a husband and wife to tax one and one-half times. This result is said to occur frequently in the case of jointly held property. As this additional tax falls "most heavily on widows, it is often referred to as the 'widow's tax'."[68] The Committee recognized that this additional tax can be minimized through proper estate planning, but stated that it believed that an individual should be free to pass his entire estate to his surviving spouse without the imposition of any additional tax. The Committee also found it appropriate to permit unlimited lifetime tax-free transfers between spouses as well: "A substantial simplification of the estate and gift taxes would be achieved by allowing an unlimited marital deduction since, under present law, it is difficult to determine the ownership of property held by a marital unit and to determine whose funds were used to acquire that property."[69]

3. *Should one use the unlimited estate tax marital deduction?* Initially, one's reaction to the unlimited marital deduction is that its use depends upon the length of time by which the surviving spouse will survive the decedent.[70] The basis for this reaction is

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66. H.R. REP. No. 201, *supra* note 30, at 159.

67. *Id.*

68. *Id.*

69. H.R. REP. No. 201, *supra* note 30, at 159-60.

70. *See generally* Garlock, *Estate Tax Unlimited Marital Deduction Has Limited Advantage In Larger Estates*, 56 J. TAX'N 236 (1982). Garlock notes the following reasons for using the unlimited marital deduction:

1. Because the top estate tax rate will not fall to 50% until 1985, the use of the unlimited marital deduction may allow the entire combined estate to benefit from a lower maximum rate.
2. Passing all of the property to the surviving spouse may enable him or her to transfer additional assets to children and grandchildren free of tax by making annual gifts, or perhaps gifts to charity.
3. A third reason has been offered—the burden of any extra total estate tax payable will be more than offset by deferring all of the tax until the death of the survivor. The thrust of the article is that this reason is not valid, especially in the case of couples living in states with significant death taxes which do not

that an estate tax is not paid at the death of the first spouse where the unlimited marital deduction is used, but will be collected on all of the property at the date of the second spouse's death. However, the estate of the second to die will in most instances be in a higher bracket than would have been the case had half the property been taxed in the estate of the first to die and half in the estate of the second. Since more tax will be paid through the use of the unlimited marital deduction, the issue is how long it would take for the interest on the earlier saved tax to exceed the additional tax payable on the estate of the second to die.

In fact, as is demonstrated by Charts 2 and 3 below, the economics of the situation are not a significant factor, in part because of the reduction of the top rate to 50% and the increase in unified credit. Moreover, as will be seen from the following discussion, there are many economic factors to be weighed in determining whether the unlimited marital deduction should be elected. Chart 2 computes the tax that would be imposed in 1987 and thereafter on the estates of both husband and wife under three alternative dispositions: when the 50% marital deduction is taken, when the 100% marital deduction is taken, and when the 100% marital deduction is taken but $600,000 is retained in the first estate. This chart demonstrates that either of the second two dispositions of property causes a somewhat higher tax to be paid than the use of the 50% marital deduction, although the extra tax can be significantly reduced if $600,000 is retained in the first estate so that the full amount of the unified credit of the first to die is utilized. Chart 3 builds on Chart 2 and computes the approximate period that would be necessary to earn an amount equivalent to the additional tax, assuming a 10% simple rate of return, both where the 100% marital deduction is used and where the 100% marital deduction is used but $600,000 is retained in the estate of the first to die. Of course, it should be remembered that $600,000 plus the deductible costs of administration is realistically the minimum amount to leave in the first estate.

As Chart 3 demonstrates, there are strong economic constraints in favor of the use of the unlimited marital deduction where the estate planner avails himself of the unified credit in the

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allow an unlimited marital deduction.
Id. at 236.

estate of the first to die. On examining Chart 3, it can be observed that if the unlimited marital deduction is used without retaining $600,000 in the estate of the first to die, there are strong economic constraints against the use of the unlimited marital deduction in estates of less than $5,000,000, but extremely strong economic constraints in favor of the use of the unlimited marital deduction in estates of greater than $5,000,000. On the other hand, where one takes proper advantage of the unified credit in the estate of the first to die, Chart 3 demonstrates that there are relatively strong economic constraints in favor of the use of the unlimited marital deduction in every size estate.

CHART 2

TAXES AT 1987 RATES ON ESTATES OF BOTH SPOUSES IN ALTERNATIVE DISPOSITIONS

(1) Size of Estate	(2) 50% Marital Deduction — Total Tax on Both Estates	(3) 100% Marital Deduction — Total Tax on Both Estates	(4) Additional Tax from 100% Marital Election
$20,000,000	$9,166,000	$9,583,000	$417,000
$10,000,000	$4,166,000	$4,583,000	$417,000
$ 5,000,000	$1,666,000	$2,083,000	$417,000
$ 2,500,000	$ 511,000	$ 833,000	$322,000
$ 2,000,000	$ 306,000	$ 588,000	$282,000
$ 1,200,000	$ 0	$ 235,000	$235,000

(5) Size of Estate	(6) 100% Marital Deduction with Retention of $600,000 in First Estate — Total Tax on Both Estates	(7) Additional Tax from 100% Marital Election
$20,000,000	$9,283,000	$117,000
$10,000,000	$4,283,000	$117,000
$ 5,000,000	$1,783,000	$117,000
$ 2,500,000	$ 543,000	$ 32,000
$ 2,000,000	$ 320,000	$ 14,000
$ 1,200,000	$ 0	$ 0

Chart 2 computes the tax which would be imposed on various sizes of estates ranging from $1,200,000 to $20,000,000 where the 50% marital deduction is utilized, where the 100% marital deduction is elected, and where the 100% marital deduction is coupled with $600,000 retained in the estate of the first to die. The assumption in every case is that all of the marital property is held by the first to die and that there is no appreciation, depreciation, or disposition of property by the surviving spouse during his or her lifetime. Expenses of administration are ignored. It is further assumed that the $600,000 subjected to tax in the first decedent's estate is left to the surviving spouse in a form subject to tax in her estate. This assumption facilitates the comparisons to be made, however, as a practical matter it may be unrealistic. First, the survivor may not need the $600,000, or if needed, it could be made available to trust and thus pass free of estate tax on the survivor's death. Second, the $600,000 may have to be used to pay state death taxes or other expenses.

For example, in the case of an estate of $2,500,000, column (2), the 50% marital deduction column, is based on the assumption that $1,250,000 will be taxed in the estate of the first to die and $1,250,000 will be taxed in the estate of the second to die. Column (2) gives the total tax that would be imposed after the use of the unified credit in both estates. The tax set forth in column (3) is the tax that would be imposed on an estate of $2,500,000, the assumption being that there was no estate tax imposed in the case of the first to die so that the full $2,500,000 becomes taxable in the estate of the second to die.

The first observation that will be made on examination of Chart 2 is that the additional tax liability incurred where the unlimited marital deduction elected is not that much different, irrespective of the size of the estate. For example, in an estate of $2,000,000 an additional $282,000 will be paid where the unlimited marital deduction is taken. On the other hand, in estates of $5,000,000, $10,000,000, and $20,000,000, the additional tax is only $417,000. Essentially the same is true where $600,000 is retained in the estate of the first to die, although the additional tax is significantly reduced. For example, in an estate of $2,000,000 the additional tax through the use of the 100% marital deduction is only $14,000, and in estates of $5,000,000 and above it is only $117,000.

As can be seen by examining Chart 2, where the planner does not avail himself of the first decedent's unlimited credit, the use of the unlimited marital deduction is uneconomical for small estates but is economically required for larger estates. In the case of an estate of $1,200,000, where there will be no tax whatsoever if a 50% marital deduction is taken (as the unified credit would eliminate the $600,000 estate of the first to die as well as the $600,000 estate of the second to die), there will be a $235,000 tax where the unlimited marital deduction is taken. This $235,000 can never be recouped by earnings on the tax saved in the first estate. In such a case there is only one credit available and that is in the estate of the second to die. Yet in a large estate, say of $10,000,000, the additional tax is only $417,000 and is recouped in two years from invested tax savings.

By the same token, Chart 2 indicates that where the planner does avail himself of the first decedent's unlimited credit, the use of the unlimited marital deduction cannot be regarded as expensive and in most cases will produce a substantial advantage if the surviving spouse lives for any significant period. This assumes, of course, that the taxes which are not paid on the first estate are appropriately invested, and not spent. For example, in the case of a $1,200,000 estate where $600,000 is retained in the estate of the first to die, one gets exactly the same result from a 100% marital deduction as where the 50% marital deduction is taken. The unified credit would eliminate the $600,000 in the estate of the first to die, as well as the balance in the estate of the second to die. In the case of estates of $5,000,000, $10,000,000, and $20,000,000, the disadvantage of $117,000 is easily recouped in a relatively short period, as shown in Chart 3.

CHART 3

APPROXIMATE PERIOD AT 10% SIMPLE RATE OF RETURN TO PAY FOR 100% MARITAL DEDUCTION

Without Retention of $600,000 in First Estate

(1) Size of Estate	(2) Additional Tax from 100% Deduction	(3) Tax Saved in First Estate	(4) Earnings Per Year	(5) Approximate Period
$20,000,000	$417,000	$4,583,000	$458,300	11 mos.
$10,000,000	$417,000	$2,083,000	$208,300	2 yrs.
$ 5,000,000	$417,000	$ 833,000	$ 83,300	5 yrs.
$ 2,500,000	$322,000	$ 255,500	$ 25,550	12 yrs., 7 mos.
$ 2,000,000	$282,000	$ 153,000	$ 15,300	18 yrs., 5 mos.
$ 1,200,000	$235,000	$ 0	$ 0	never

	With Retention of $600,000 in First Estate			
(6)	(7)	(8)	(9)	(10)
Size of Estate	Additional Tax from 100% Deduction	Tax Saved in First Estate	Earnings Per Year	Approximate Period
$20,000,000	$117,000	$4,583,000	$458,300	3 mos.
$10,000,000	$117,000	$2,083,000	$208,300	7 mos.
$ 5,000,000	$117,000	$ 833,000	$ 83,300	1 yr., 5 mos.
$ 2,500,000	$ 32,000	$ 255,500	$ 25,550	1 yr., 3 mos.
$ 2,000,000	$ 14,000	$ 153,000	$ 15,300	11 mos.
$ 1,200,000	$ 0	$ 0	$ 0	never

Chart 3 assumes that the additional tax which would be paid in the estate of the first to die is invested at 10%. Ten percent seems like a moderate assumption for the present day, since one may achieve nearly that rate of return in tax-exempt bonds, thus eliminating the effects of taxes from consideration. Even if rates drop and it is assumed that taxable investments are made, the conclusions demonstrated by Chart 3 will not change substantially. Chart 3 reflects the same size of estates the taxes of which were calculated both on a 50% and a 100% basis in Chart 2. Column (2) gives the additional tax liability which would be incurred as a result of the use of the unlimited marital deduction and column (3) gives the amount of tax which would be saved in the first estate by the election of the unlimited marital deduction. Column (4) then shows the earnings per year, at 10%, on the tax saved. Column (5) gives the approximate period of time that will be necessary for the estate tax saved by the use of the unlimited marital deduction to return an amount equal to the subsequent additional tax which will be imposed by its use. At the $2,000,000 estate level, nearly nineteen years is necessary to achieve an economic pay-back from the election of the marital deduction, whereas at $10,000,000 only a year and one-half is necessary, and at $20,000,000 eight months is all that is required. As should be obvious, where one has an estate of $1,200,000, the unlimited marital deduction is never economical, for no tax is saved in the first estate electing 100% marital deduction as no tax would have been payable had the 50% deduction been taken.

Columns (6) through (10) present the same data where the planner is wise enough to couple the use of the unlimited marital deduction with the use of the first decedent's unified credit. Here the economic constraint is entirely different and almost requires the use of the 100% marital deduction if economic factors are paramount. In the case of a $20,000,000 estate, survival for only three months is necessary to offset the additional tax and at $5,000,000 where the period is the longest, a year and five months is sufficient. Even in cases where both spouses are elderly and the period of survival for the surviving spouse may be assumed to be minimal, the pay-back period is so short that use of the unlimited marital deduction seems mandated if economics are the sole consideration.

When analyzing the advisability of using the unlimited marital deduction, one should also consider the situation where the surviving spouse has significant property of his or her own. Interestingly enough, Chart 4 demonstrates that there is little change where that is the case.

Chart 4 was constructed on the following basis, using the same estate sizes that have been used in the prior charts: It assumes that the husband is the propertied spouse with 75% of the couple's property and that the husband elects to use an equalizing marital deduction clause. That is, for example, where his estate is $15,000,000 and his wife's estate is $5,000,000, the marital bequest is in the amount of $5,000,000. Therefore, the estate of the first to die is $10,000,000 if an equal amount is in the estate of the second to die. The total tax on both estates is shown in column (3). Column (4) shows the total amount of tax that would be paid in both estates where the unlimited marital deduction is utilized, but it is assumed that $600,000 is retained in the estate of the first to die. Column (5) shows the additional tax from the use of the unlimited marital deduction.

CHART 4

TAXES AT 1987 RATES ON ESTATES OF BOTH SPOUSES IN ALTERNATIVE DISPOSITIONS WHERE BOTH SPOUSES HAVE ASSETS

(1) Size of H's Estate	(2) Size of W's Estate	(3) Equalizing Marital Deduction	(4) 100% Marital Deduction	(5) Additional Tax from Marital Deduction
		Total Tax on Both Estates	Total Tax on Both Estates	
$15,000,000	$5,000,000	$9,166,000	$9,283,000	$117,000
$ 7,500,000	$2,500,000	$4,166,000	$4,283,000	$117,000

$ 3,700,000	$1,250,000	$1,666,000	$1,783,000	$117,000
$ 1,875,000	$ 625,000	$ 511,000	$ 543,000	$ 32,000
$ 1,500,000	$ 500,000	$ 306,000	$ 320,000	$ 14,000
$ 900,000	$ 300,000	$ 0	$ 0	$ 0

In estates of $5,000,000, $10,000,000, and $20,000,000, the additional tax cost is exactly the same as in the case where the surviving spouse did not have property—$117,000. Essentially, the numbers are comparable. In Chart 2, a total estate of $2,500,000 produces a future additional tax of $32,000 through the use of the unlimited marital deduction. In Chart 4, a $2,500,000 estate possessed by both husband and wife produces the same additional $32,000 cost for the use of the unlimited marital deduction as the use of an equalizing marital deduction clause.

The foregoing analysis, which suggests that the unlimited marital deduction should almost always be elected, is somewhat distorted by its assumption that there is no appreciation and that any earnings are spent. A slightly different picture emerges if it is assumed that earnings are accumulated or that there is appreciation. In such a case the unlimited marital deduction becomes slightly disadvantageous. This is true because less of the augmented value will be subject to estate tax on the death of the surviving spouse if the 50% marital deduction is elected.

Assume a $5,000,000 estate, a 10% interest or growth factor, either a 50% or a 100% marital deduction (in the latter case, with $600,000 retained in the first decedent's estate), and that it is 1987 so the full benefit of reduced rates and the maximum unified credit is available. Further assume the surviving spouse lives ten years. There is an advantage to a 50% marital deduction if one alters one's focus.[71] As Chart 5 calculates, on these assumptions $234,000 more will be available to the successor at the death of the surviving spouse in 1987 if the 50% marital deduction rather than the 100% marital deduction is elected by the first decedent.

71. *Id.* at 236-41.

CHART 5

1987 AND 1997 TAXES IN ALTERNATIVE DISPOSITIONS WHEN GROWTH IS CONSIDERED

		50% Marital	100% Marital
1987	H's Estate	$5,000,000	$5,000,000
	Marital Deduction	2,500,000	4,400,000
	H's Taxable Estate	$2,500,000	$600,000
	Tax on H's Estate After Unified Credit	833,000	0
	Marital Portion	$2,500,000	$4,400,000
	Successor's Portion	$1,667,000	$ 600,000
1997	Marital Portion	$2,500,000	$4,400,000
	Assumed Growth on Marital Portion	2,500,000	4,400,000
	W's Estate	$5,000,000	$8,800,000
	Marital Deduction	0	0
	W's Taxable Estate	$5,000,000	$8,800,000
	Tax on W's Estate After Unified Credit	2,083,000	3,983,000
	Net to Survivors	$2,917,000	$4,817,000
	Successor's Portion of H's Estate	$1,667,000	$ 600,000
	Assumed Growth on Successor's Portion of H's Estate	1,667,000	600,000
	Total to Successors	$6,251,000	$6,017,000

As a practical matter, it seems likely that decedents will, and perhaps properly should, focus on the immediate tax and interest advantage of electing the 100% marital deduction and downplay the overall economic gain that could result to the family unit many years in the future as a result of a 50% marital deduction election. Furthermore, in considering whether to elect the 100% marital deduction as opposed to the 50% marital deduction, one must bear in mind the possibility of using life insurance to fund the estate tax payable on the second death. A recently developed life insurance contract, generally referred to as survivorship whole life insurance, is particularly suitable for this purpose. Simply described, a survivorship whole life insurance policy insures the lives of two persons and the proceeds are payable on the second death. Although the concept is intriguing and the policy itself is capable of producing extremely dramatic results in a variety of areas, one particular use would be in connection with the election of the 100% marital deduction. The policy would provide the funds to pay the tax on the survivor's death, permitting the estate to pass largely or totally estate-tax-free.

There are several features of this particular contract which makes it particularly attractive. First, two lives are insured in one policy. The proceeds are payable on the second death, and the order of death (such as husband first, wife second) is not relevant. Second, this policy can be acquired for a significantly lesser amount (in some cases up to 50%) than the cost to insure a single life or the premium for separate policies on two lives. In addition to premium cost considerations, this policy can be designed so as to produce a net after-tax cost, over the entire period the policy is in force, of an amount as little as twice the annual premium. For example, assume that a male aged fifty-nine and a female aged fifty-four are jointly insured. Using maximum leverage, a cumulative net after-tax cost or outlay of $37,500 made over seven years will provide a minimum of $1,000,000 upon the second death. This is an extraordinary return on invested assets when viewed from any perspective.

In contrast to these results, flower bonds[72] are frequently purchased to provide a significant discount on the payment of estate taxes. A bond with a face value of $1,000 which had been purchased for $750 could be turned in to discharge a $1,000 estate tax liability thus providing, in effect, a 25% discount on the payment of estate taxes. However, by utilizing survivorship whole life insurance, as much as a 96% discount on the amounts necessary to discharge estate taxes or other estate settlement costs is attained. By combining survivorship whole life insurance with the election of the 100% marital deduction, one may, with a limited expenditure, largely eliminate the burden of estate taxes from the transmission of property from an older generation to the younger generation.

4. *State death tax considerations.* In considering the use of the unlimited marital deduction, attention must be given to the impact of state taxation as to whether the full estate can pass federal estate-tax-free even though the unlimited marital deduction is claimed. This is a problem only in the very largest estates, because only then will the $600,000 left in the first decedent's estate be inadequate to pay the state tax.

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72. Flower bonds are certain United States bonds which provide that they may be turned in at par value in payment of estate taxes. These bonds have a low interest rate and therefore sell at a considerable discount. Thus, a substantial advantage is obtained if a decedent, shortly before his demise, acquires flower bonds which are then used for the payment of estate taxes. Bonds of this type are no longer issued, but prior issues are still outstanding.

By way of example, consider the situation existing in New York prior to October 1, 1983.[73] New York law presently provides for estate tax deductions for a resident's estate equal to the deductions from his federal gross estate allowable in determining his federal estate tax under the Internal Revenue Code, with certain minor adjustments. However, the marital deduction is limited to 50% of the adjusted gross estate until October 1, 1983.[74] Thus, a 100% marital deduction for federal purposes will not eliminate the New York tax for decedents dying prior to October 1, 1983. Alternatively, assume one lives in New Jersey, which has an inheritance tax law that makes no provision for a marital deduction.[75] In either case the decedent, although exempt from federal tax, will not be exempt from state tax. To the extent that state death taxes must be paid, they reduce the amount of the federal marital deduction unless paid from the $600,000 retained. State death taxes must be paid from funds not sheltered by the marital deduction, since the

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73. New York State on December 19, 1982, amended its estate and gift tax laws to adopt the federal estate and gift tax provisions in effect on September 3, 1982. *See* 1982 N.Y. Laws chs. 916 & 917. The unlimited marital deduction was adopted, but only so as to take effect for decedents dying after September 30, 1983, and for gifts made after that date. This legislation included the following changes effective January 1, 1983:

(1) Estate and gift tax rates are made the same.

(2) Lifetime transfers are added to transfers made at death for estate tax purposes, and any gift tax paid offsets the estate tax so computed.

(3) The per donee exclusion is increased to $10,000 ($20,000 for joint gifts by married couples).

Id. See generally Blattmachr, *N.Y. Conforms to U.S. Rules For Estate & Gift Taxes,* 188 N.Y.L.J., Dec. 27, 1982, at 1, col. 3.

74. The New York statute, in my view, leaves something to be desired in the way of clarity. Until October 1, 1983, it limits a New York decedent to a 50% marital deduction. Section 955 provides that the New York estate tax deductions for an estate of a deceased resident mean the deductions "from his federal gross estate allowable in determining his federal taxable estate," adjusted as provided in §§ 956 and 957. The adjustments in § 956, according to the title, relate to modifications for real and tangible personal property outside of New York State which are not subject to New York estate tax. Section 957 deals with a modification for limited powers of appointment created prior to September 1, 1935. Thus, it would seem that any increase in the federal marital deduction would result in an increase in a New York State marital deduction. However, buried in § 956, the section headed "Modifications for Real and Tangible Personal Property Outside New York State," is a provision limiting the marital deduction for New York purposes to that allowable for federal tax purposes as was specified in the Revenue Act of 1976. That is, the New York State marital deduction shall in no event exceed the greater of $250,000 (reduced by the gift tax adjustment) or 50% of the amount by which the value of the New York gross estate exceeds the aggregate amount of certain deductions and other adjustments. *See* N.Y. TAX LAW §§ 955(a), 956, 957 (McKinney 1982).

75. N.J. REV. STAT. § 54.34-5 (1935).

amount paid in taxes will not be transferred to the surviving spouse. Therefore, as state death taxes increase, the marital deduction for federal purposes is reduced; as the federal marital deduction is reduced, federal tax liability increases.

At most levels the average state death tax will be less than $600,000 and can be funded without invasion of the marital share. In those cases where the state tax will be greater than $600,000, there appear to be two ways to approach this problem. One could modify the clause leaving property in the estate of the decedent to add an amount sufficient to discharge the estate's obligation for state death taxes to the $600,000 and the allowance for administrative expenses retained. Alternatively, one could provide that state death taxes be paid from the marital share. From the standpoint of the marital deduction, either technique has exactly the same result. The payment to the surviving spouse, and therefore the marital deduction, is reduced by the amount of state death taxes paid. Accordingly, a federal tax liability is necessarily incurred in the decedent's estate as a result of the reduction in the marital deduction. In either event, it appears that algebraic computations will not be necessary to determine the amount of the marital deduction. Presumably the problem will arise because only a 50% marital deduction or less is allowed for state purposes. If so, the federal tax paid will not reduce the state marital deduction, only the federal, as the federal tax cannot exceed half the adjusted gross estate.

Chart 6 below sets forth the marital deduction which will be permitted in an estate for state tax purposes where the marital deduction is limited to half the adjusted gross estate, the state death taxes imposed are New York rates,[76] and deductions other than the marital deduction are ignored. Chart 6 assumes that the $600,000 subject to tax to use up the credit is used to pay the state tax and it estimates the additional federal liability resulting from the payment of the excess state taxes from the marital deduction.

76. N.Y. TAX LAW § 952(a) (McKinney 1975).

CHART 6

Size of Estate	State Marital Deduction	State Death Taxes	State Death Taxes in Excess of $600,000	Resulting Federal Tax
$20,000,000	$10,000,000	$1,437,000	$837,000	$418,000
$10,000,000	$ 5,000,000	$ 542,000	$ 0	$ 0
$ 5,000,000	$ 2,500,000	$ 201,000	$ 0	$ 0
$ 2,500,000	$ 1,250,000	$ 75,000	$ 0	$ 0
$ 2,000,000	$ 1,000,000	$ 53,000	$ 0	$ 0
$ 1,200,000	$ 600,000	$ 26,000	$ 0	$ 0

A New York gross estate of about $10,740,000 (before a 50% state marital deduction) is required before there is a greater than $600,000 New York State estate tax.

5. *Should estates be equalized?* In the past, looking at tax factors alone, estate lawyers have generally counseled the equalization of estates. That is, assuming that the husband held the bulk of the couple's property in his name, he would be advised to transfer property to the wife to the extent this could be done tax-free until she held approximately half of the property. The purpose of equalization was to provide a tax benefit should the spouse without property be the first to die. If the spouse with property was the first to die, the estate could be effectively split in half by using the standard A-B trust formula,[77] with the A trust eligible for the marital deduction and the B trust excludible from the wife's estate. Thus, where the taxable estate was, let us say, $10,000,000, $5,000,000 would be taxed when the husband died and $5,000,000 would be taxed when the wife died, thus bringing about the lowest possible estate tax burden. On the other hand, without equalization, if the propertyless wife died first, there would be no tax on

77. For many years, a standard will drafting technique has been to establish for the benefit of the surviving spouse a so-called "A" trust, a trust eligible for the marital deduction, and a so-called "B" trust. Under the A trust the surviving spouse would have an income interest and a power of appointment. It would be includable in the surviving spouse's estate. Under the B trust, the income would be payable to the surviving spouse for life (with a liberal power of invasion), but with the remainder interest vested in the children or others so that the B trust was excludable from the surviving spouse's estate. This system effectively provides the surviving spouse with income from all of the decedent's property and substantial dominion over both the A trust and the B trust. However, only the A trust, and not the B trust, would be includable in the surviving spouse's estate.

her estate; possibly even her lifetime credit would go unutilized. Moreover, unless the surviving husband married again, his estate would be subject to tax at higher rates since he would not be able to avail himself of a marital deduction, his wife having predeceased him.

The question of equalization must be reexamined now that an unlimited marital deduction is available for both estate and gift tax purposes. This makes it possible to equalize estates immediately by lifetime transfers. The question remains, however, as to whether equalization is desirable. For example, consider the prospective decedent with a $20,000,000 estate. If he transfers half the property to his wife, he will die with a $10,000,000 estate which presumably he will pass to the objects of their joint bounty, possibly with an income interest to the surviving spouse for life. Yet he may achieve precisely this same result in his will by availing himself of the 50% marital deduction. Alternatively, as was pointed out above, if he avails himself of the unlimited marital deduction except to the extent of $600,000, it will almost certainly prove advantageous, inasmuch as the $117,000 additional tax cost will almost surely be made up by the interest savings in the postponement of the tax from the time of his death until the time of his spouse's death. Therefore, assuming that the possessor of the property will be the first to die, equalization does not seem to be significant.

Fate being what it is, however, one cannot always be certain that the first decedent will be the spouse with property. If the spouse with property does not make any equalizing transfers and his spouse dies first, his estate will bear an additional $417,000 in tax. It will be taxed on the same basis that the spouse would have been taxed had the 100% marital deduction been utilized and no provision made to retain $600,000 to use the unified credit. The tax imposed will exceed by $417,000 the tax that would have been imposed had the estate been divided into two $10,000,000 portions, each subject to tax and the use of the unified credit. It can be said that from this viewpoint there is some advantage to equalization. On the other hand, one may question whether a tax savings of $417,000 at some time in the future is sufficient to justify the immediate disposition of property to another, subjecting it to the hazards that such a course of action necessarily presents. Furthermore, one can reduce the tax disadvantage to $117,000 in such a case by the transfer of only $600,000 to obtain the advantage of another unified credit.

In considering this problem, it is important to keep in mind the change Congress made with respect to qualified terminable interest property. As will be noted below, the use of this new form of disposition permits one to utilize the 100% marital deduction for either estate or gift tax purposes without surrendering the right to control the disposition of the property at the death of the surviving spouse. In light of the economic advantages of the unlimited marital deduction, one may expect the new qualified terminable interest property provisions of section 2056(d) to be frequently utilized to permit the 100% marital deduction to be taken without surrendering control of the decedent's property to the surviving spouse. Thus, equalizing estates—more likely passing enough property to the propertyless spouse to permit the payment of estate expenses and full use of the unified credit—is greatly facilitated by the existence of qualified terminable interest property.

Consider the matter now from the standpoint of the more moderate estate, say $2,500,000. Assuming that the possessor of property can be assured of being the first to die, there is little advantage to lifetime transfers. On the other hand, if a lifetime division is not made and the surviving spouse is the one with the property, an additional tax of $322,000 will be imposed as a result of the higher rates and the loss of the use of one unified credit. If $600,000 were transferred to the non-propertied spouse, the additional tax to be imposed on both estates would be only $32,000. This amount of additional tax is so small that further equalization seems unwise in light of nontax disadvantages.

It appears that equalization of estates is somewhat more pressing with respect to estates at lower monetary levels than estates at higher levels. Although the tax penalty for not equalizing is smaller in absolute dollar terms, it is a larger percentage of the estate. Moreover, at all levels, once the less propertied spouse has sufficient assets to utilize the unified credit in full, the nontax disadvantages of a transfer of property probably outweigh the potential tax savings to be derived from equalization.

6. *The use of an equalization clause.* It appears that equalization clauses may be used somewhat more often in the future. An equalization clause, a sample of which is set forth in the footnote below, is a clause which alters the marital bequest if the spouses

die within six months of each other, so that the parties' property is placed half in the estate of the first to die and half in the estate of the second to die.[78] Under the old law,[79] it may have been desirable to use the maximum 50% marital deduction if a spouse had property, even though this would increase somewhat the tax in the estate of the surviving spouse, because of the property she or he already possessed. On the other hand, where the surviving spouse dies in a common disaster or shortly after the first death, any advantage from a full 50% deduction is lost. Accordingly, equalization clauses were developed to reduce the marital bequest so as to equalize the amounts of the estates and thus produce the lowest possible tax. While there was some controversy concerning the question of whether the use of an equalization clause resulted in a terminable interest, that controversy has now been properly resolved—such a clause does not result in a terminable interest.[80]

Consider now an equalization clause in the context of the use of the 100% marital deduction. As has been demonstrated, the use of the unlimited marital deduction combined with the retention of $600,000 in the first estate will produce an additional tax of no more than $117,000 in the estate of the second to die. As pointed out above, this amount can usually be earned in a comparatively short period by appropriate investment of the tax that would otherwise be paid by the estate of the first to die. However, if the spouse who was expected to survive instead dies in a common disaster with the decedent, or dies shortly thereafter, there will be no opportunity to earn the necessary income from the tax savings in the estate of the first to die. Therefore, one might well wish to revert to either a 50% deduction, if it is assumed that the briefly surviving spouse has no assets, or to a balancing of the two estates in a situation where the briefly surviving spouse has some

78. For example, "If my wife and I shall die simultaneously or under such circumstances as to make it impossible or difficult to determine who predeceased the other, I hereby declare it to be my will that it so be deemed conclusively that my wife survived me and the above provisions of this Article shall be construed and given effect on the assumption and basis that my wife survived me. However, in such a case, or if my wife should die within six months of the date of my death, I direct that the principal of the Trust created under this Article shall be further reduced in such event so that the total value of the adjusted gross estate of my said wife, including said principal as reduced, shall be equal to the total value of my adjusted gross estate, excluding said principal as reduced."

79. I.R.C. § 2056 (1976) (amended by ERTA, *supra* note 2, at § 403(a)).

80. *See* Rev. Rul. 82-23, 1982-1 C.B. 139 (agreeing to follow the cases holding that the use of an equalization clause does not result in a nondeductible terminable interest).

property.

Admittedly, the stakes are relatively small here inasmuch as the maximum detriment in estates of over $5,000,000 is $117,000, hardly a princely sum all things considered. In the case of a $20,000,000 estate where, as Chart 3 demonstrates, survival for three months is sufficient to recoup the additional cost, an equalization clause cannot be regarded as terribly important. On the other hand, there is no particular disadvantage to using an equalization clause, and savings can be realized. It can be reasonably assumed that in a $20,000,000 estate one might consider reducing the six month period (the maximum allowed in equalization clauses) to three months, inasmuch as that is the break-even point. At $10,000,000 and below, where it is estimated that seven months or more would be required to earn the additional tax cost, a six-month clause would seem to be appropriate.

7. *Handling of administration expenses.* Under present law, one aspect of post-mortem estate planning which is well recognized is an election by the executor to deduct expenses either for estate tax purposes, or, providing the appropriate waiver is filed under section 642(g), for income tax purposes against the income of the estate. In most instances, the choice is an obvious one as the executor determines where the deduction will provide the greatest tax benefit. An estate in the 50% estate tax bracket and only the 20% income tax bracket would be better off taking the deduction for estate tax purposes. There are a number of collateral consequences of this election which must be considered, but they are beyond the scope of this Article. For example, the use of these expenses for income tax purposes will have the effect of increasing a marital deduction which is based on a formula clause using the adjusted gross estate, since the adjusted gross estate is determined by subtracting from the gross estate only those expenses which are allowed (as distinguished from allowable) for estate tax purposes.

The general considerations which have ordinarily governed in the past, however, need to be re-examined where the 100% marital deduction has been elected. It might be thought that in every case where the 100% marital deduction is claimed administration expenses will now be claimed for income tax purposes. By definition, one thinks of the unlimited marital deduction as eliminating any estate tax, so that any deduction of administration expenses would produce no estate tax savings, whereas, no matter how little income an estate may have, it will have some income where the expenses may be put to use. In the ordinary situation this analysis is sound, and in most cases administration expenses should be claimed for income tax purposes.

On the other hand, there are situations where such an election may not be wise. This will be particularly true as the unified credit is phased-in. For example, in 1983 when the exemption equivalent of the unified credit is $275,000, there may be a number of estates electing the 100% marital deduction which will have deductible administration expenses in excess of $275,000. In any situation where the deductible administration expenses are in excess of the amount protected by the unified credit, the treatment of administration expenses as income tax deductions will have the effect of producing an estate tax despite the election of the unlimited marital deduction.

The reason for this is obvious upon reflection. Administration expenses, wherever deducted, are paid from the estate. The marital deduction can never exceed the amount actually available to be transferred to the surviving spouse. If the expenses are less than the amount protected by the unified credit, they can be paid from the amount protected by the credit without impacting upon the amount passing to the surviving spouse, and be available for the unlimited marital deduction. In such a case, the combination of the unlimited marital deduction and the unified credit negate any estate tax.

On the other hand, if one assumes that the administration expenses are greater than the amount protected by the unified credit, the excess over the amount protected by the unified credit must necessarily come from the amount payable to the surviving spouse. This reduces the amount payable to the surviving spouse and thus the amount available for the unlimited marital deduction. This reduction in the amount passing to the surviving spouse has a pyramiding effect on the amount of estate tax which must be paid.

Assume, for example, that the amount passing to the surviving spouse under an unlimited marital deduction bequest is reduced by $100,000 as a result of the payment of administration expenses which are $100,000 in excess of the amount protected by the exemption equivalent of the unified credit. Those expenses are deducted for income tax purposes. The executor will suddenly have a $100,000 taxable estate—the amount not protected by the unified credit nor passing to the surviving spouse, and thus exempt from tax by reason of the unlimited marital deduction. This amount will be in the 37% bracket and will produce a tax of $37,000. This $37,000 tax must necessarily be paid from the amounts otherwise passing to the surviving spouse as there is no other source of funds in the estate. The funds represented by the exemption equivalent have presumably gone to pay administration expenses. Therefore, the unlimited marital deduction is now reduced by $37,000, which produces an additional $37,000 subject to tax at 37% or $13,690, further reducing the amount passing to the surviving spouse and increasing estate taxes. This pyramiding will, of course, continue in several more stages, in each case increasing the amount of estate tax paid and reducing the amount of the unlimited marital deduction.

The obvious answer in the case above is for the executor to claim the first $275,000 of administration expenses for income tax purposes, thus producing an income tax savings, and claim the remaining $100,000 as a deduction for estate tax purposes. The estate tax deduction of $100,000 will then negate the $100,000 of taxable estate which otherwise would be subject to tax and produce a zero estate tax.

There is another point which must be considered in this connection. Assume that the executor makes a careful analysis of the situation and concludes that the income tax savings from taking the extra $100,000 of expenses will be greater than the additional estate tax cost of claiming those expenses for income tax purposes, even with pyramiding. In view of the reduction in top rates to 50% and the fact that the estate tax rates begin at 37%, it is probably an unusual situation where this question will present itself to any significant degree. However, in such a situation, there is an additional complication in electing to take the expenses for income tax purposes to obtain the greater tax savings. The income tax savings will redound to the surviving spouse who, by definition, is the recipient of a 100% marital deduction bequest and will be entitled to the estate income. On the other hand, the additional estate tax which will be paid—though less than the income tax savings—will be a charge to corpus under local law and, therefore, will reduce the interest of the corpus beneficiaries—the remaindermen of the 100% marital deduction trust. In a situation such as this, section

11-1.2 of the New York Estate Powers and Trust Law[81] requires that the income beneficiary reimburse the corpus beneficiaries to the extent of any disadvantage which they suffer by reason of the election to deduct administration expenses for income rather than estate tax purposes. This reimbursement, since it flows from income to corpus, would not have the effect of reducing the marital bequest and, therefore, may be done without any impact on the estate tax.

Furthermore, in considering the impact of the deduction of expenses for income rather than estate tax purposes, in a situation where the deduction will have the effect of producing an estate tax, one must not lose sight of the additional impact on state death taxes. For example, in a state which adopts the 100% marital deduction and bases its tax on the estate as determined for federal purposes, in the situation described above not only will an additional federal estate tax be produced by the subtraction of the payment of administration expenses taken for income tax purpose from the 100% marital bequest, but there will be an additional state estate tax cost as well, further reducing the federal marital deduction.

8. *Alternate valuation date election.* Another popular post-mortem estate planning technique which must be re-examined in light of adoption of the unlimited marital deduction is the alternate valuation date election. Under this election, an executor may decide to value all of the assets in the estate at death or six months later (or the date of actual distribution if less than six months following the date of death). In most cases, the date selected will be the date which will result in the lowest values and in the lowest amount of estate tax. However, where a particular asset is highly appreciated and necessarily will be sold, it may be advantageous to elect a valuation date which produces a greater estate tax in view of the income tax savings that would arise from having this particular asset take its value on that valuation date. This sort of election presents an interesting question as to whether the heirs who benefit from the income tax savings resulting from the step-up in basis, assuming they are different persons, should reimburse the corpus beneficiaries for the additional estate tax which will occur

81. N.Y. EST. POWERS & TRUST LAW § 11-1.2 (McKinney Supp. 1982-83).

as a result of the election of the higher valuation date.[82] In the ordinary situation, it must be recognized that the combination of the alternate valuation date election and the 100% marital deduction permits an executor to elect the higher values, thus producing an income tax savings without any offsetting estate tax cost. However, as indicated in the discussion below, there are a number of complications.

Where the 100% marital deduction is elected, there will be no estate tax payable whether the property is valued at the date of death or at the alternate valuation date, irrespective of which is higher and which is lower. Accordingly, the executor is in a position to examine the income tax aspects of the valuation date election carefully and to determine which valuation date will produce the greatest income tax savings. Furthermore, even if the income tax savings will accrue entirely to one group of beneficiaries, there would appear to be no need for reimbursement inasmuch as the other group of beneficiaries has suffered no detriment as a result of the favorable (although higher in value) valuation date election.

It does seem, however, that there can be situations which will put an executor in an exceedingly difficult position. For example, assume that son A is left an asset which at date of death has a value of $200,000, and at the alternate valuation date has a value of $300,000. Assume also that son B is left an asset which at the date of death had a value of $300,000 and an alternate valuation date value of $200,000, and that each son plans to sell his asset. If the alternate valuation date is elected, the first son will avoid a capital gains tax on a $100,000 gain, but the second son will not have the advantage of a $100,000 loss on his sale. Conversely, election of date of death values will entitle the second son to his $100,000 loss, but at a cost of a capital gains tax to his sibling. Presumably, these are matters which can be resolved by discussion with the interested parties and perhaps a compensating payment from one to the other. However, if agreement cannot be reached, the executor will be forced to make a choice even if it is a choice which will have only income tax, and not estate tax, significance.

In a 100% marital deduction situation, where the estate will be tax-free in any event, there is no particular pressure on the ex-

82. *See generally* Taggart, *Adjustments Required Where Tax Elections Alter Interests Among Beneficiaries*, in POST MORTEM ESTATE PLANNING 221-54 (1981).

ecutor to value property carefully, and this produces other complications. For example, if the estate is objectively valued at $2,000,000 at the date of death and objectively valued at $2,500,000 on the alternate valuation date, may the executor value the property at $3,000,000 for alternate valuation date purposes with impunity (looking to the eventual capital gains tax savings)? One may wonder whether the Internal Revenue Service will be alert and challenge valuations on nontaxable returns merely because of the eventual impact that the valuation may have for income tax purposes. One may wonder whether new section 6659, providing for an additional tax in the case of valuation overstatements for purposes of the income tax, will provide any restraint. Section 6659 provides in pertinent part that if an individual has an underpayment of income tax which is attributable to a "valuation overstatement," then there shall be added to the tax an amount equal to a defined percentage of the net underpayment. A valuation overstatement results if the value of any property or the adjusted basis of any property claimed on any return exceeds 150% of the amount determined to be the correct valuation or adjusted basis where the property has been acquired within the last five years and the underpayment is at least $1,000. The Internal Revenue Service may waive all or any part of the additional tax on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return, and that such claim was made in good faith.

This provision originated in the House and was intended primarily to provide additional protection against abusive tax shelters, although the Ways and Means Committee report does not so state.[83] There is nothing which specifically makes this provision inapplicable to an excessive estate tax valuation to achieve income tax objectives, but as a practical matter it does not seem that section 6659 provides much protection to the Internal Revenue Service. First, the property must be overvalued by 50% or more, and it is difficult to imagine an executor, even if a family member, being so aggressive as to claim that kind of overvaluation on an estate tax return. Certainly, the possibility of claiming a 49% overstatement without penalty would seem to allow ample room for maneuver.

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83. H.R. REP. No. 201, *supra* note 30, at 243-44.

Second, there is additional protection for the heir in a situation where he was not the executor. There certainly could be a legitimate claim raised by such an heir that he had not made a valuation overstatement when he relied on the amount fixed by the executor on an estate tax return with respect to which he had no responsibility. It is difficult to believe that an heir should be required to determine independently the proper valuation of property where that property has been valued for estate tax purposes by the executor—particularly where any increase in value, even if it has no federal income tax impact, may well have an impact on state taxes payable by the estate. Third, the five year holding period safe harbor and the provision permitting the Internal Revenue Service to waive the additional tax provide further protection.[84] Certainly a strong claim can be made for a waiver of the penalty, even if technically applicable, where the heir relied on a valuation made by the executor and it is shown that he or she was not privy to any discussions with respect to the advantages of an excessive valuation for estate tax purpose.

Perhaps the major disadvantage with respect to artificial increases in values on a 100% marital deduction return, whether to obtain increased depreciation deductions or reduce capital gains taxes, is the possible impact of that valuation when the second spouse dies. It is not likely that the courts will be receptive to the wife's executor claiming that there was a substantial excess valuation in the prior spouse's estate and the proper value for estate tax purposes is significantly less.

Election of increased values will not have detrimental state estate or inheritance tax impact in those states which do not have an alternate valuation date. Only in those states which ground their tax on a federal base will the increased values result in an increased state estate or inheritance tax. Even then, an increase in

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84. The value of a property fixed for estate tax purposes is presumptively correct in determining the basis of the property for income tax purposes, but it can be rebutted. *See* Rev. Rul. 54-97, 1954-1 C.B. 113. The taxpayer, however, may be estopped from asserting a different value. *Cf.* Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974) (heir and co-executor estopped from asserting a higher value at date of death for income tax purposes than fixed on the estate tax return). *But see* Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982) (over Service objections, the mitigation provisions of § 1311 permit reopening a closed income tax year and recomputing gain on a sale of stock by an estate increasing its basis where the value of the stock was later increased in an estate tax proceeding in the Tax Court).

value will result in an increased state death tax credit. In states which have a tax in addition to the so-called "sponge tax"[85] and use federal alternate valuation date values, there will be an additional tax cost as a result of such an election.

E. *Qualified Terminable Interest Property*

1. *In general.* The House and the Senate agreed that there should be an unlimited marital deduction. In addition, the House proposed, and the conference committee ultimately accepted, the proposition that certain new terminable interest property should qualify for the marital deduction.[86] If the prescribed standards are met, one may establish a marital deduction trust for the life of one's surviving spouse and specify how the property is to pass at the death of the surviving spouse. This provision has enhanced importance because of the adoption of the unlimited marital deduction. Such a trust is frequently referred to as a "Q-tip" trust (from Qualified Terminable Interest Property trust).

The rationale of new section 2056(d) is best understood from the explanation which is given in the House report and relates to the desire on the part of the House to provide for control by the decedent over the property as it passes from the surviving spouse.[87] Under present law, as a practical matter, a testator who wishes to avail himself of the marital deduction must relinquish control over its subsequent disposition. Such a testator may permissibly restrict the surviving spouse from disposing of the property in any fashion during the lifetime of the surviving spouse, but the power to dispose of the property by will must be given to the surviving spouse. Even in the case of an estate trust under which there are few restrictions on the nature of the trust (that is, it may be invested in unproductive property and income may be accumu-

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85. A state inheritance or estate tax which is imposed in an amount that will not exceed the federal credit provided under § 2011 for state death taxes is referred to among tax practitioners as a "sponge tax." Because of the federal credit for state death taxes, a decedent's estate will pay precisely the same amount of tax whether his state has a death tax or not, provided the state death tax does not exceed the federal credit. By imposing a tax up to the amount of the credit, the state obtains revenue which would otherwise pass to the federal government without any additional burden being imposed on a decedent's estate. Many states impose a death tax which is limited to the amount necessary to "soak up" the available federal credit.

86. S. REP. No. 176, 97th Cong., 1st Sess. 247 (1981).

87. H.R. REP. No. 201, *supra* note 30, at 159-60.

lated rather than paid to the surviving spouse), the surviving spouse ultimately must be given the power to dispose of the property at his or her death.[88] This loss of control over property at death is consistent with the premise underlying the marital deduction that the property must be subject to tax upon the death of the surviving spouse. But, with the passage of the 1981 Act, that treatment can be obtained without giving the surviving spouse control over the disposition of the property.

2. *Legislative history.* The House report recognized that under present law a surviving spouse must be given control over the property to obtain the marital deduction.[89] Accordingly, a decedent cannot insure that his or her spouse will subsequently dispose of the property as the decedent would wish. Introduction of the unlimited marital deduction meant that, if used, the first to die could not maintain control over even half of his or her property, as could be done if the 50% marital deduction were elected. The Ways and Means Committee felt a decedent should not be forced to choose between surrendering control of an entire estate to avoid the imposition of an estate tax on death and reducing tax benefits in order to ensure that the inheritance would pass in a desired manner on the surviving spouse's death.

3. *Qualified terminable interest property and its characteristics.* Under section 2056(b)(7)(B), qualified terminable interest property is property which passes from the decedent, where the surviving spouse has a "qualifying income interest" for life in the property, and an appropriate election is made by the decedent's executor. Assuming that qualified terminable interest property exists by reason of the executor's election, section 2044 has been added to include the value of all qualified terminable interest property with respect to which a marital deduction was allowed in

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88. An estate trust is a trust in which corpus and accumulated income, if any, is made payable at the wife's death to her estate. Therefore, the wife's interest is not terminable under § 2056(b)(2), since no one after the wife or her estate will take it. Treas. Reg. § 20.2056(e)-2(b)(2)(ii) (promulgated Sept. 17, 1982). The marital deduction is allowed for the full value of the trust, not just the value of the wife's income interest since the bequest to the wife's estate is regarded as a bequest to the wife. As this is not terminable interest property, none of the requirements of § 2056(b)(5) and the standard marital deduction trust need to be met. *Cf.* Rev. Rul. 72-333, 1972-2 C.B. 530 (one may combine an estate trust and a § 2056(b)(5) trust, as, for example, where the trust provides for income to the wife, for life, corpus to her estate to the extent it is needed for expenses, with the balance as she appoints by will).

89. H.R. REP. No. 201, *supra* note 30, at 160.

the gross estate of the surviving spouse. Under new section 2519, a gift tax is imposed if all or part of a qualifying interest is disposed of during the life of the surviving spouse. Moreover, special provision has been made with respect to the handling of the estate tax to be imposed on the death of the surviving spouse.

Section 2055(d) provides that where there is qualified terminable interest property, the property shall be deemed to have passed to the surviving spouse and no part of the property shall be treated as passing to any person other than the surviving spouse. Therefore, although such a bequest is technically terminable interest property, it has been redefined by Congress as not being terminable interest property and therefore is eligible for the marital deduction. To have a qualifying income interest for life, a surviving spouse must be entitled to all of the income from the property, payable annually or at more frequent intervals, and there can be no power to appoint any part of the property to any person other than the surviving spouse, except to the extent that there is a power exercisable at or after the death of the surviving spouse. The requirement that the income be payable annually is consistent with the requirements of the terminable interest rule contained in section 2056(b)(5), the provision which qualifies the A trust in the standard marital A and B trust formulation[90] for the marital deduction. The House report makes clear that prohibiting the appointment of the property away from the surviving spouse does not preclude granting a power to the trustee to invade the corpus for the benefit of the spouse.[91]

The surviving spouse must be entitled to the income for a period measured solely by the spouse's life, so an income interest granted for a term of years or a life estate subject to termination upon remarriage or the occurrence of some event will not be qualified terminable interest property. The House report also states that the property need not be left in trust, provided that the interest in property provides the spouse with rights to income which sufficiently satisfy the rules applicable to marital deduction trusts specified in Treasury Regulation section 20.2056(b) through (f).[92]

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90. *See supra* note 77.

91. H.R. Rep. No. 201, *supra* note 30, at 161.

92. *Id.* Treas. Reg. §§ 20.2056(b) through (f) (promulgated Sept. 17, 1982). This is an extremely broad cross-reference, encompassing as it does 27 pages in the version of the estate tax regulations which I have at hand, and neither it, nor any other regulation contains a

The statute provides that the term "property" for this purpose includes an interest in property, so that the spouse could be given a half interest in a patent, for example. However, the surviving spouse presumably could not be given the decedent's interest in a term of years (unless the term was clearly longer than the surviving spouse's life expectancy) or per autre vie.

The statute further provides that the election with respect to qualified terminable interest property is made by the executor on the estate tax return of the decedent, and once made is irrevocable.[93] The discussion in the House report does not suggest why the power to elect was granted to the decedent's executor, rather than to the decedent, exercisable in his will. The provision for an election by the executor has both advantages and disadvantages.

First, the advantages. At the time of the filing of the decedent's estate tax return, the precise extent of his estate and the reasonably precise nature of the surviving spouse's estate will be known and a determination made as to whether to elect to take advantage of this provision. Therefore, there is an opportunity to perform some post-mortem estate planning. However, the economic constraints in favor of the use of the unlimited marital deduction make this flexibility of little interest as a planning technique. Nonetheless, qualified terminable interest property will no doubt frequently be combined with a 100% marital bequest, and therefore an executor usually will be directed by will to make the election.

The temporary regulations provide that the election may be made with respect to a portion of the property otherwise qualifying as qualified terminable interest property.[94] For example, suppose a decedent leaves 100% of his property in trust, income to his wife for life, remainder to their children. This would be qualified terminable interest property should the executor make the appropriate election. The regulations permit an election to be made with respect to 10% of the trust, 50% of the trust, 70% of the trust, or

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section 20.2056(f). The general explanation of ERTA prepared by the Joint Committee on Taxation, shortens the reference to section 20.2056(b)-5(f), dealing with the right to income from a trust, a more modest reference. STAFF OF JOINT COMM ON TAXATION, 97TH CONG., 1ST. SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981. 235 (Comm. Print 1981).

93. I.R.C. § 2056(b)(7)(B)(v) (1982).

94. Treas. Reg. § 22.2056-1(b) (promulgated Sept. 17, 1982).

any specific portion whether fractional or percentile as, for example, is permitted under Regulation section 20.2056(b)-5(b). Under Regulation section 20.2056(b)-5(b), in the case of a life estate with the power of appointment in the surviving spouse, another exception to the terminable interest rule, a marital deduction is permitted with respect to any specific portion of an interest in property passing from the decedent to the surviving spouse where that portion meets the requisite conditions, even though there is another portion of the transfer which does not meet the requisite conditions. The temporary regulations seem to be supported by the statutory provision that a specific portion of property shall be treated as separate property.[95] It appears that the statute is saying that a specific portion of property, *i.e.*, 10% of a trust, shall be treated as separate property and thus can be treated as qualified terminable interest property.

Additional support for the view that elections with respect to specific portions are proper is found in the fact that essentially the same result could be achieved, even if less precisely, if the final regulations were to require that only an entire interest in the property could qualify as qualified terminable interest property. A decedent could, in his last will, create five separate trusts, each with substantially similar terms, so that the executor could elect with respect to one or more of the trusts, or even with respect to all five of the trusts, once a post-mortem analysis of the estates of the two spouses indicated what was desirable. As was suggested above, only in the unusual case would less than a 100% election be warranted.

Now the disadvantages. A grant of broad discretion to an executor on the question of whether or not to elect to have a particular disposition treated as qualified terminable interest property could present a problem for an executor. There would appear to be no conflict between the beneficiaries, unless one visualizes a will in which the executor has the right not only to elect with respect to a trust established in the will which was in a form to qualify as qualified terminable interest property, but is also given the right to decide whether or not there shall be such a trust (for example, whenever the bequest is to the surviving spouse for life, remainder to the children). Therefore, whether or not the transfer is treated for estate tax purposes as eligible for the marital deduction, there will

95. I.R.C. § 2056(b)(7)(B)(iv) (1982).

not be an increase in the survivor's interest or a decrease in the interest of the children.

On the other hand, a broad grant of discretion could produce difficult choices for the executor. Is he to produce the smallest amount of tax in the first estate, or in both first and second estates? If less than a 100% marital deduction election is made, can a subsequent change in the value of property on audit by the Internal Revenue Service have the effect of changing the economic desirability of a particular election? Should that risk be a factor in an election? As indicated above, ordinarily a testator will indicate that the election should be made with respect to all of the property so that the 100% marital deduction is utilized, but, if not, the testator should provide in his will precisely what considerations the executor should bear in mind in making the election. Similar rules are provided with respect to the gift tax, except that the election is made by the donor rather than by the testator's executor.[96]

This provision creates a modest dilemma with respect to the handling of the tax burden in the estate of the surviving spouse. Assume that the surviving spouse was also a person of means, and the first spouse to die decided to use this provision and sets up a trust, income to the surviving spouse for life, remainder to a younger sister. Under new section 2044, the value of the surviving spouse's gross estate will include the value of any property for which a deduction was allowed under section 2056(b)(7) on the transfer of the property to the decedent (or under section 2523(f), in the case of a transfer during the decedent's lifetime). This inclusion in the surviving spouse's estate could increase considerably the taxes to be borne by that estate and reduce the amount of that estate available for the objects of the second spouse's bounty.

Congress dealt with this problem by the addition of section 2207A. Section 2207A provides a rule which has the effect of avoiding imposition of any additional taxes on the property of the surviving spouse by reason of the inclusion of the qualified terminable interest property in the estate of the second spouse to die. It imposes this additional transfer tax on the recipients of the qualified terminable interest property. Section 2207A provides that if any part of the gross estate consists of property which is includable in the gross estate by reason of section 2044, the estate shall be enti-

96. I.R.C. § 2523(f) (1982).

tled to recover the tax from the person receiving that property. The tax recoverable is the amount by which the total estate tax which was paid exceeds the tax which would have been payable if the value of the qualified terminable interest property had not been included in the gross estate. The second decedent may overturn this requirement by will. If there is more than one person receiving the property, the right of recovery shall be against each such person, pro rata, in accordance with the amount of his or her bequest. Similar rules apply in the case of interest and penalties respecting additional taxes attributable to qualified terminable interest property.

One may raise some questions as to this provision. First, despite the precedent for this provision under sections 2205, 2206, and 2207, it may be questioned whether Congress has the power to create such a right of action in an executor. If an executor may not sue, presumably he would not be permitted to withhold the tax from the property to be distributed pursuant to the will.

Second, the treatment of penalties and interest would seem to be debatable. For example, assume an executor collects the appropriate tax from those receiving qualified terminable interest property, but fails to file a return on time and thus subjects the estate to interest and penalties. Under the statute it appears that a further claim may nonetheless be asserted by the executor against those receiving qualified terminable interest property for a proportionate share of penalties and interest, even though there was no conceivable benefit to or responsibility on those persons respecting the delayed return.

The Ways and Means Committee proposal added section 2519 dealing with the disposition of life estates in qualified terminable interest property to deal with the possibility that a surviving spouse might dispose of the income interest during life. This section provides that any lifetime disposition of all or part of a qualifying income interest for life in any property shall be treated as a transfer of property and subject to gift tax. Thus, whether the transfer was originally by gift or by devise, the lifetime disposition of the life interest by the holder will be treated under the section as a taxable gift.

Concomitant with this provision, section 2207A provides for the recovery of any gift tax on such a transfer from the person receiving the property in the amount by which the total tax for the year exceeds the total tax which would have been payable if the value of such property had not been taken into account. Section 2207A has certain problems. First, the tax is recoverable from the person who receives the transferred interest. The assumption of the statute apparently is that the property would be transferred to the ultimate recipient designated by the original owner of the property. However, it is perfectly conceivable that a surviving spouse would transfer the income interest to A, even though the remainder of the property is vested in B. Why A should be expected to pay the gift tax on the transfer, except by reason of the secondary liability imposed by section 6324(b), as in the case of any other transfer, is difficult to fathom. Does this provision have the effect of creating a net gift? Second, even assuming that the transfer of the life interest is to the ultimate recipient of the property, the Committee's formula does not necessarily make the recipients of the second transferor's bounty whole. Keep in mind that we now have unified estate and gift taxes so that any transfer has an impact beyond the particular year in which the transfer is made. Thus, a transfer of a qualifying income interest in year five will be treated as a transfer for purposes of computing the estate tax when the transferor of that income interest finally dies. Frequently, the gift tax on the transfer during the surviving spouse's life will be relatively low, but the impact on the estate tax when the surviving spouse finally dies could be much more substantial. Yet the only tax burden which is offset is the initial gift tax cost and not the ultimate tax cost of having the property treated as taxable in the hands of the surviving spouse. Finally, the gift tax imposed on the transfer may use some or all of the spouse's unified credit. If so, the credit is used and the cost of the loss of the credit may not be recovered from the donee.

In the case of a lifetime transfer to a spouse of a qualifying income interest, the interest would be eligible for the annual exclusion, but this would be irrelevant in view of its qualification as qualified terminable interest property. This means that the 100% marital deduction is available. On the other hand, a disposition of the remainder interest, presumably at the same time, would not be eligible for the annual exclusion. If the income interest is transferred by the donor's spouse, it would be eligible for the annual exclusion and the marital deduction if transferred to a spouse.

F. *Joint Property*

1. *In general.* Joint property is another area to which Congress has given increased attention recently and in which the Economic Recovery Tax Act of 1981 effected a significant change. As is well known, prior to amendment by the Tax Reform Act of 1976, section 2040 provided that property held jointly with the right of survivorship was includable in the estate of the first to die, except to the extent the survivor could show that he or she had contributed to the acquisition or improvement of the property. This system produced certain anomalies inasmuch as the decedent could make a taxable gift on transferring property into joint names, pay a gift tax, and yet the property would nonetheless be fully includable in his estate. In addition, the problems of tracing the contribution of spouses, especially where there were subsequent improvements to the property or the property had been purchased with a mortgage, were regarded by some as needless complications.

In 1976 and 1978, Congress substantially revised section 2040 in two major respects. First, Congress introduced provisions which treated material participation in a farm or other business by the surviving spouse as a contribution to the joint property, justifying exclusion of the joint property from the decedent's estate to the extent of contribution.[97] This provision, which had certain complexities, was repealed by the Economic Recovery Tax Act of 1981.[98]

Second, and more importantly, Congress created what was known as a "qualified joint interest."[99] The essential purpose of the qualified joint interest concept was to rectify the anomaly referred to above. It permitted a husband and wife, by electing to have a transfer into joint names treated as a gift, to exclude one-half of the value of jointly held property from the estate of the first to die. In this connection, it will be recalled that under section 2515 a transfer of real estate into joint names was not treated as a taxable gift. Therefore, with respect to property most commonly held jointly, real estate, no gift tax had been paid. This being so, the taxing of all of the property in the estate of the first to die,

97. I.R.C. § 2040(c) (added by the Revenue Act of 1978, Pub. L. No. 600, § 511, 92 Stat. 2763; *repealed* 1981).

98. ERTA, *supra* note 2, at § 403(c)(3)(A).

99. I.R.C. § 2040(b)(2) (amended by ERTA, *supra* note 2, at § 403(c)(1)).

assuming that the consideration for the property had originated with the decedent, was not as anomalous as it might have seemed on the surface. In any event, under the qualified joint interest provisions adopted in 1976, taxpayers could elect to treat the transfer of real estate into joint names as being taxable and, even if no gift tax were payable by reason of the marital deduction, annual exclusion, and the unified credit, the property was treated as being owned half by the decedent and half by the surviving spouse. Thereafter, only half was includable in the estate of the first to die. Of course, since only half was included in the estate of the first to die, only half received a step-up in basis at that time. As part of the 1976 changes, there were provisions made for permitting individuals who already held property in joint names to transform their interest into qualified joint interests.[100] Presumably this was done in some cases.

The 1981 Act, besides repealing the concept of material participation, significantly revised the rules dealing with joint property and provided that such property was to be treated as being owned half and half by husband and wife, irrespective of which spouse contributed to the acquisition of the property. Therefore, only half would be included in the estate of the first spouse to die. These provisions apply only in the case of property held jointly by husband and wife. Section 2515, which provided that no gift resulted on the transfer of the property into joint names, and section 2515A, added by the Revenue Act of 1976 to provide similar rules with respect to joint ownership of personal property, were repealed.

2. *Legislative history.* The House report discussion of the joint property changes is presented as part of the discussion of the unlimited marital deduction. The report simply states that the present rules governing the taxation of jointly held property between spouses were unnecessarily complex, the tracing requirements burdensome, and there was widespread noncompliance because few taxpayers understood the gift tax consequences of joint ownership.[101]

The Ways and Means Committee also noted that in view of

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100. STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 535 (Comm. Print 1976).

101. H.R. REP. No. 201, *supra* note 30, at 160.

the unlimited marital deduction, the taxation of jointly held property between spouses is only relevant for determining the basis of property of the survivor and the qualification for certain provisions, such as sections 2032A, 6166, 6166A, and 303.[102] The House report concluded that it should adopt what it regarded as an easily administered rule under which each spouse would be considered to own one-half of jointly held property regardless of which spouse furnished the original consideration.[103] The Senate report is essentially to the same effect.[104]

3. *Significance of the change.* The new rule, which has the effect of treating joint property for estate gift tax purposes as owned by a married couple half and half, has certain advantages and disadvantages. The change, of course, limits tracing, and the unlimited marital deduction eliminates the necessity of paying a gift tax, using some of the unlimited credit, or spreading the transfer over several years in order to get property into joint names. On the other hand, the fact that property is deemed owned half by each spouse means that on the death of the first to die, only half will be included in the decedent's estate and, therefore, only half will be subject to a step-up in basis. Had all the property been owned by the decedent, the property could have been left to the wife without any tax by using the unlimited maritial deduction, and at the same time the full amount of the property, not just half, would have been stepped-up to fair market value. However, if the property can be converted to community property, a step-up for both halves is obtainable.

It must be recognized that if property is not in joint names and the owner of the property—presumably the spouse whose contribution produced the property—is the surviving spouse, then none of the property will have a stepped-up basis in the hands of the surviving spouse, since it will not be property of the decedent and will not take a step-up in basis at all. This problem cannot be solved by transferring all of a property to the noncontributing spouse shortly before his or her death, or partly mitigated by putting the property into joint names shortly before his or her death. The provisions of section 1014(e), which preclude a step-up in the

102. *Id.*
103. *Id.*
104. S. REP. No. 144, *supra* note 49, at 126-27.

basis of appreciated property acquired by a decedent by gift within one year of death, would apply, and the basis of such property in the hands of the donor who acquires the property from the decedent would be the adjusted basis of the property in the hands of the decedent immediately before his or her death. The 50% step-up for joint property is consistent with the idea of no step-up for individually owned property, absent death.

It may be possible to deal with this problem by using the provisions of section 2036. For example, assume that a husband who has created a property interest transfers it to his wife and reserves the right to use the property for his life if it is tangible property, or reserves the right to income if it is intangible property. If the donor spouse dies first, the property will be in his estate, pursuant to the provisions of section 2036, which include in the decedent's estate any property which he transferred during his life where he reserved the right to the income or use of the property. At the same time, if the spouse with actual ownership of the property dies prior to the donor spouse, the property would be in that spouse's estate. Thus, the decedent's estate will presumably obtain a basis step-up beyond the value attributable to the reservation of rights by the donor spouse.

This technique probably can be used with respect to joint property as well. That is, the husband transfers the property into joint names, but reserves the right to all the income or, if it is tangible property, the right to use the property to the exclusion of his wife. It would seem that this technique would be effective even in the case of joint property, although, particularly in the case of tangible property, it may be difficult to show that the decedent did retain the right to use, including the right to exclude. This is especially true where what has been given is the family home which was jointly occupied. One may speculate whether the value of a step-up in basis is sufficient to justify these kinds of maneuvers. Although they have no federal estate tax impact, they have significant collateral state and local law consequences.

One must still confront the question—perhaps the most frequently asked question—should property be placed in joint names? The local law aspects of joint property are well known. When half an intrest in property is given away, it is given away. On the other hand, many states have enacted for matrimonial dispute purposes the so-called equitable distribution system,[105] whereby the actual ownership of the property is rendered considerably less relevant in dividing the couple's property in divorce. The property is divided based on the overall equities, considering the contributions of each spouse to the marriage and so on. Thus, in an equitable distribution state, the lawyer's prior concern with respect to joint property—its impact in the event of a dissolution of the marriage—is significantly reduced.

With respect to the tax aspects, the unlimited marital gift tax deduction has eliminated any tax barrier to the transfer of property into joint names, and the unlimited marital deduction for estate tax purposes has eliminated the significance of holding property jointly or severally. If held severally by the decedent, the property passes tax-free to the surviving spouse. If held by the survivor, it is not subject to tax in the hands of the decedent. If held jointly, half will be included in the estate of the decedent and will pass tax-free to the survivor pursuant to the unlimited marital deduction. If the unlimited marital deduction is not claimed and the old 50% marital deduction formula is adhered to, half of the joint property passing to the surviving spouse by right of survivorship will be treated as fulfilling part of the marital bequest and is a part of the half of the decedent's property which the surviving spouse is bequeathed. If the property is not held jointly, the full amount can, of course, be bequeathed specifically or otherwise to the surviving spouse.

Thus, it appears that from an estate tax standpoint, there is no particular advantage or disadvantage to holding property in joint names. However, when one reflects upon the basis of property, there are certain considerations, outlined above, which suggest that assuming the contributing spouse will be the first to die, one should not hold property in joint names. This is true because a step-up in basis of all of the property will be received without estate tax cost if the contributing spouse dies first and the property is wholly in his name. If the property is owned jointly, however, only half will receive a step-up in basis. Whether this is sufficient to lead counsellors to recommend that property not be held in joint names remains to be seen.

One must also shed a tear for those individuals who were so

105. N.Y. DOM. REL. LAW § 236 Part B (McKinney Supp. 1982-83).

rash as to take advantage of the change with respect to joint property adopted in 1976. It will be recalled that at that time, Congress made it possible for an individual to exclude half of any joint property in the name of husband and wife from the estate of the first to die on the condition that the parties elect to treat the creation of the joint interest as a gift. If the property was already in joint names, one could achieve the same result by retransfers. No doubt many of the individuals who took advantage of this provision arranged to do so without the payment of any gift tax. But there may be some who felt the estate tax exclusion and the equalization of estates were sufficiently advantageous to justify incurring a gift tax liability. If someone did incur a substantial gift tax liability as a result of electing to take the benefit of the 1976 changes, he or she might well complain. From 1982 on, such equalization can be achieved tax-free, simply and directly. The dust has barely settled on the 1976 changes and Congress has adopted new rules which are different in conception from those which had been applied for many, many years, and also different from the concept recently adopted in 1976. Even more depressing to those individuals who took advantage of the 1976 changes, if they were not able to cover the transfer with the per donee exclusion, is the fact that they have made a transfer which will be considered in fixing the final rate they will have to pay for estate tax purposes.

G. *Increase in Per Donee Gift Tax Exclusion, Tuition and Medical Expense Exclusion, and Annual Filing of Returns*

1. *In general.* Another significant change made by the Act, at least for the extremely wealthy, is the increase in annual per donee exclusion to $10,000 from $3,000 ($20,000 if the couple elects to split gifts) and the treatment of payments of tuition and medical expenses as nontaxable transfers.[106] Gift tax returns were also made due, as before, on a yearly basis.[107]

Under the Act, the increase to $10,000 applies to transfers after December 31, 1981, and a separate transitional rule is provided.[108] The transitional rule is that if: (1) an instrument is executed before September 12, 1982, (2) which provides for the power

106. I.R.C. §§ 2503(b), 2503(e) (1982).
107. I.R.C. § 6075(b)(1) (1982).
108. ERTA, *supra* note 2, at § 441(c)(2).

of appointment—really a power of invasion if one is thinking of a *Crummey* power[109]—and the power is defined in terms of the amount of the gift tax exclusion under section 2503(b), (3) the instrument has not been amended, and (4) the state has not enacted a statute construing any reference to section 2503(b) as meaning 2503(b) after the 1981 enactment, then the increase to $10,000 from $3,000 "shall not apply to such gift."[110]

2. *Legislative history.* In proposing an increase in the annual gift tax exclusion, both committee reports refer to the fact that the exclusion was intended originally to be a matter of administrative convenience. The 1981 House report quotes the original Senate report to the effect that the exclusion was intended to "obviate the necessity of keeping an account of and reporting numerous small gifts. . . ."[111] In 1932, the House had proposed a $3,000 exclusion. The Senate increased that figure to $5,000, and the $5,000 exclusion was enacted. The 1981 Senate report chose to quote from the 1932 report the statement that this amount was intended to be "sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."[112] The $3,000 level was set in 1942, and it has been a point of some wonder that Congress believed numerous citizens were making Christmas and wedding gifts of this size and that a gift of $3,000 can be regarded as a "relatively small" amount.

The increase to $10,000 seems to ignore the importance that the annual exclusion has assumed in estate planning. The almost invariable recommendation to a prospective decedent intent on saving taxes prior to 1982 was that he and his spouse split gifts and transfer each year $6,000 to as many objects of their bounty as were available. Needless to say this advice is only of utility for the wealthy. Both committee reports quite accurately point out that inflation has reduced the real value of the exclusion. The committees proceeded to increase the exclusion to $10,000, whereas a $3,000 exclusion in 1942 would be equivalent to an exclusion of about $16,500 in 1981 dollars.

In addition, the Ways and Means Committee proposed an ad-

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109. For an explanation of a *Crummey* power, *see infra* text accompanying note 124.

110. ERTA, *supra* note 2, at § 441(c)(2) (last line, flush language).

111. H. REP. No. 201, *supra* note 30, at 193 (quoting S. REP. No. 665, 72d Cong., 1st Sess. 41 (1932)).

112. S. REP. No. 144, *supra* note 49, at 129.

ditional exclusion for tuition and medical expenses which was ultimately accepted in conference and has become law.[113] The Committee stated that while certain payments of tuition on behalf of children who have attained their majority and certain payments of medical expenses on behalf of elderly relatives are technically considered gifts under present law, they should nonetheless be exempt regardless of the amount paid.[114] The provision, however, is not limited to medical expenses paid for elderly relatives, nor is the tuition exclusion limited to children.

3. *Significance of the increase.* The substantial increase in the annual exclusion will permit the wealthy to transfer over their lives substantial amounts of property to the objects of their bounty, free of any transfer tax. In view of the magnitude of the sums which could be transferred free of tax even prior to the 1981 Act, where a husband and wife elect to split gifts, only the extremely wealthy will be able to take advantage of the new provision. For example, consider a husband and wife with a $10,000,000 taxable estate, two children, and four grandchildren. Each year they may transfer $120,000 gift-tax-free to the children and grandchildren without the transfer having any impact on the transfer tax which would be ultimately imposed on the disposition of their estate. Over ten years, $1,200,000 can be transferred, coming off the top of an estate eligible for the 50% top rate, which means a savings of approximately $600,000, in addition to the income tax savings which are likely to result. The fact that such gifts are not regarded as transfers for purposes of computing the rate applicable on their estate is of less importance because the new 50% top rate is reached by an estate of $2,500,000.

This benefit is not without its problems, and the major difficulty is how to handle sums of this magnitude on behalf of donees who are under the age of majority or, even if they have attained their majority, are under the age of discretion. Because of the size of the sums that would be involved in a consistent gifting program, one would anticipate that trusts would be utilized rather than transfers under the Uniform Gifts to Minors Act.[115] A grandchild whose paternal and maternal grandparents both embark on an an-

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113. I.R.C. § 2503(e) (1982).

114. H.R. Rep. No. 201, *supra* note 30, at 193.

115. Unif. Gifts to Minors Act, 8 U.L.A. 181 (1966) (adopted in N.Y. Est. Powers & Trusts Law §§ 7-4.1-7-4.12 (McKinney 1967)).

nual gifting program will have an $800,000 trust at the time he or she turns twenty-one, not counting income and appreciation. This may well be a more substantial sum than the grandparents are prepared to place in the hands of a twenty-one year old.

In order to obtain the exclusion with respect to transfers in trust to minors, section 2503(c) must be utilized. That section permits an annual exclusion for a gift to an individual under the age of twenty-one, even though the interest may technically constitute a future interest. This exclusion is conditioned upon the requirement that the property and the income therefrom may be expended by or for the benefit of the donee before attaining the age of twenty-one years, and to the extent it is not expended it will pass to the donee on his attaining twenty-one.[116] If he dies, it must be payable to his estate or as he may appoint.

It is established law under section 2503(c) that, in referring to the property and the income therefrom, an income interest alone can be considered property so that there is no requirement that the corpus be passed to the donee upon attaining his majority.[117] However, this means that there is no exclusion with respect to the corpus. Furthermore, over the years the Internal Revenue Service has grown increasingly liberal in its interpretation of what constitutes passage to the donee upon his attaining twenty-one years. Presently, so long as there is a short period of time following the donee's attainment of twenty-one where he can elect for a brief period to take the property, the original transfer qualifies for the exclusion, even though, if the donee fails to make the election, the property continues in trust for an unlimited period.[118]

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116. I.R.C. § 2530(c) (1982).

117. Rev. Rul. 68-670, 1968-2 C.B. 413.

118. In Rev. Rul. 74-43, 1974-1 C.B. 285, the Service ruled that § 2503's requirements were complied with if the beneficiary had: (1) a continuing right after 21 to compel a distribution, or (2) a right during a limited period to compel a distribution of the corpus. Rev. Rul. 74-43 revoked Rev. Rul. 60-218, 1960-1 C.B. 387, which held that § 2503(c) was not complied with if one provided that a trust was extended unless the minor at 21 elected to terminate it. Consider the alternative approach discussed later in the text and related authorities where a present interest is sought not under § 2503 (c), but because the annual gift may be withdrawn for a brief period. In I.R.S., Private Letter Ruling 7946007 (July 26, 1979), the Service ruled that, where a trust was set up on December 29 and the beneficiary was not informed of his right to demand distribution by the end of that year, there was no present interest. However, in I.R.S. Private Letter Ruling 8022048 (Mar. 4, 1980), the Service ruled that a gift to a trust for the benefit of a minor daughter during the last week in December qualified as a present interest as the donor-parent was the natural guardian of his

As a consequence of the increased amount which can now be transferred tax-free by use of the increased per donee exclusion, there will be increased pressure by donors to restrict the rights of the donee on attaining age twenty-one and to continue the property in trust until the donee reaches a more advanced age. As indicated above, the Internal Revenue Service has generally acquiesced in restrictions on the donee's right to elect, but one can expect additional skirmishing in this area in situations where the magnitude of the sums transferred makes a possible taking of all of the property at age twenty-one of great concern to the donor.

Alternatively, a present interest in a trust results if the beneficiary, or, if a minor, an authorized representative, has the power for a period to withdraw the annual gift from the trust, even if the right to withdraw does not continue for the future. These are the so-called *Crummey* trusts discussed below.

A good deal of litigation has considered the extent to which a present interest exists when withdrawals of annual gifts are circumscribed in some way, and more of such dispute can be expected. One may anticipate that the use of this sort of power to avoid all the restrictions of section 2503(c) will prove popular.

The 1982 increase in the per donee exclusion to $10,000 also facilitates the use of short-term trusts. As is well known, under section 673(a) the transfer of property for a ten year and one day term, income to the donee, reversion to the donor, is a useful vehicle for shifting income from a high bracket donor to a low bracket donee, often a child. When the exclusion was $3,000, a donor and a spouse joining in a gift could transfer about $13,300 to such a trust without gift tax. The value of the income interest was about $6,000, which was covered by the per donee exclusion, and the balance was the remainder which was not a gift because it was retained by the donor. The new annual exclusion of $10,000 permits approximately $44,400 of property to be transferred into trust by a donor who elects to split a gift with his or her spouse without any

minor daughter under local law, and the state permitted a guardian to receive property distributed from the trust. The trust agreement permitted withdrawal of $3,000. Since the donor as natural guardian possessed actual knowledge and the legal right to withdraw, the gift was deemed a present interest. The Service refused to rule whether gifts during December qualified as a present interest where a withdrawal could only be made by a legal guardian, because if a legal guardian had been required, it would have taken several days to obtain the necessary appointment.

gift or estate tax impact. If one is not married, essentially the same result can be achieved by a gift of $22,200 in December and an additional $22,200 in January. If one is married, $88,800 can be transferred on the same basis. At present interest rates a single split gift would produce significant income to the donee. Transfers under section 673(c) to elderly relatives where the reversion is triggered by the death of the income beneficiary will also be favorably affected, but the size of the gift which can be given tax-free will depend upon the age of the donee.

The principal advantage of a short-term trust has always been the income tax benefit, but its use was sometimes inhibited because of the gift tax consequences of creation. Now that the gift tax consequences have been eased, one may expect more use of short-term trusts as a vehicle to provide college costs (beyond tuition, now otherwise gift-tax-free) or other support for a needy child or relative. Again, it is the well-to-do with capital who primarily benefit since individuals with relatively high incomes often do not have sufficient capital to establish a substantial short-term trust.

4. *The exclusion of tuition and medical expenses.* As previously noted, the Act provides that any amounts paid on behalf of any individual (whether related or not) as tuition to a recognized educational organization for the education and training of such individual, or as payment for medical care to any person who provides medical care as defined in section 213(e), will not be considered transfers by gift. In one sense, the provision provides a trap for the unwary. The statute requires, and the House report confirms, that the exclusion for expenses and tuition is applicable only with respect to payments made directly to the individual or institution providing the service.[119] Payment to a child by a check which he endorses over to his college presumably would not qualify.

The exclusion for medical expenses includes medical insurance and all those medical expenses as defined in section 13, i.e., those incurred essentially for the diagnosis, cure, medication, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body. If the individual receiving the medical care has his expenses reimbursed by insurance, the payment by a

119. H.R. REP. No. 201, *supra* note 30, at 193-94.

donor of an expense which would otherwise qualify for the exclusion is not eligible for exclusion irrespective of when the reimbursement is made.

The exclusion for educational expenses requires that the payment be made to an educational organization as described in section 170(b)(1)(A)(ii); that is, an institution which normally maintains a regular faculty and curriculum and normally has a regular body of pupils or students in attendance at the place where its educational activities are regularly carried on. This exclusion applies to both full and part-time students, but only as to tuition costs, not extending to books, dormitory fees, transportation to school, and so on.

This provision has the effect of making more clear than ever that amounts which can be regarded as quasi-support under local law are subject to gift tax if they are not payments for tuition or medical care. The House report states that in providing for this exclusion, the Ways and Means Committee did not intend to change "the law that there is no gift if the person paying the medical expense or tuition is under an obligation under local law to provide such items to the recipient."[120] In such a case the payment is not a gift because it is in discharge of an obligation to support. But the problem lies in defining what is encompassed by the obligation to support. There has always been a bit of uncertainty as to how payments which are not in discharge of an obligation of support under local law are to be handled, and as a practical matter many quasi-support payments which are technically gifts go unreported. As one prominent text states, the practice is probably different than what the law technically requires.[121] This change can be regarded as an affirmation by Congress that it intends to treat as a gift, if in excess of the annual exclusion, payments which are not regarded as discharging an obligation to support under local law. The problems in this area are likely to arise only in situations where the donor has embarked on an annual giving program so that the exclusion is not available when the Internal Revenue Service questions the treatment of a particular payment. For example, parents with an annual giving program who provide their son with

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120. *Id.* at 194.

121. STEPHENS, MAXFIELD & LIND, FEDERAL ESTATE & GIFT TAXATION, ¶ 10.02[5][a](1978) ("Theory and practice are bound to diverge on such issues.").

an automobile on his high school graduation may find it difficult to justify a car as an item of support under local law so that no gift tax is due.

The House report also states: "In addition, the Committee bill does not change the income tax consequences otherwise applicable to such payments."[122] The reference to the income tax consequences is presumably a reference to the rule established under Regulation section 1.662(a)-4 to the effect that if a trust makes a payment which has the effect of discharging someone's obligation to support the beneficiary of the trust, it shall be deemed income to the person whose duty to support is discharged, though not received by him. Furthermore, this reference would seem to indicate that the son receiving the car in the example above would not be subject to income tax. One general difference between the income tax law in its approach to gifts and the gift tax law is that in the gift tax law donative intent is irrelevant; a gift is made if value is transferred without consideration, even if there is no donative intent, provided it was not a transfer in the ordinary course of business. On the other hand, under the income tax law, to have a gift excluded from the donee's income there must be donative intent. It seems reasonably clear in the car example given above that the parents have donative intent so that the expected income tax result—no income to the son—would obtain.

5. *Effective dates and Crummey trusts.* As noted above, these new rules apply to transfers made after December 31, 1981, but a separate, permanent transitional rule is provided.[123] The transitional rule is that if: (1) an instrument is executed prior to September 12, 1982, (2) containing a power of appointment phrased in terms of the amount of gift tax inclusion under section 2503(b), (3) the instrument has not been amended on or after September 12, 1982, *and* (4) the state has not enacted a statute under which such a power of appointment is to be construed as being defined in terms of the amount of the $10,000 exclusion under section 2503(b), then the amendment increasing the exclusion to $10,000 shall not apply.

Congress recognized that many existing trusts provide powers of appointments specifically defined in terms of the section 2503(b)

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122. H.R. REP. No. 201, *supra* note 30, at 194.
123. ERTA, *supra* note 2, at § 441(c)(2).

annual gift tax exclusion of $3,000. Presumably this is a reference to trusts which include so-called *Crummey* powers which, by authorizing the donee to withdraw $3,000 of the property transferred, ensure that the transfer qualifies for the annual exclusion even though it would otherwise be regarded as a future interest.[124] The House version of the transitional rule, which prevailed, apparently was intended to preserve the $3,000 limitation on withdrawals from *Crummey* trusts.[125]

The Senate had proposed only a two-year transitional rule. Under the Senate bill, the two-year transitional rule provided that the increased annual gift tax exclusion would not apply to instruments in which powers are defined in terms of section 2503(b), and such powers were granted under a trust created before thirty days after the date of enactment and not amended after that date, if there is no state law applicable to such instrument which would construe the power as referring to the increased gift tax exclusion.[126] The proposed rule, however, was to be effective only with respect to powers exercisable after December 31, 1981, and before January 1, 1984. This, according to the Finance Committee, would provide sufficient time for trustees to obtain clarification of the donor's intent through judicial construction of the trust governing instrument.[127] Had the Senate change been enacted, one must wonder whether it would have been effective under state law to alter the terms of a trust, assuming no state statute was passed specifically confirming the interpretation that the expanded exclusion was met. The Senate apparently assumed that it may change the local law interpretation of a trust provision. The conference committee wisely did not press the issue.

There are also interpretive problems with the effective date as enacted. The transitional rule provides that if the instrument has not been amended, "and" the donor's state has not enacted a statute redefining the reference to section 2503(b), then the amendment made by subsection (a) which would increase the gift tax ex-

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124. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). A *Crummey* power authorizes the donee to withdraw $3,000 of the property transferred and insures that the transfer qualifies for the annual exclusion even though it would otherwise be regarded as a future interest.

125. H.J. Res. 266, 97th Cong., 1st Sess. § 403 (1981).

126. S. REP. No. 144, *supra* note 49, at 129-30.

127. *Id.*

clusion to $10,000 "shall not apply to such gift."[128] Literally interpreted, this would seem to mean that the instrument must be amended *and* the state must have enacted a statute providing for a revised interpretation of instruments before the high exclusion is available. Presumably it was intended that either one would be effective to make the $10,000 exclusion available. It is hoped that the regulations will adopt this view.

The second interpretive difficulty is the fact that if the transitional rule applies, the increase to $10,000 from $3,000 shall not apply "to such gift." The problem is that Congress did not wish to alter instruments because of its change in exclusion, but whether it did or did not make such alteration depends, it would seem, on state law. Should Congress attempt to dictate state law? Assume an individual has created a *Crummey* trust, defined in terms of the $3,000 limit, and makes a transfer to that trust. Is it likely that local law would interpret the trust in 1982 and beyond as permitting a withdrawal of $10,000? If it did, why should the donor be denied a full exclusion on a gift of $5,000? Assuming the requirements for the exclusion are met, it is the extra withdrawal that the change could permit against the will of the donor that is of concern, not the amount of the exclusion. Can Congress, by saying that a $10,000 exclusion is not available, change a power to invade? Suppose the trust grants a power to invade to the extent of $3,000 or "such other amount as Congress sets under section 2503(b)." Is the exclusion $3,000, or $10,000? Ten thousand dollars would seem to be the amount of invasion permitted under local law and the effective date provision doesn't seem to alter that conclusion, yet it seems to limit the exclusion in such a case to $3,000.

This question aside, the problems created by the new changes for a donor who has set up a *Crummey* trust are not great, but they may cause some inconvenience. First, it would seem reasonable for a state to adopt a rule as anticipated by Congress that a reference with power defined in terms of section 2503(b) would be interpreted to mean $10,000 rather than $3,000. It can be reasonably assumed that most of the individuals who have created a trust of this nature would prefer to take full advantage of new section 2503(b), rather than be bound by the old $3,000 limit. For those few who would not wish to take advantage of the full limit, they

128. ERTA, *supra* note 2, at § 441(c)(2)(last line, flush language).

may establish another trust, or limit their gifts to $3,000 so that the increase to a $10,000 draw-out does not as a practical matter expand the rights of the beneficiary.

On the other hand, there would seem to be comparatively little difficulty for a grantor who wishes to take advantage of the $10,000 limit to create a new trust rather than waiting to see what state law will provide. This assumes that the existing trust cannot be effectively amended to increase the limitation to $10,000. Moreover, one should keep in mind that depending upon the terms of the particular trust, granting the income beneficiary the right to withdraw $10,000 may have transfer tax consequences as well as income tax consequences to the beneficiary with the power. The possible income tax consequences under sections 671 through 679 generally have been ignored in the past, and the transfer tax consequences were obviated by the provisions of sections 2041(b)(2) and 2514(e) so that a lapse of a power of appointment does not produce transfer tax consequences where the property subject to the power did not exceed the greater of $5,000 or 5% of the assets from which the lapsed power could be satisfied. So long as the annual exclusion was $3,000, one could be certain there would be no transfer tax consequences to the beneficiary who did not exercise his power to withdraw the $3,000 from the trust, thus effectively transferring all but the income interest in the $3,000 to the remainderman. Now that the exclusion amount has been increased to $10,000, however, the protection of sections 2040(b)(2) and 2514(e) is no longer available, and a beneficiary who does not take out the $10,000 annual portion may be deemed to have made a gift to the remainderman and to have retained the income from the gift so that the $10,000 is includable in his estate.

H. *Estate Tax Treatment of Transfers Made Within Three Years of Death*

1. *In general.* In the Economic Recovery Tax Act of 1981, Congress saw fit to add another chapter to the long and tortured history of dealing with transfers within three years of death. Whether the changes made will simplify the law or introduce new complications remains to be seen. Under the Act, section 2035 will no longer automatically bring in property transferred by the decedent within three years of his death, and its scope is much circumscribed. The inclusion is retained with respect to gifts of life insur-

ance and interests in property which, if retained until death, would be includable in the gross estate under sections 2036, 2037, 2038, and 2042. Furthermore, the Act requires the inclusion of all transfers made within three years of death (other than gifts eligible for the annual gift tax exclusion) solely for purposes of determining the estate's qualification for the special benefits provided by section 303 (capital gain redemption), section 2032A (special use valuation), section 6166 (deferred payment of estate tax), and for purposes of determining what property is subject to the estate tax lien. Furthermore, section 2035 will continue to require the inclusion of all gift taxes paid by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976 and within three years of death.

Without reviewing in tortuous detail the history of section 2035 and its predecessors, a history amply set forth in other quarters, it is worth noting briefly the saga that began in 1916. In 1916, with the enactment of the modern estate tax, all transfers made in contemplation of death were includable and those made within two years of death were presumptively made in contemplation of death.[129] In 1926 Congress, dissatisfied with the 1916 rule which incorporated a rebuttable presumption, declared that transfers made within two years of death were conclusively presumed to have been made in contemplation of death and, therefore, includable in the decedent's gross estate.[130] When the Supreme Court held this irrebuttable presumption unconstitutional in *Heiner v. Donnan*,[131] Congress responded that same year by eliminating the conclusive presumption and returning to the rebuttable presumption.[132] In 1950, the two-year period was increased to three years and transfers made prior to three years were made not subject to inclusion.[133] So the law remained until 1976. In the Tax Reform Act of 1976, in conjunction with the adoption of the unified transfer concept, Congress saw fit to mandate the inclusion in the gross estate of all transfers made within three years of death.[134] The leg-

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129. Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 756, 777-78.

130. Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 9, 70.

131. 285 U.S. 312 (1932).

132. Revenue Act of 1932, ch. 209, § 803(a), 47 Stat. 169, 279 (amending Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 70).

133. Revenue Act of 1950, ch. 994, § 501(c), 64 Stat. 906, 962 (amending I.R.C. § 811 (1939)).

134. Tax Reform Act of 1976, *supra* note 1, at § 2001(a)(5).

islative history of the 1976 Act shows that Congress concluded, in light of the nature of the unified transfer approach, that mandatory inclusion would not be unconstitutional.[135]

In 1981, in the Economic Recovery Tax Act, the Finance and Ways and Means Committees returned to their contemplation of transfers within three years of death under section 2035 and each came up with a different solution. Ultimately, the proposal of the Ways and Means Committee prevailed.

2. *Legislative history.* The Finance Committee's approach was to conclude that there was no reason to tax appreciation that accrued after a gift had been made.[136] However, the Committee did not repeal section 2035. Instead, it included gifts made within three years of death at their value at the time of the gift in order to deny prospective decedents the possibility of making deathbed transfers which would enable them to change the size and the makeup of the gross estate so as to qualify for section 303 (capital gain redemption), section 2032A (special use valuation) and section 6166 (reduced interest rate) benefits. The Committee indicated that it would in no event have repealed section 2035 for life insurance.[137] Such property would continue to be included at date of death fair market value.

The House version, which ultimately prevailed, took a slightly different tack. The Ways and Means Committee proposed that section 2035 not be applicable to estates of decedents dying after December 31, 1981. Section 2035 was retained, however, with respect to gifts of "life insurance" and "interests in property otherwise includable in the value of the gross estate pursuant to sections 2036, 2037, 2038, 2041 or 2042. . . ."[138] Moreover, the House bill required the inclusion of all transfers made within three years of death (other than gifts eligible for the annual gift tax exclusion) for purposes of determining the estate's qualification for the special benefits provided by section 303, section 2032A and section 6166, and for purposes of determining the property subject to the estate tax lien. Since "contemplation" property will not normally

135. *See* H.R. REP. No. 1380, 94th Cong., 2d Sess. 14 (1976). *See also* STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 528-29 (Comm. Print 1976).

136. S. REP. No. 144, *supra* note 49, at 138.

137. *Id.*

138. H.R. 4242, 97th Cong., 1st Sess. § 424(a)(1981).

be includable in the donor's estate, it will no longer be accorded a step-up in basis in the hands of the donee.

3. *The significance of the change.* As indicated in the general discussion above, it does not appear that this provision will have any great significance for estate tax purposes. As has been explained, under the unified transfer tax concept the amount of any gift which is made, valued at the time of the gift, is considered in fixing the ultimate amount of transfer taxes to be paid by a decedent. For that reason, if there is no appreciation, there is no difference in result whether a transfer was made within or before three years of death. On the other hand, if the transferred property appreciates substantially, old section 2035 would have brought back and subjected to estate tax that appreciation. Beginning in 1982, this is no longer the rule, and such appreciation, if any, will not be subject to estate tax in the estate of the donor-decedent.

On the income tax side, it might be thought that the loss of a stepped-up basis would cause pain to all taxpayers. It depends. Putting aside situtations where the 100% marital deduction is used or the estate is so small that there is no estate tax loss in passing the property through the estate of the decedent, it appears that it will not always be so painful. There is little detriment if all that is at issue is post-gift appreciation, but there is considerable detriment if substantial pre-gift and little post-gift appreciation is at stake.

The first estate tax bracket once the unified credit is fully phased-in to $192,800 is 37%. The maximum tax on capital gains under the Act is 20%. Therefore, in the case of post-gift appreciation, a 37% tax would have to be paid to save a 20% tax. Accordingly, unless the decedent's estate (including the gift) after the marital and other deductions is less than $600,000 (the amount exempt by the unified credit), so that inclusion produces no estate tax detriment, the value of the step-up would be less than the estate tax cost.

For example, if the property was acquired long before the gift and had substantially appreciated at that time, an analysis will show there would be very little impact from the loss of a step-up in basis if there is also substantial post-gift appreciation. Assume that an individual acquired stock for $1,000 which has appreciated to $101,000 at the time of a gift to his favorite nephew. Assume the individual dies two and one-half years later, and the stock is worth

$201,000. The donee's basis at the time of the gift was $1,000, so that at the time of the decedent's death, under the old law, he would face a capital gains tax on $200,000 at a 20% rate, or $40,000. The inclusion of the property in the decedent's estate under old section 2035 would have the effect of eliminating any appreciation and giving the donee a basis of $201,000 in the property. Only $100,000, the difference between the value at the date of the gift and the value at the date of death would be, as a practical matter, subject to tax by reason of new section 2035. The first $101,000, the value at the date of gift, would be subject to the unified transfer tax in any event, as a result of the transfer. Inclusion of an additional $100,000 would produce a tax of $37,000 at the lowest bracket and a $40,000 capital gains tax would be saved. If the estate were in the 50% bracket, the estate tax cost would be $50,000, and the income tax saving would remain at $40,000. Thus it can be seen that, even in a situation where the property is substantially appreciated in the hands of the donor, inclusion in the gross estate of the donor is not necessarily advantageous. The additional amount included for estate tax purposes and the tax imposed thereon may be higher than the amount of capital gains tax which would be eliminated had the property been included.

If the donor's $1,000 stock had not appreciated at all at the time of the gift, but had appreciated to $201,000 by the time of the donor's death, the results would be as follows: The donee's basis at the time of the gift would still be $1,000, so that under the old law he would face the same capital gains tax as in the prior example, $40,000. But inclusion would have the effect of eliminating any appreciation and the gains tax. However, the full amount of the appreciation, $200,000, would be included in the decedent's estate because of section 2035, and would at the minimum produce an additional estate tax of $74,000. Here, with post-gift appreciation, inclusion costs more than the step-up saves.

Finally, if the example given above is altered again so that the $1,000 property has appreciated to $201,000 at the time of the gift, the donee would still face a $40,000 capital gains tax liability. On the other hand, inclusion of the property would eliminate this tax, and there would be no additional tax cost inasmuch as the $201,000 would be taken into account in computing the tax to be paid on the decedent's estate in any event.

Thus, it can be seen from the above examples that in some cases the noninclusion of the property as a result of the 1981 change to section 2035 will be advantageous, for the estate tax savings resulting from exclusion would be larger than the capital gains tax to be saved from the stepped-up basis resulting from inclusion. On the other hand, where one is dealing entirely or almost entirely with pre-gift appreciation, so that this portion of the property would be subject to tax as a practical matter in the decedent's estate irrespective of when the transfer occurred, inclusion produces no detriment and therefore there is some loss to the donee by reason of the resulting lack of a step-up in basis.

I. *Basis of Property Acquired from the Decedent*

The Act contains a special rule to preclude transfers to a decedent for purposes of obtaining a stepped-up basis. This provision originated in the House bill. There was no comparable provision in the Senate bill. The original House provision applied to any transfer made within three years of death.[139] The conference committee reduced the period to one year.[140] Thus, under the Act, the basis step-up provisions of section 1014 do not apply with respect to appreciated property acquired by the decedent as a gift within a year of his death if the property is to pass directly or indirectly back to the original donor or donor's spouse. Such a provision appears appropriate in light of the unlimited marital deduction.

The initial estate tax rate, 37%, is higher than the new 20% maximum rate on capital gains, but an advantage may still result from passing property through the estate of a decedent if the decedent's estate is less than $600,000 or if there is no tax on his estate by reason of the use of the unlimited marital deduction. In the absence of the unlimited marital deduction, it might be questioned whether any significant amount of this kind of planning would occur, but with the unlimited marital deduction it is a possibility.

One disadvantage to such an avoidance plan in the case of a taxable estate is the fact that the estate tax rate is higher than the maximum rate on capital gains. For example, the amount included in the estate where the donor transferred property to his father on the father's deathbed would be the fair market value of the property transferred. Thus, if on facts similar to those in the prior ex-

139. *Id.*
140. S. Rep. No. 176, 97th Cong., 1st Sess. 138 (1981).

amples, the donor had property which he acquired for $1,000 which appreciated to $101,000 and he then transferred the property to his father on his deathbed, the $100,000 appreciation which would have been subject to a capital gains tax of $20,000 would have its basis stepped-up and the capital gains tax of $20,000 eliminated. However, if the decedent is subject to estate tax at all, he will be subject to tax at the rate of 37%, 17 points higher than the maximum advantage to be achieved by the elimination of the capital gains tax. Moreover, since the property was acquired by gift from the original donor, that donor's own transfer tax liability will necessarily be increased. Every transfer above the per donee exclusion level is considered in computing the estate tax so that as a result of the son's transfer, there would be an additional $91,000 of taxable transfers which would ultimately have to be considered in fixing the final rate in the estate of the son. Perhaps the ultimate increase in transfer tax to be paid by the son is not all that significant inasmuch as it is likely to be paid many years in the future. On the other hand, any transfer tax imposed on the property in the estate of the decedent is an immediate cost and cannot be ignored.

This maneuver would thus appear to be practical only when the property can pass through the decedent's estate without attracting a transfer tax. However, and this justifies the provision, this could result any time the unlimited marital deduction is claimed, irrespective of the size of the estate.

As the House report makes clear, a stepped-up basis will be denied where the original donor receives the benefit of the appreciated property irrespective of whether the bequest is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest.[141] The House report implies that the statutory language "such property is acquired from the decedent by (or passes from the decedent to) the donor" should be interpreted in the case of a pecuniary bequest as denying a step-up only if the inclusion of the appreciated property in the estate affected the amount that the donor receives under the pecuniary bequest.[142]

Although the statute denies a full step-up in basis, it does permit the donor-recipient of the property to receive the benefit of

141. H.R. REP. No. 201, *supra* note 30, at 188-89.

142. *Id.*

whatever additions to basis are made by the donor. Thus, in the example above, if the property in the decedent's hands is improved to the extent of $10,000 so that the decedent had a basis immediately prior to his death of $11,000, the donor-recipient's basis will be $11,000, not the $1,000 that he had originally. Moreover, the statute applies similar rules in the case of property which is sold by the estate where the donor of the property (or his spouse) is entitled to the proceeds of sale.[143] Finally, if not all of the donated property is transferred back to the donor or his spouse, then the stepped-up basis will be available to the extent that the donor is not to receive the property.

The House report provides a hypothetical example where A transferred appreciated property with a basis of $10 and a fair market value of $100 to a prospective decedent within three years of his death, and the fair market value at the date of death was $200.[144] Under the general rule, A would receive the property with a $10 basis. In this particular example, the decedent had augmented the basis by $10 so that the donor became entitled to a $20 basis. In another example, it is assumed that the decedent's estate consisted only of the appreciated property of $200 and liabilities of $50 so that the donor would be entitled only to three-fourths of the appreciated property.[145] The example explains that the 25% of the property which the donor would not receive at the donee's death would be entitled to a stepped-up basis, whereas the three-quarters received by the donor would not. The example indicates that the basis of the appreciated property would be $65 in the hands either of the executor or the heir.[146] It may be assumed that where 25% is disposed of by the executor and the balance is distributed in kind to the donee, the executor would be able to sell his quarter income-tax-free and the heir's portion of the property would have a basis of $15. Thus, the basis of the appreciated property in the hands of the executor would be $50 (the fair market value of one-quarter) and the three-quarters passing to the donor would be entitled to a basis of $15 (three-quarters of the donor's basis).

143. I.R.C. § 1014(e)(2)(B) (1982).
144. H.R. Rep. No. 201, *supra* note 30, at 189.
145. *Id.*
146. *Id.*

J. *Extensions of Time for Payment of Estate Tax Respecting Interests in Closely Held Businesses*

Since the Revenue Act of 1976, there have been two overlapping provisions which permitted the deferred payment of estate taxes attributable to closely held businesses, sections 6166 and 6166A, and other provisions offering special advantages: section 303 (capital gain redemption) and section 6601(j) (low interest rate).

For income tax purposes under section 303, if more than 50% of the gross estate consists of stock in a single corporation (or, in certain circumstances, of more than one corporation), the redemption of all or a portion of this stock to pay estate taxes and administration expenses is eligible for capital gain rather than dividend treatment.

Section 6166, added by the Tax Reform Act of 1976, provides for a five year deferral of the payment of estate taxes, followed by a ten year installment payment of those taxes if the value of the interest in a closely held business exceeded 65% of the adjusted gross estate, but only to the extent of the tax attributable to the closely held business interest. Section 6601(j) provides a 4% rate of interest with respect to the deferred installments to the extent of the first $1,000,000 in closely held business interests.

Under section 6166A, an extension of time for payment of the estate tax is permitted where the value of the interest in a closely held business exceeds either 35% of the gross estate or 50% of the taxable estate, but only to the extent that the tax is attributable to the value of the interest in the closely held business. Under section 6166A, the tax may be paid in up to ten equal installments, the interest rate on which was not reduced as in the case of installment payments under section 6166.

There were differences between the two provisions in terms of the definition of what constituted a closely held business. Nonetheless, under both provisions, the tax balance was accelerated if there was a failure to pay any installment on time or if there was a disposition of a specified fraction of the value of the decedent's interest in the business—although this fraction was one-third in the case of section 6166, and one-half in the case of section 6166A.

Both the Finance and the Ways and Means Committees wisely concluded that these various provisions should be simplified and coordinated to provide a single set of rules. The 1981 Act essentially achieves that result.[147]

K. *Disclaimers*

1. *In general.* The gift tax treatment of disclamers has had a long but unhappy history. Although section 2518 was added in an effort to provide certainty, it is not clear that this has been its effect as numerous interpretive difficulties have been recognized since its enactment.[148] The change in the statute which was proposed by both the Finance and Ways and Means Committees—permitting a direct transfer from the primary recipient of property, as directed by the will, to the person who would receive the property if a disclaimer were made—is likely to do little to abate the difficulties surrounding section 2518.

The rules prior to section 2518 with respect to disclaimers were relatively straightforward, even though the results varied considerably depending on local law. The context in which the issue arises is one in which the decedent leaves property to his wife, for example, and post-mortem estate planning establishes that the decedent's and his widow's total estate tax burdens would be lessened if the widow disclaims all or a portion of the bequest. Alternatively, the bequest may be to a son who disclaims since the property will pass under the decedent's will to the son's children, and the son avoids a gift or estate tax by disclaiming rather than accepting the property and transferring it to his children. In either event, under the rules as they developed prior to 1976, no gift tax liability was incurred by the disclaimant provided he did not accept any of the benefits of the property transferred and the disclaimer was effective under local law as a true disclaimer—that is, it was a refusal to accept rather than an acceptance followed by a transfer. If there was an acceptance followed by a transfer, a gift tax liability would be imposed.[149] If the recipient died between the acceptance and the transfer, an estate tax liability would be im-

147. I.R.C. § 6166 (1982).

148. *See* Frimmer, *Proposed Regs. Under Section 2518 Explain and Expand The Federal Disclaimer Statute*, 53 J. TAX'N 266 (1980); Frimmer, *Disclaimers After the Tax Reform Act of 1976; Chaos out of Disorder*, 31 S. CAL. TAX INST. 811 (1979); Frimmer, *Using Disclaimers in Post-Mortem Estate Planning: 1976 Law Leaves Unresolved Issues*, 48 J. TAX'N 322 (1978).

149. Treas. Reg. § 25.2511.1(c) (1973); Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir.), *cert. denied*, 344 U.S. 836 (1952).

posed. Thus, the result of a disclaimer depended on local law, which necessarily varied from state to state. Moreover, it can be argued that real estate could not be disclaimed in many jurisdictions since under the common law title vested immediately upon the death of the decedent in the named recipient and, therefore, he necessarily was deemed to have received the property even though he in fact enjoyed no benefit from it and transferred it as soon as could possibly be done.[150]

It was with this background that section 2518 was added by the Tax Reform Act of 1976. Rumor has it that the provision was drafted by representatives of the American Bankers Association and received comparatively little attention from either House of Congress prior to its insertion in the Tax Reform Act of 1976. Be that as it may, many interpretative problems are presented by section 2518, even though it seems relatively straightforward on its face. It provides that if any person makes a qualified disclaimer with respect to any interest in property, then the federal estate and gift taxes shall apply with respect to the interest as if the interest had never been transferred to the person making the disclaimer. A qualified disclaimer is defined as an irrevocable and unqualified refusal by a person who is left an interest in property, provided such refusal is in writing, the person has not accepted the interest or any of its benefits, and it passes without any direction on the part of the person making the disclaimer to the spouse of the decedent or to a person other than the person making the disclaimer. Finally, the disclaimer must be made no later than nine months after the later of: (1) the date on which the disclaimant attains age twenty-one or (2) the date of the transfer creating the interest in the disclaimant. Disclaimers of undivided portions of interests are permitted. A power with respect to property is treated as an interest in property.

The scholarly writing in this area has identified many difficulties with respect to section 2518.[151] One major difficulty, however, has to do with the issue of whether a disclaimer must be effective under local law. It may have been thought by the draftsmen of

150. *See generally* CRIBBET, FRITZ & JOHNSON, PROPERTY 314-15 (1960). *Cf.* 45 Fed. Reg. 48,922 (1980) (to be codified at 26 C.F.R. § 25.2518) (proposed July 22, 1980) ("A disclaimant is not considered as accepting property because under applicable local law to the property vests immediately in the disclaimant upon the death of a decedent.").

151. *See supra* note 148.

section 2518 that they had written a statute which eliminated the effects of local law and established a uniform federal rule with respect to disclaimers.

On its face, the requirement that the disclaimer be made within nine months implies that it was thought that a uniform rule was being established. On the other hand, the requirement that the interest pass without any direction on the part of the person making the disclaimer can be interpreted as requiring that the disclaimer be valid under local law. The key issue under local law, which until recently was still being litigated, is the question of whether a disclaimer of a remainder has occurred in a reasonable time where the disclaimer is not made until the remainder vests in possession rather than at the time the remainder interest is created.[152] The discussion in the House report in 1976 reflects the fact that with the enactment of section 2518, Congress intended to create a uniform federal standard so that a disclaimer would be effective for federal estate and gift tax purposes whether or not valid under local law.[153] However, section 2518 has been interpreted, probably correctly, as requiring that the prospective disclaimant be prepared to demonstrate that he meets all the requirements of federal law, including the execution and the transfer of the disclaimer within nine months of the creation of the interest (assuming he is over twenty-one), and that the disclaimer is effective as a disclaimer under local law.[154] Under this interpretation, as state law varies, there is comparatively little uniformity established by section 2518.

2. *Legislative history.* Both the Ways and Means and Finance Committees proposed to amend section 2518, although perhaps somewhat differently. The House version of the disclaimer provision ultimately prevailed. The conference report indicates

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152. Jewett v. Commissioner, 638 F.2d 93 (9th Cir. 1980), *aff'd,* 102 S.Ct. 1082 (1982)(1972 disclaimer of a remainder interest was a gift even though valid under state law—the income interest had not yet terminated—was not made within a reasonable time since disclaimant received his interest in 1939).

153. H.R. REP. No. 1380, 94th Cong., 2d Sess. 65-68 (1976).

154. *E.g.,* I.R.S. Private Letter Ruling 7951034 (Sept. 6, 1979). *But cf.* Estate of O.W. Newman, Jr., 38 T.C.M. (CCH) 898 (1979), *aff'd,* 624 F.2d 1096 (5th. Cir. 1980), *cert. denied,* 450 U.S. 998 (1981)(1974 disclaimers pursuant to § 2056(d)(2) which complied with the requirements of that section, but are nevertheless invalid under state law, are ineffective for the purpose of determining the marital deduction; Judge Tannenwald implies in his opinion that § 2518 does not require a disclaimer to be valid under state law).

that except for technical language differences the Senate version was the same as the House bill, but it appears from an examination of the Senate language added to House Joint Resolution 266 that this may not be the case.[155]

The Senate language added section 2518(c)(3), entitled "Refusals Ineffective Under State Law."[156] It provides that for purposes of the rule requiring the interest pass without any direction on the part of the person making the disclaimer, the property shall be treated as passing without any direction if three conditions are met: (1) the unqualified refusal to accept such interest must comport with the requirements applicable to the federal disclaimer rules, (2) the refusal cannot result in the passing of such interest under applicable state law, and (3) the person making such refusal transfers within the federal time limitations such interest to the person to whom the interest would have passed had the refusal been an effective disclaimer under applicable state law. Whether or not the Senate language is different from that of the Act, it still seems to require that the individual recognize that his disclaimer is ineffective prior to the expiration of the federal period for disclaiming.

3. *Problems with the change.* It does not appear that Congress has enacted a solution to ineffective disclaimers except for a few cases. The Act adds to section 2518 a new subsection (c)(3) which provides that the general rule of section 2518 applies where there is a written transfer of the transferor's entire interest in the property which meets requirements similar to the requirements that: (1) the writing be received by the estate of the decedent or the transferor of the interest within nine months of the transfer creating the interest, (2) the person has not accepted the interest or any of its benefits, and (3) the transfer is made to a person or persons who would have received the property had the transferor made a qualified disclaimer. If these conditions are met, the transfer will be treated as a valid disclaimer. Apparently the belief of the congressional committees, particularly evidenced by the Senate report, was that this provision will solve the uniformity problem presently existing with respect to section 2518. Careful analysis of the provision suggests, however, that in most cases it will not.

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155. *See* H.R.J. Res. 266, 97th Cong., 1st Sess. § 407 (1981).
156. *Id.*

It must be recognized that there was no problem under old section 2518 for those who were well informed. There is no unreasonable difficulty, if one is well advised, in making a disclaimer which is effective under local law and meets the federal requirements as well. The difficulty arises when the uninformed, with no eye on either local law or the federal statute, undertake to make a disclaimer or where a disclaimer is made with an eye on only local law or only federal law. The solution offered by new section 2518(c)(3) is another option for those who are well advised. There is little to help the uninformed.

There are two circumstances where section 2518(c)(3) will help the uninformed. One case is where proper guidance is received, albeit a bit late, but not too late. For example, assume that local law requires that an effective disclaimer be made within six months after the transfer of property takes place. Assume further that the recipient is not advised of the existence of this local requirement until seven months have passed, although he has done nothing to accept the benefits of the property. If he then makes a disclaimer, which would be timely for federal estate and gift tax purposes, he will nevertheless be deemed to have made a transfer because section 2518 will not apply. However, if his counsel at this point is familiar with new section 2518(c)(3), he can prepare an instrument which will be effective under local law, although not labeled a disclaimer, which will transfer the property directly from the disclaimant to the individual who would receive the property had an effective disclaimer been filed under local law. Section 2518(c)(3) will then apply, and no gift tax liability will be incurred by the disclaimant.

Consider, however, the more likely scenarios. Case 1: Under local law a disclaimer filed within ten months of the transfer of the interest is effective and a disclaimer is made nine and one-half months after the date of transfer. While it is fully effective under local law, it fails the time requirements of section 2518 and a gift tax liability results. Section 2518(c)(3) provides no help.

Case 2: If the disclaimant is unaware that he has six months under local law to disclaim, and after seven months his counsel prepares a document labeled "Disclaimer" which purports to disclaim his interest in the property, such an instrument would meet all the requirements of section 2518 putting new 2518(c)(3) aside, and it would appear to be effective to avoid a gift tax liability if only the federal statute is consulted. However, assume that on audit the validity of the disclaimer is questioned, and it is discovered that since the disclaimer was made seven months after the original transfer, it is ineffective under local law. Section 2518 is inapplicable; and an unnecessary gift tax liability is incurred. New section 2518(c)(3) will not provide relief in this instance. What will have been drafted is an instrument which is labeled "Disclaimer," which will read something to the effect that "I hereby disclaim all right, title and interest in the property left me by my dear Aunt Sophie, and I declare that I refuse to accept this interest or any of it's benefits." If this is the form of the instrument, it will be exceedingly difficult for a revenue agent or even for a court to characterize this document as "a written transfer of the transferor's entire interest in the property which is to a person or persons who would have received the property had the transferor made a qualified disclaimer. . . ." Would it not be better to write a statute which provides a federal rule for disclaimers, which ignores the issue of whether the property technically has been accepted and transferred under local law (as is in effect done under new section 2518(c)(3)) and which validates local law disclaimers not meeting the tests of local law?

Clearly there are states in which the law with respect to disclaimers takes a somewhat unusual form.[157] Under these laws a disclaimer which is executed after the time for making an effective disclaimer is not valid as a disclaimer, but is deemed to transfer the property to the individual who would receive the property had the disclaimer been valid. In other words, in those states, even though the document is labeled "Disclaimer" and takes the standard form for such an instrument, that document has the effect of passing the disclaimed property as if a deed of gift had been executed. It would seem that, as to transfers in such states, the new legislation would validate what would be an otherwise invalid disclaimer.

It may also be questioned whether the new section 2518(c)(3) will be of assistance in those situations where the nature of the property is such that under local law it cannot be disclaimed. In these situations, one would be in a position to execute a document

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157. *See, e.g.*, S.D. Codified Laws Ann., § 43-4-34 (Supp. 1982); Texas Prob. Code Ann., § 37A (Vernon Supp. 1978).

which would transfer one's interest to a person who would have received the property had the transferor made a qualified disclaimer. On the other hand, it may be questioned whether such a transfer meets "requirements similar to the requirements of paragraph (2) and (3) of subsection (b)," which require that a person has not accepted the interest or any of its benefits.[158] Under local law, the transferor will be deemed automatically to have received the interest and would be entitled to its benefits if he did not act to transfer them. It would seem that the transfer could only take place after they have been received as a legal, if not as a practical, matter.

CONCLUSION

Although this survey of the effect of the 1981 changes in federal estate and gift tax law may seem rather long, there are many issues raised by that legislation which remain to be explored. No doubt over the next several years some of these issues will be resolved by regulations, rulings, and court decisions. As to others, a consensus will develop among the commentators. As is the case with any complex piece of legislation, however, there will be troublesome issues which will continue to plague even the careful practitioner and will not be solved, if at all, for many years to come.

In reflecting upon this area of the law, there are two salient points which immediately come to mind—perhaps one should say—questions. First, is it necessary to have an estate and gift tax law which is so complex, especially considering the limited amount of revenue which it raises? Second, have not the 1981 amendments produced so radical a change in the application of our estate and gift taxes to the extremely wealthy—compared to those of more modest means—as to make these taxes inequitable?

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158. I.R.C. § 2518(c)(3)(A) (1982).