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I. Introduction

Professor Lawrence Zelenak's recent Article provides an excellent analysis of the relevant issues and their treatment in a tax regime in which gains and losses are recognized at gifttime and deathtime transfers.[1] I have argued for the same policy change, suggesting further the repeal of the wealth transfer tax system altogether and possibly the repeal of Section 102[2] to require the inclusion in recipients' gross income of gifts, bequests, devises, and inheritances.[3] Still further, in agreement with Professor Zelenak, I would retain the present concepts of the marital deduction, unlimited charitable deduction for deathtime transfers, and some minimum exemption that would be indexed for inflation.

II. Taxing Gains at Death

A. *Revenue Concerns*

Under present legislative rubrics, any proposed Code amendments resulting in revenue reductions must be "paid for" with other amendments. The transfer tax system is approximately a twelve billion dollar revenue gainer.[4] Revenue estimates vary on the amount that would result from taxing net gains on gifttime and deathtime transfers; assume for purposes of the present discussion that rules could be fashioned to produce more than twelve billion dollars to offset the revenue loss if the

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1. Lawrence Zelenak, *Taxing Gains at Death*, 46 Vand. L. Rev. 361 (1993).

2. 26 U.S.C. § 102 (1988).

3. Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 Tax Notes 1413 (1991). See also Robert B. Smith, *Burying the Estate Tax Without Resurrecting Its Problems*, 55 Tax Notes 1799 (1992) (recommending repeal of transfer taxes, adoption of carryover basis, and new higher income taxes); Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith*, 56 Tax Notes 951 (1992); Charles O. Galvin, *More Reasons to Bury the Estate Tax*, 59 Tax Notes 435 (1993).

4. U.S. Dep't of Comm., Bureau of the Census, *Statistical Abstract of the United States 1992* 316 (U.S. G.P.O., 112th ed. 1992).

wealth transfer tax system were eliminated.[5] Moreover, if Section 102 were repealed, the revenue gains would, of course, be substantially greater.[6]

B. *Why Eliminate the Transfer Tax System?*

I have responded in detail to this question elsewhere[7] and will only summarize some of my arguments here.

1. The target population to which the wealth transfer tax system applies is only a miniscule percentage of the total population. Treasury estimates of wealth holdings in the United States reflect that about one million people have net assets of one million dollars or more, and many members of this group can effectively avoid any serious impact of the wealth transfer tax system.[8] Even assuming that these numbers are low, is it really worth the costs of administration, collection, and enforcement to continue a transfer tax system when more effective allocations of resources could be applied to the income tax system to achieve a more fair result?

2. Even within the small target population a minimum of effort can produce opportunities for substantial transfers of wealth without tax. Indeed, estate planning has developed into a major cottage industry for tax practitioners and financial advisors, with a surfeit of literature, conferences, and seminars on the subject. A carefully devised program of lifetime giving, trusts and special powers of appointment, life insurance, payments to defray the living expenses of younger members of the family, private annuities, and a host of other arrangements offer the estate

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5. Professor Zelenak cites authority for estimated amounts representing the loss from failure to tax gains at death. The estimates range from $11.6 billion to $28 billion. Zelenak, 46 Vand. L. Rev. at 371 & n.44 (cited in note 1).

6. Joseph Pechman stated that "[t]here is little statistical information available on families who receive gifts or bequests and therefore no reliable basis upon which to allocate either the assets transferred or the [transfer] taxes collected." Joseph A. Pechman, *Who Paid the Taxes, 1966-85?* 16 (Brookings Inst., 1985). Earlier estimates indicated that repeal of §102 would add approximately 3% of adjusted gross income to the taxable base. Commission to Revise the Tax Structure, *Reforming the Federal Tax Structure* 154 (Fund for Public Policy Research, 1973). Assuming that adjusted gross income is between $3 and $4 trillion, the addition of 3% would produce $90-$120 billion, which taxed at an average rate of 20% would produce $18-$24 billion in revenue. See generally Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

7. Galvin, 52 Tax Notes 1413 (cited in note 3); Galvin, 56 Tax Notes 951 (cited in note 3); Galvin, 59 Tax Notes 435 (cited in note 3).

8. Treasury estimates reflect that in 1986 about 3.3 million people had gross assets of $500,000 or more, of which about 1.5 million people had net assets of $500,000 to $1 million. Less than 1 million had net assets of $1 million or more. Marvin Schwartz and Barry Johnson, *Estimates of Personal Wealth, 1986*, 9 SOI Bulletin No. 4 at 71 (U.S. Dep't of the Treasury, 1990); U.S. Dep't of Comm. at 464 (cited in note 4). As any student of basic estate tax is aware, a married couple with $1.2 million in net assets can avoid transfer taxes altogether.

owner numerous options for tax avoidance. Indeed, one is tempted to conjecture, perhaps with some cynicism, that support for the wealth transfer tax system comes principally from the legions of advisors and practitioners who assist in its avoidance.[9]

3. Among those within the target population, significant differences in tax consequences can exist between people in similar economic circumstances; horizontal and vertical equity are lacking. Thus, X may enjoy an appreciation in value of his portfolio, die, and leave a stepped-up basis for his heirs.[10] Y, on the other hand, may be required by market forces to convert his portfolio before death, pay the capital gains tax, and then have his estate taxed again on the remaining accumulation. Some argue that the estate tax pays for the step up in basis for X; thus, the tax acts as a kind of toll charge to effect the step up. Y's estate may pay approximately the same toll charge, however, but without the step-up advantage because the cost basis and fair market values of Y's portfolio at his death are roughly equal.[11]

Consider another example: the couple who leave their estate to an only child as contrasted with the childless couple who divide their estate among nieces and nephews in straitened financial circumstances. Each may pay the same estate tax but the amounts received by the beneficiaries in relation to their respective personal economic conditions may be quite different.[12]

4. If the wealth transfer tax system continues, it will, of course, contain the important component of the generation skipping transfer (GST) tax.[13] Just as the gift tax was enacted as a backstop to the estate tax, so the GST tax generally attempts to ensure the taxation of wealth transfers at least once a generation. The tax first appeared in the 1976 Act but was such a Rube Goldberg invention that Congress scrapped it in 1986 and enacted the present "simplified" version. I believe that the administrative problems inherent in the GST system will in time become impossible to handle. Thus, a trust arrangement entered into today may permit discretionary distributions of income to grandchildren

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9. See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 Colum. L. Rev. 161 (1977); Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 Syracuse L. Rev. 1215 (1984).

10. 26 U.S.C. § 1014 (1988).

11. The capital gains tax may reduce Y's estate, yet the remainder of the estate could he subject to estate taxes as high as 55%. See ABA Section of Taxation, Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, 41 Tax Lawyer 395 (1988), which suggested that unrealized appreciation be taxed 14 percentage points higher than a top 50% rate. Id. at 446. The Report suggested alternatively that the estate tax on the non-appreciated assets could be allowed a credit of 10 percentage points. Id.

12. See Pechman, *Who Paid the Taxes, 1966-85?* at 16 (cited in note 6).

13. 26 U.S.C. ch. 13 (1988).

with the ultimate termination to grandchildren or great-grandchildren. For GST purposes the taxable distributions and taxable termination may take place many years from now.[14] What kind of audit trail or tickler file will the IRS maintain to ensure that an individual trustee or successor trustee will follow the technical requirements of the original document?[15] In large metropolitan areas the sophisticated trust officer may be relied on to keep records for many years, but what about trustees who are relatives, business associates, or family members, and their successors? And what about banks in smaller communities with one or two trust officers? It seems unlikely that the GST tax is going to work in an even-handed way.

5. The transfer tax system often is touted as having the social engineering objective of breaking up concentrated accumulations of wealth. There is doubt that a transfer tax accomplishes this goal; moreover, a well-designed comprehensive income tax would better accomplish the objective.[16]

C. Policy Considerations for an Accretion System: Taxing Gains at Gift or Death and Repealing Section 102

A comprehensive income tax is one in which all income is taxed, all income is taxed to those who earn it, and all income is taxed when it is earned. Such a comprehensive system would provide maximum fairness and equity and would be in accordance with recognized Haig-Simons principles.[17] This system would require taxpayers to conform as nearly as possible to accrual accounting and to mark-to-market assets each

14. 26 U.S.C. §§ 2612, 2621, 2622 (1988).

15. Thus, suppose that G creates a living trust for his married daughter for life, then to her children for life, with remainders over to G's great-grandchildren. G files a gift tax return in 1993. G selects his business associate as trustee, and names his daughter's oldest child as successor trustee and a corporate fiduciary as ultimate successor. Taxable distributions and the final taxable termination may be many years in the future. Assuming that annual income tax returns are filed for the trust and the beneficiaries, will such taxable distributions be recognized for GST purposes?

16. As one commentator has noted, "Of all major taxes in developed countries, only income taxes significantly promote progressivity by taxing those with higher incomes at higher rates. Estate and inheritance taxes, as well as wealth taxes that exist in some countries, might be argued to be more progressive in theory, but nowhere have these taxes raised more than a tiny proportion of total revenues." Gene Steuerle, *Progressive Income Taxation: A Liberal or Conservative Instrument of Policy?*, 52 Tax Notes 113, 113 (1991). During the 1980s the incomes of those in the top 1% of the income distribution grew by 75%; the top 5%, by 45%; the top 20%, by 30%; the lowest 20% declined by 4%. In 1980 the average real income of the top 1% was 61 times the poorest 10%; in 1990 the income of the top 1% was 117 times the poorest 10%. Joint Economic Comm., 1991 Economic Report of the President, S. Rep. No. 27, 102d Cong., 1st Sess. 13 (1991).

17. Henry C. Simons, *Personal Income Taxation* 61-62 (U. of Chicago, 1938); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *The Federal Income Tax* (Columbia U., 1921).

year,[18] probably above some minimum threshold amount.[19] In such a regime, gains and losses would be recognized annually so that the issue of gifttime and deathtime recognition of gain or loss would become far less significant. By similar reasoning Section 102 should be repealed. Just as one hundred dollars of recognized gain enriches the wealth of a taxpayer, so also does the receipt of a gift or inheritance of one hundred dollars; the two transactions should be treated in the same way.[20] These policy changes would at first glance seem difficult to sell to a public already wary of tax proposals. The opportunities for a broad base with a very low flat rate or low graduated rates are so significant, however, that the changes are not only logically defensible in an accretion system but can be made politically palatable.

D. *Practical Considerations*

Assume that mandatory accrual accounting or a mark-to-market system are some years away, but let us adopt Professor Zelenak's recommendations and my additional suggestions for the repeal of Section 102 and the wealth transfer tax system. In this connection Professor Zelenak has dealt effectively with issues of administration —determination of basis and value, grandfathering, the marital exemption, life insurance, income in respect of decedents, inter vivos trusts, and other problem areas. I address here only the issue of a basic exemption, because such an exemption can create important parameters that will simplify compliance and administration.

Suppose that gains and losses are recognized at gift or at death, and suppose further that, in accordance generally with Professor Zelenak's suggestion, $600,000 worth of assets may "pass through" during life or death with non-recognition to the transferor or transferee. In this regime, in the case of a decedent's estate, the estate representatives would value the net assets as they do under present rules with a corresponding basis step-up.

Example 1: The estate has various assets with a basis of $400,000 and a value of $500,000 with debts and claims of $200,000, or a net estate of $300,000. Neither the decedent nor the transferees would recognize gain or loss. The transferees would take a basis of $500,000 in the assets received, subject to debts of $200,000.

18. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation,* 134 U. Pa. L. Rev. 1111, 1118-19 (1986); Thomas L. Evans, *The Evolution of Federal Income Tax Accounting—A Growing Trend Towards Mark-to-Market*, 67 Taxes 824, 825 (1989).

19. See Charles O. Galvin, *Tax Legislation in the Reagan Era—Movement to or from a Consumption Base?*, 48 L. & Contemp. Probs. 31 (Autumn 1985) (suggesting a threshold of $250,000 for consumer durables and $100,000 for other investments).

20. Dodge, 91 Harv. L. Rev. at 1184 (cited in note 6).

Example 2: The estate has various assets with a basis of $400,000 and a value of $700,000 with debts and claims of $600,000, or a net estate of $100,000. Neither the decedent nor the transferees would recognize gain or loss. If the debts are paid, the transferees would receive assets with a basis of $100,000.

Example 3: The estate has various assets with a basis of $400,000 and a value of $700,000 with debts and claims of $40,000, or a net estate of $660,000. The estate representatives would recognize gain in the decedent's last income tax return of $60,000, and establish a basis of $700,000. Assume that the representatives pay off the debts and transfer $660,000 to the estate beneficiaries. The beneficiaries would report $60,000 of income and claim a basis in the assets received of $660,000.

I believe that the treatment discussed above is eminently fair in an accretion-type income tax system. Nor am I concerned about generation skipping. In Example 3, whether Grandparent leaves the net $660,000 to grandchildren or great-grandchildren, the results to the transferor's estate and to the transferees should be the same. In the case of lifetime gifts, the above examples would apply; further, some minimum annual exclusion—perhaps $10,000—would seem appropriate in addition to the $600,000 non-recognition threshold.

I have used a non-recognition pass through of $600,000, whether used during life or at death or partially during life and at death, and a gifttime annual exclusion of $10,000, because these are thresholds presently used in estate planning. The number of taxpayers affected by these thresholds would be manageable—probably between one million and two million filers in any taxable year.[21] Quite obviously, if the transfer tax system were eliminated, if gifttime and deathtime transfers triggered gain or loss recognition above the threshold, and if Section 102 were repealed for amounts in excess of the threshold, these changes would require a whole new set of revenue projections, which might result in different thresholds. It is fair to assume nonetheless that the net revenue gains would be significant.

E. *Policy Considerations for a Consumed Income System*

There is a growing interest in substituting a consumed income—or cash flow—tax for the present accretion system.[22] Broadly stated, tax-

21. Internal Revenue Service statistics give some idea of the numbers involved. Estate tax returns reporting gross estates in excess of $600,000 filed in 1988 numbered 90,949; in 1989, 45,695; and in 1990, 50,367. Of the 50,367 returns filed in 1990, only 23,104, or about 46%, reported an estate tax after credits in the aggregate amount of about $9 billion.

22. See Charles O. Galvin, *What Lies Ahead? Speculations on Tax Reform for the Twenty First Century*, The Vanderbilt Lawyer 4 (Spring 1993); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Comsumption Tax*, 70 Tex L. Rev. 1145 (1992); David F. Bradford and the U.S.

payers in such a system would include in income all receipts, and would deduct all investments placed in a qualified account. The qualified account would shelter not only the investments placed in it but all income accruing to those investments, functioning as an unlimited IRA. As funds are removed from the qualified account for consumption, they would be subject to tax; a transfer of wealth out of the qualified account at gifttime or deathtime would be treated as an exercise of consumption choice by the transferor. The transferee would treat the gift or bequest as taxable income, subject, of course, to the right of the transferee to obtain an offsetting deduction by placing the property received in the transferee's qualified account.

Thus, for example, if Dad gives or bequeaths to Daughter one million dollars in stock held in Dad's qualified account, Dad's income tax base in the year of gift or death would reflect one million dollars in consumed income. To avoid bunching of the income in one year, Dad or Dad's estate would be entitled to some form of averaging. Daughter would include in her income the amount received, which she could offset by a deduction for whatever portion of the stock Daughter places in her qualified account.

The problems of compliance and administration would seem to be no greater than those under an accretion system.

III. Conclusion

Professor Zelenak has contributed significantly to the ongoing discussion concerning gain or loss recognition at gifttime or deathtime. A critical analysis and reassessment of either a desirable accretion system, a consumed income system, or some hybrid of both should move lawmakers to serious consideration of Professor Zelenak's proposal. There is reason to hope that discussion of the issues will continue.

Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 8, 101 (Tax Analysts, 2d ed. 1984); Alvin Warren, Jr., *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L. J. 1081 (1980); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113 (1974).