3-17-2014

Revitalizing the Estate Tax: 5 Easy Pieces

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donations to those types of charities. They may not be, but that’s a different question from talking about harm to the sector in general or harm to the poor from those proposals.

More ambitiously, we should grant larger tax benefits to contributions to organizations that provide basic needs to the poor. You want to help education? Let’s provide more incentives for donations to a tutoring program in a low-income area than we do for donations to your kid’s school (which you would probably do anyway). To that end, I propose that donations to organizations that provide basic services to the poor be treated more generously for tax purposes than other donations. Let’s say that you donate $100 to a soup kitchen. If the deduction remains a deduction, perhaps you are treated as if you had donated $200 (thus triggering a government subsidy of $80 instead of $40). If an AGI floor is implemented, perhaps those contributions are not subject to the floor. If the deduction is changed to a credit of, say, 15 percent, maybe you would receive a 30 percent credit for those types of donations.

By emphasizing donations to organizations helping the neediest, we’d be putting our money where our mouths are when it comes to charitable giving. We routinely use charity for the poor not only as a justification for continuing the tax status quo but also to excuse less government aid to the poor. For example, the bipartisan letter to Baucus argued that if the deduction were reformed, “the government would be required to step in and fund those services now being provided through private generosity. Accordingly, preserving the charitable deduction is also prudent as a matter of broad fiscal policy.”12 There are very valid reasons for wanting charity to do more, and government less, when helping the poor. Quite often, charities can find more efficient, more responsive, and more creative ways of assisting the poor than the government can. So let’s structure the tax incentives for charitable giving to reflect these values. Perhaps it’s an area in which Republicans and Democrats can find common ground.

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12 See supra note 5.
one accounts for the amount of charitable contributions made and taxes paid by the estate. In 2006, for example, the largest estates (those with gross values exceeding $20 million) on average paid taxes equal to 15.57 percent and made charitable contributions of 17.83 percent of their gross value. In other words, one-third of the assets of the largest estates were transferred outside the family. We also showed that there are strong arguments that the estate tax gap is much lower (10 to 13 percent) than is commonly assumed because of the personal liability that can be imposed on the executor and the historically high audit rate for estates. We concluded that only when we have an accurate view of the role that the estate tax currently plays can we make sensible decisions in charting its future.4

In another article,5 we documented the dramatic increase in income and wealth inequality over the past 30 years and the accompanying adverse social consequences and long-term negative effect on economic growth. We argued that tax policy historically has played an important role in reducing inequality and that the estate tax is a particularly apt reform vehicle in light of the role of inherited assets among the very rich and the adverse economic effects of that inherited wealth. We updated our earlier work showing that the estate tax plays a significant role in breaking up concentrations of wealth, with fewer adverse effects on taxpayer behavior than the income tax.

In this article, we advance five estate and gift tax reform proposals that would generate needed revenue, reduce inequality, and contribute to economic growth: (1) disallow minority discounts when the transferred asset or business is controlled by family before and after the transfer; (2) maintain parity between the unified credit exemption amounts for estate and gift taxes; (3) reduce the wealth transfer tax exemptions to $3.5 million, increase the maximum tax rate to 45 percent, and limit the generation-skipping transfer tax (GSST) exemption period to 50 years; (4) restrict the ability for gifts made in trust to qualify for the gift tax annual exclusion; and (5) impose a lifetime cap on the amount that can be contributed to a grantor retained annuity trust (GRAT).

These five estate tax reform proposals are for the most part not new. Most have been advanced in various forms in the past by the American Bar Association, the American College of Trust and Estate Counsel, and commentators, and many have been embraced by President Obama in prior budget proposals. We offer our thoughts on the proposals here in the hope that they will help promote these much-needed reforms.

Proposal 1: Disallow minority discounts when the transferred entity or asset is controlled before and after the transfer by the transferor, or the transferor’s spouse, ancestors, or lineal descendants. Minority discounts have troubled policymakers and academics for decades. Planning with minority discounts usually involves using a series of transfers to divide up a taxpayer’s control of an asset, such as a business or real estate, in order to reduce the asset’s value for purposes of the wealth transfer taxes. Division of control reduces the asset’s value because it impairs the transferees’ ability to direct the use of the asset for more profitable pursuits. For a business, loss of control also increases the intrinsic risk associated with the business and reduces the opportunities to engage in favorable transactions, such as employment, with it.7 As a result, eliminating control regarding portions of a business transferred by the taxpayer can result in significant discounts below what the value would have been if control had been included.8


7See Fellows and Painter, supra note 6, at 903-904; and Repetti, supra note 6, at 425-426.

It is difficult to quantify the amounts of the minority discounts involved. Ted D. Englebrecht, Mary M. Anderson, (Footnote continued on next page.)
The difficult issue regarding minority discounts, however, is that in most instances, the control premium has probably not been destroyed. Rather, through careful selection of the transferees, the taxpayer can create a situation in which the transferees will be able to reestablish control. That is, transferees can work together to restore the value that “disappeared” when ownership was divided. As discussed below, it would not make economic sense to destroy the control premium because every dollar of premium destroyed saves only 40 cents in taxes.

The process for eliminating the control premium in gifts and bequests can occur in many contexts, but it usually entails one of the two following scenarios, or a blend thereof, involving a series of transfers of minority interests to: (1) the same individual over a period of years; or (2) several different individuals in the same year or over a period of years. For example, in scenario 1, the taxpayer may make a series of transfers of minority blocks of stock in her controlled corporation to her child over a period of years so that her child will have obtained control of the corporation after all the transfers. Because our transfer tax system ignores the identities of the transferee and transferor, each transfer is valued separately, with the result that the gifts would not include the control premium that had been divided up among the transferees. A variation of scenarios 1 and 2 might involve transferring a valuable asset to a limited liability company or family limited partnership and then making transfers (gifts and bequests) of minority member interests in the LLC or FLP to the same transferee over a period of years, or making gifts to several different individuals in the same year.

It is easy to see that the control premium has been transferred in scenario 1 because a single individual ends up controlling the asset. There has also been a transfer in scenario 2 but of a different type. Scenario 2 represents the transformation of a portion of the value formerly associated with control into an option or opportunity for the donees to re-create that value. To do so, however, they must agree about managing the transferred entity or asset. Game theory suggests that if the minority owners are members of a family, they have a higher probability of reaching such an agreement than non-family members:

Family members have an advantage in forming coalitions because group members are more likely to make credible promises when they have a history of dealing with one another and are likely to continue to do so in the future. Repeated contact allows the creation of credible commitments because non-exploiters are able to retaliate in the future against a person who breaks the commitment. Some commentators have asserted that homogeneity in preferences is another factor likely to result in a stable coalition. Because of shared experiences, family members probably are more likely to have similar preferences.

Similarly, John F. Coverdale recently explained:

In most cases, family members do not behave like unrelated third parties. . . . A student of marriage and family has suggested four reasons for this: first, the threat of expulsion from the family network or of lessened esteem

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and Otto Martinson found that the mean discounts allowed by the Tax Court during the 1993-2002 period were 25.35 percent for marketability and 14.82 percent for lack of control discounts. Engelbrecht et al., “An Empirical Investigation of the Minority Interest and Marketability Discounts in Valuation of Closely Held Stock for Estate and Gift Tax Purposes,” 22 J. Applied Bus. Res. 89, 99 (2006). Although in theory the marketability discount should be unaffected by the size of the minority interest, some courts have stated that the amount of control affects the marketability discount and have allowed larger discounts for smaller minority interests. See John A. Bogdanski, Federal Tax Valuation, para. 4.04 (2013). This makes it difficult to quantify the size of an aggregate discount attributable to a taxpayer being a minority stakeholder. In an examination of 1998 returns, Barry Johnson, Jacob Mikow, and Martha Britton Eller found that on average, combined marketability and minority discounts of 29.8 percent were claimed for minority interests in stock and 36.3 percent for limited partner interests. Johnson et al., “Elements of Federal Estate Taxation,” William G. Gale et al. eds., Rethinking Estate and Gift Taxation 113 (2001). Some have argued that an examination of premiums paid in acquisitions in which control was acquired implies a minority discount of 30 percent for large corporations. American Business Appraisers LLP, “Why Do We Take a Minority Discount?” available at http://www.absap.com/articles/minority_discount.html. For an analysis of the factors that should affect the determination of minority discounts, see Aswath Damodaran, “The Value of Control: Implications for Control Premiums, Minority Discounts and Voting Shares Differentials,” 8 N.Y.U. J. L. & Bus. 487 (2012).

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10Scenario 2 involves making gifts to several individuals, rather than a bequest, because a minority discount is unavailable if the taxpayer’s gross estate holds a controlling interest, even though the taxpayer may be bequeathing portions of the asset to several individuals. This dichotomy between the estate and gift taxes is discussed in greater detail in Repetti, supra note 6, at 419-422.

11Repetti, id., at 417.

12Id. at 465-466 (citations omitted).
within that network deters non-cooperation; second, information about other family members reduces transaction costs; third, background social norms favor family cooperation; and fourth, humans have evolved to behave altruistically toward family.12

Given the continuing relationship among family members, a taxpayer can construct transfers so that control will not be destroyed. Indeed, there is no economic incentive to destroy value.13 Every dollar of control premium that is destroyed saves only 40 cents in taxes. Consider, for example, a parent who transfers a family business to two children, giving each child an equal right to control the business. The sum of the values of the children’s interests in the business under current valuation methods is less than the value that the business had when owned entirely by the parent. This reduction in value reflects that neither child can implement her plans for the business unilaterally. If one child wishes to sell the business, but the other does not, the former will be unable to maximize profit from the sale because a third-party buyer will have to negotiate control with the latter. If the value of the business is discounted by $100, the donor saves $40 in gift tax because the tax applies to the value of the property transferred to each donee. If this diminution in value is irreparable, the children have lost $100, with the result that the family’s wealth has decreased by a net of $60 ($100 reduction in value less $40 in tax savings). Suppose, however, that the children can restore $100 of value by incurring $10 of after-tax transaction costs to negotiate an agreement to sell the business to a third party together. If they do so, they will enjoy a net increase in value while the donor will have saved $40 in taxes. As long as the children can incur less than $40 of costs to restore value, there will be a net savings to the family as a whole.14

Presumably, if a parent divides up control, he expects that the children will reach an agreement. If dividing up control were to destroy the control premium, the parent would have better alternatives. He could maximize after-tax wealth for his children by selling the business as a whole and making gifts of the cash proceeds more than three years before his death. Alternatively, if the business has a low income tax basis, he could hold the business until death and direct the estate to sell it as a whole after his death in order to take advantage of the step-up in basis.

There have been several thoughtful proposals to eliminate minority discounts. Many have focused on the use of entities such as LLCs and FLPs to achieve minority discounts and have sought to set liquidation value as the floor for valuation. For example, Wendy C. Gerzog has suggested that the discount involving LLCs or FLPs be disregarded if the entity does not engage in a trade or business, and that the entity’s assets should be valued at their net value without minority discounts.15 William S. Blatt has recommended that a business entity transferred to family members not be given a value lower than its liquidation value.16 In a different approach, Walter D. Schwidetzky has recommended that section 2035 be amended to include in a taxpayer’s gross estate the taxpayer’s transfers of assets to FLPs and transfers of FLPs to family members within three years of death.17 We disagree with these approaches because they would still permit low valuations in many situations. Gerzog’s approach would still allow minority discounts for family-controlled businesses. Blatt’s liquidation value approach would permit active businesses to be valued at less than their likely going concern value because liquidation values are often less than going concern values. Schwidetzky’s approach would apply only to transfers made within three years of death.

Another approach is to deny a minority discount if the transferor controlled the entity before the transfer — either outright or as the result of attribution. Alan Feld has proposed a rebuttable presumption that the control premium is included in the transfer of a minority interest by a taxpayer who controls the entity.18 Ronald H. Jensen has recommended that minority discounts be “disallowed if the taxpayer’s primary purpose for using the entity to make his gratuitous transfers is to qualify the transfers for a valuation discount.”19 The difficulty with these thoughtful suggestions is that they are administratively burdensome.20 Feld’s approach would compel the courts, the IRS, and taxpayers to explore the transferee’s relationship to the other owners and the relationship among the other owners in order to determine

12Coverdale, supra note 6, at 258-259 (citations omitted).
13Dodge, supra note 6, at 254, n.54 (“of course, in many of these cases, the economic loss attributable to the creation of minority interests is probably illusory, or else the transaction would not have been undertaken in the first place”).
14For a more detailed exploration of this phenomenon, see Repetti, supra note 6, at 417-418.
15Gerzog, supra note 6.
16Blatt, supra note 6, at 263-264.
17Schwidetzky, supra note 6, at 38-41.
18Feld, supra note 6, at 945. The taxpayer could rebut the presumption by showing that the transferee will not be included in the control group. Id.
19Jensen, supra note 6, at 203-204.
20Repetti, supra note 6, at 474, 481-482.
whether the presumption that the transferee would participate in control can be rebutted. Under Jensen’s suggestion, the courts would have to undertake a similar inquiry to discern the taxpayer’s purpose for the transfers. Because the courts do not examine the relationship of the transferee to the other owners, this determination would increase the quantity of analysis required for both the estate tax and gift tax.21

Mary L. Fellows and William H. Painter have proposed that “any gratuitous transfer of shares from a donor who originally owned a controlling interest in a corporation shall be valued as if they were part of the controlling block.”22 This proposal would deny a minority discount if the taxpayer held control, regardless of who the transferees are.23 While this approach would not require the types of inquiries that the rebuttable presumption and purpose approaches discussed above would, we think that the approach is too broad because it would apply in situations in which it is unlikely that control has been transferred — for example, when a controlling shareholder makes transfers to non-family members.

Lastly, one of us previously proposed that a minority discount should be denied when the transferor and his family members control the entity both before and after the transfer.24 This proposal is similar to the approach adopted earlier by the IRS in Rev. Rul. 81-253, 1981-2 C.B. 187,25 and to a 1987 proposal by the House Budget Committee.26 The advantage of this approach is that it applies to situations in which it is most likely that control has been transferred because the transferees are family members. Also, this approach is not as administratively burdensome as the rebuttable presumption or purpose approach because the transferor’s intent and the degree of hostility among the transferees would be irrelevant.27

We believe that control is most likely transferred when the transferor, her spouse, their ancestors, or their lineal descendants control the entity both before and after the transfer. This is the same sort of attribution rule that Congress adopted in section 2701(a) for distribution rights.28 Section 2701 in effect creates an irrebuttable presumption that family members in a controlled entity will work together to enhance the value of gifts of common stock in an estate freeze by not paying dividends on preferred stock retained by the transferor.29 This approach should be extended to minority discounts because the same motivation for family members who are closely related to each other to work together exists in the context of minority discounts as in estate freezes. We reject the argument that this approach is inappropriate because it would not distinguish situations in which the transfer of control was unlikely, for example, because of hostility among owners. For reasons discussed earlier, it is very unlikely that a transferor would destroy value by dividing up control of an asset among family members who cannot work together. As a result, the instances in which the irrebuttable presumption would be overinclusive are few.

Proposal 2: Maintain parity between the unified credit exemption amounts for the estate and gift taxes. Obama’s wealth transfer tax proposals include reducing the unified credit exemption equivalent amount to $3.5 million for estates and $1 million for gifts, and increasing the maximum tax rate to 45 percent.30 The proposals also limit the GSTT exemption to generation-skipping transfers (GSTs) that occur within 90 years of the initial transfer to which the exemption was allocated. As discussed below, we agree with some of these recommendations and propose changes for others. In this section, we explain why we believe it is important that the unified credit amount be the same for both the estate tax and gift tax. In the next section, we address the desirability of reducing the exemption amounts to $3.5 million, increasing the maximum rate to 45 percent, and limiting the period for which the GSTT exemption may be used.

21Id.
22Fellows and Painter, supra note 6, at 923. Dodge also has endorsed this approach. Dodge, supra note 6, at 255-256.
23Treasury adopted this approach. Treasury, supra note 6, at 386-387.
24Repetti, supra note 6, at 481.
26H.R. Rep. No. 100-391, at 1043 (1987). The House Budget Committee proposed language stating that the value of stock is “deemed to be equal to its pro rata share of all the stock of the same class in such corporation, unless a different value is established by clear and convincing evidence” (emphasis added). The committee report explained:
In determining whether a different value can be established under the clear and convincing evidence standard, all stock held, directly or indirectly, by an individual or by members of such individual’s family is treated as held by one person. Thus, a minority discount will not be appropriate for transfers between family members unless all the stock held by that person or the person’s family would qualify for the discount. [Emphasis added.]
27Repetti, supra note 6, at 474, 481-482.
28These are rights to distributions from a corporation regarding its stock or from a partnership regarding a partnership interest. Section 2701(c)(1).
29See Repetti, supra note 6, at 437-438.
We disagree with the president’s proposal that the unified credit exclusion for the gift tax ($1 million) should be lower than the exclusion for the estate tax ($3.5 million). A little background may be helpful to understand our concern. The federal estate and gift tax exclusion amounts had been identical for almost 25 years before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In EGTRRA, Congress caused the estate tax exclusion to exceed the gift tax exclusion beginning in 2004. In 2010 the exclusion amounts were once again the same under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

The justification for the different credit levels in EGTRRA was that a less generous exclusion amount for gifts was needed to protect the income tax base. But as the ABA noted, this justification was never supported beyond mere speculation. At the same time, the less favorable treatment of gifts arising from gifts versus bequests, the code has potentially created several problems. The ABA observed:

No sound reason exists to severely penalize individuals who wish to give away assets during life. Anecdotal evidence from practice indicates that the considerably less generous credit under the gift tax prevented parents from making lifetime transfers to children as a result of the effective tax penalty on the value of cumulative transfers falling between the two credit levels. Rather than imposing a penalty on gratuitous transfers made during life, we believe that, from the public policy perspectives of encouraging generosity among family members and promoting the free transferability of capital, lifetime transfers are to be encouraged. As a practical matter, lifetime gifts shift property to individuals who are more likely to put the property to productive economic use. The re-unification of the gift and estate tax unified credits achieved by the 2010 legislation therefore represents a salutary return to a significant and important prior policy.

Perhaps because of the potential social benefits arising from gifts versus bequests, the code has historically contained provisions that encourage gifts over bequests. The gift tax is tax exclusive, while the estate tax is tax inclusive, with the result that the tax liability associated with gifts is lower than for bequests. Moreover, the annual exclusion enables donors to transfer significant amounts as gifts tax free. It would be counterproductive to retain these provisions and then adopt a credit exclusion for gifts that is lower than the credit for estates, and that would have the effect of discouraging gifts. Consequently, we recommend that the exclusion amounts for the gift tax and estate tax be the same.

Proposal 3: Return to the $3.5 million exemption, increase the maximum rate to 45 percent, and limit the GSTT exemption to transfers occurring within 50 years. As mentioned above, we agree


It seems reasonable to believe that the rich — that is to say, people who have sufficient disposable wealth to be concerned about the transfer taxes — are relatively risk-averse when it comes to their excess capital. This assumption may seem counter-intuitive at first, because one might expect the average person to take the greatest chances with money that he does not need. But risk-taking is for most mortals the necessary counterpart of higher rates of return, and it is the rich who presumably are least concerned with the growth of their disposable wealth. We may expect the rich to take fewer risks simply because they are least dissatisfied with the rate of return on low-risk investments.

If this intuition about the wealthy is correct, it should follow that the dispersion of their wealth through gratuitous transfers will place capital in the hands of people more willing to take chances. In the case of closely held businesses, for example, we associate an intergenerational turnover of management with innovation and provide some income tax incentives to speed up the changing of the guard. Seen in this light, the transfer tax preference for inter vivos gifts may have welfare benefits, as it can nudge wealth out of the hands of aging owners and into the possession of younger, more productive entrepreneurs. [Citations omitted.]

“Hearings on Tax Reform Before the House Comm. on Ways and Means,” 91st Cong., 1st Sess. 3992 (1969) (testimony of George Craven); Id. at 4005 (testimony of Robert F. Spindell).

One countervailing influence is that there is a carryover income tax basis for gifts, while bequests receive a step-up in basis. We believe that this may affect the assets that taxpayers select for inter vivos gifts but that it does not significantly reduce the amount of those gifts.

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with the president's proposal to return the unified credit exemption amount to $3.5 million. The very generous $5 million unified credit exemption for gifts and bequests and the $5 million GSTT exemption (both of which, adjusted for inflation, are $5.34 million in 2014) permit large amounts of money to escape transfer taxation. This results in a significant loss of revenue and contributes to the concentration of wealth.

To see how these exemptions interact to pass along large concentrations of untaxed wealth, consider that a taxpayer can transfer $5.34 million as either a gift or a bequest to a dynasty trust (a trust that is not subject to the rule against perpetuities) that will make payments to the taxpayer's descendants without incurring any transfer tax. That is, neither the transfer within the trust nor the trust's transfers to beneficiaries will ever be subject to the GSTT, estate tax, or gift tax. Assuming a 6 percent rate of capital appreciation and that only trust income (not capital) is distributed annually to beneficiaries, the $5.34 million transferred into a dynasty trust would grow to $98 million in 50 years, $1.01 billion in 90 years, and $1.8 billion in 100 years. As discussed elsewhere, the concentration of this type of wealth in families contributes to many social harms and conflicts with the policy rationales for imposing transfer taxes.

When the GSTT was adopted in 1986, the exemption amount was only $1 million, and the rule against perpetuities prevented the creation of dynasty trusts in most states. In contrast, it is reported that by early 2013, 29 states and the District of Columbia had repealed provisions that permit dynasty trusts. It is likely that the GSTT exemption has played a significant role in the drive for states to permit dynasty trusts. In hearings that preceded the enactment of the GSTT in 1986, Raymond Young, the chair of the GST Tax Subcommittee of the Boston Bar Association, testified before Congress that the exemption would result in a marketing blitz by banks and trust companies:

We are obliged to point out...that if [the 1986 GSTT exemption] is adopted...it will be an inducement to generation skipping. You will have more generation skipping than you ever had under pre-1976 law, and there will be a greater erosion of the tax base, because you will have the banks, lawyers, financial planners, and all others saying, here you are, this is a specially created opportunity for you. Congress has said you can take $1 million, put it aside, no generation-skipping tax.

The purpose of the GST, estate, and gift taxes is to impose a transfer tax on the passage of wealth from one generation to the next. Yet the existence of dynasty trusts, in combination with the generous GST, estate, and gift tax exemptions, permits large amounts of assets to be passed from one generation to another without a transfer tax being incurred. This was probably never contemplated by Congress when the GSTT exemption was adopted, because lawmakers would have reasonably believed that the rule against perpetuities would prevent the GSTT exemption from being applied forever. Indeed, Congress has previously exhibited a dislike for transfers that avoided the rule against perpetuities in order to escape from transfer tax. In 1951 Congress adopted section 2041(a)(3) to prevent taxpayers from creating successive powers of appointment that would avoid application of the rule against perpetuities and, therefore, would not result in a taxable transfer. The legislative history to section 2041(a)(3) states:


In at least one State a succession of powers of appointment, general or limited, may be created and exercised over an indefinite period without violating the rule against perpetuities. In the absence of some special provision in the statute, property could be handed down from generation to generation without ever being subject to estate tax.47

Given that the generous exclusion amounts for the GST, estate, and gift taxes, combined with the lack of a time limit for the GSTT exemption, conflict with the policy rationale for those taxes, we recommend two changes. First, we would reduce the GST, estate, and gift tax exclusion amounts to $3.5 million and limit the GSTT exemption to a specific period.

There are several possible approaches for determining the limitation period. The president’s proposal recommends that the GSTT exemption be limited to 90 years.48 The administration presumably proposes this period because it approximates the period for the rule against perpetuities. We think that a better approach is to limit the GSTT exemption to a period that approximates the span of two generations. This would mean that in the most extreme situation — in which a transferor makes a transfer in trust before he has any children — the exemption would still be available to benefit the transferor’s grandchildren. The current statutory scheme for the GSTT assumes that the period for two generations is 37.5 years.49 Data suggest, however, that grandchildren are born, on average, 50 years after the birth of the grandparent.50 We think that the estimated two-generation period should reflect those data. Consequently, we recommend that the exemption terminate 50 years after the initial transfer in trust to which the exemption is allocated.

We also agree with the president’s proposal to increase the maximum rate to 45 percent. As we recently discussed, the estate tax is an effective tool for reducing wealth concentration.51 This is beneficial because there is significant evidence that wealth concentration is harmful to society.52 Yet as a result of declining rates and increased exemptions, the role of wealth transfer taxes in reducing wealth concentration has decreased. The top marginal estate tax rate in the United States was 70 percent or above during most of the post-World War II period through 1981.53 Beginning in 1981, rates began to decrease. As a result of those decreases, the estate tax collected was about 0.6 percent of GDP in the 1960s and only 0.25 percent of GDP in 2004, according to calculations by Thomas Piketty and Emmanuel Saez.54 They observe that the decline in the amounts collected has contributed significantly to the general decline of progressivity in the U.S. tax system.55

The greatest potential harm from taxing gifts and estates is that it may discourage saving.56 However, there are strong arguments that the effect of the estate and gift taxes may be less than that of the income tax,57 and the empirical evidence to date suggests a minimal effect on savings.58 Given the relative economic efficiency of the estate tax versus

52Id.
54Piketty and Saez, supra note 53, at 7.
55Id. at 12-13.
56Id. For examinations of other harms that may arise from wealth transfer taxes, see, e.g., Charles Davenport and Jay A. Soled, “Enlivening the Death-Tax Death-Talk,” Tax Notes, July 26, 1989, p. 591; Repetti, “The Case for the Estate and Gift Tax,” Tax Notes, Mar. 13, 2000, p. 1493, 1500-1501; Richard Schmalbeck, “Avoiding Federal Wealth Transfer Taxes,” Rethinking Estate and Gift Taxation (2001). All these studies reject the argument that the cost of complying and administering the estate and gift tax exceeds the revenues collected.
57See, e.g., Caron and Repetti, supra note 5, at 1285-1288; Repetti, supra note 40; and Repetti, supra note 56.
58There are three studies that have directly examined the effect of federal estate taxes on savings. One found no evidence that the estate tax reduces savings. Seymour FiekoKowsky, “The Effect on Saving of the United States of Estate and Gift Tax,” Federal Estate and Gift Taxes (1966). Two found that the estate tax is related to a reduction of about 10 percent in reported gross estates. Wojciech Kopczuk and Joel Slemrod, “The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors,” National Bureau of Economic Research Working Paper No. 7960 (2000); David Joulfaian, “The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence,” 59 Nat’l Tax J. 253, 266 (2006). It is not clear, however, whether this is attributable to a decrease in savings or is window dressing to reduce the size of the reported estate. A fourth study also found a similar reduction in reported estates, but it combined data for state estate and inheritance taxes with federal estate tax data. Douglas Holtz-Eakin and Donald Marples, “Distortion Costs of Taxing Wealth Accumulation: Income Versus Estate Taxes,” NBER Working Paper No. 8261.

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the income tax and the estate tax’s role in decreasing the concentration of wealth, it makes sense to increase the maximum rate to an amount closer to the historical rate.

Proposal 4: Restrict the ability of gifts made in trust to qualify for the gift tax annual exclusion. The annual exclusion was included in the gift tax as an administrative measure intended to “obviate the necessity of keeping an account of and reporting numerous small gifts and . . . to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts.”59 The annual exclusion was $5,000 in 1932-1938, was reduced to $4,000 in 1939-1942 and to $3,000 in 1943-1981, and was increased to $10,000 in 1981-1999. Since 1999, the annual exclusion has been indexed for inflation in $1,000 increments,60 with resulting annual exclusions of $11,000 (2002-2005), $12,000 (2006-2008), $13,000 (2009-2013), and $14,000 (2014-?).

The original conception of the annual exclusion to keep wedding, Christmas, and other relatively small gifts out of the gift tax regime was implemented in section 2503(b)(1)’s restriction of the annual exclusion to gifts of present interests and disqualification of gifts of future interests in trust because present interests make it easier to value the transfer and identify the beneficiary. Congress provided a limited exception for annual exclusion gifts to a trust for the benefit of a single minor beneficiary under section 2503(c).61 (A mandatory income interest in other types of trusts also is treated as a present interest, as are transfers to section 529 college savings plans.)

Interestingly, however, the original enactment of the annual exclusion may have foretold its later role as an estate planning colossus. In inflation-adjusted terms, the $5,000 annual exclusion of 1932 equals more than $85,000 in today’s dollars — far exceeding the wedding, Christmas, and other relatively small gift targets of the exclusion, and far exceeding today’s $14,000 annual exclusion.

Over 45 years ago, the Ninth Circuit sanctioned the treatment of beneficiary withdrawal rights as present interests qualifying for the annual exclusion in Crummey v. Commissioner.62 With the courts’ subsequent blessing of annual exclusion treatment of withdrawal rights for multiple contingent beneficiaries63 and repeated rejection of attempts by the IRS to restrict the reach of Crummey powers,64 the annual exclusion has morphed into a significant estate depletion strategy for wealthy families.

For example, a married couple with four married children who each have four children is able to make $672,000 of annual exclusion gifts through a Crummey trust, removing $6.72 million from the couple’s estates over a 10-year period.

That strategy is of course built on a fiction — that the Crummey beneficiary’s right to withdraw $14,000 in a given year is a present interest, even though all the parties expect that the holder will not exercise that power. In most cases, it is against the holder’s interest to exercise the power and thereby turn off the spigot of future contributions for her benefit. In our years of practice, we never encountered the exercise of a Crummey power and concur in Bridget J. Crawford’s observation that “if one were to survey 1,000 estate planning lawyers, it is unlikely that any could report firsthand knowledge of the exercise of a Crummey power.”65

Congress, however, has restricted the utility of Crummey trusts for GSTT purposes. The GSTT annual exclusion is available only for single-beneficiary Crummey trusts.66 This gift tax/GSTT disparity of treatment thus adds complexity to multigenerational estate planning.

We believe the time has come to return section 2503(b) to its original purpose of excluding only wedding, Christmas, and other relatively small gifts from the gift tax. The cleanest way to do this is to deny the annual exclusion to all gifts in trust other than a section 2503(c) trust for a single minor beneficiary (and mandatory income interests in other trusts).67 Alternatively, the annual exclusion could be extended to section 2642(c) single-beneficiary Crummey trusts as well.68

(Apr. 2001). Given the ease with which state estate taxes may be avoided, we do not believe that this study helps determine the effect of the federal estate tax.

60Section 2503(b)(2).
61The trust must (1) permit the trust income and property to be expended by or for the benefit of the minor before the age of 21; (2) pass to the minor upon his attaining the age of 21; and (3) pass to the minor’s estate (or under the minor’s general power of appointment) if the minor dies before the age of 21.

62997 F.2d 82 (9th Cir. 1986).
64See, e.g., Estate of Holland v. Commissioner, T.C. Memo. 1997-302; and Estate of Kohlsaat v. Commissioner, T.C. Memo. 1997-212.
66Section 2642(c).
67See ABA, supra note 31, at 32-33; Crawford, supra note 65, at 446.
68See also William C. Brown, “Judicial Expansion of the Future Interest Exception to the Gift Tax Annual Exclusion: Examination of the Legislative History and Policy Basis for the Future Interest Exception,” 65 Tax Law. 477 (2012); Bradley E.S. Fogel, “Back to the Future Interest: The Origin and Questionable Legal Basis of the Use of Crummey Withdrawal Powers to Obtain (Footnote continued on next page.)
Proposal 5: Restrict GRATs through a lifetime cap. In a GRAT, an individual transfers assets to an irrevocable grantor trust in return for an annuity valued in accordance with the section 7520 actuarial and interest rate tables. The grantor typically zeroes out the GRAT by ensuring that the present value of the annuity equals the amount transferred into the trust, thus eliminating any gift tax on the transfer (a technique approved by the Tax Court in 2000 for a zeroed-out GRAT created by Audrey Walton, the wife of the brother of Wal-Mart founder Sam Walton). In this situation, grantors are banking on the assets contributed to the trust appreciating at a rate in excess of the rate of return assumed in the section 7520 tables — an increasingly likely prospect given the historically low interest rates of recent years. If the assets in the GRAT perform better than anticipated in the section 7520 tables, that extra value passes tax free to the next generation. If the assets underperform, the grantor loses nothing (other than the use of the capital during the term of the trust and any professional fees incurred). To mitigate the risk of the grantor dying during the term of the trust, which would result in the fair market value of the trust at the date of the grantor’s death being included in the grantor’s estate under section 2036, grantors typically use very short (two-year) trust terms.

In 2013 press reports documented that the surge in the use of GRATs among the very wealthy has achieved eye-popping reductions in estate and gift taxes — by one estimate, $100 billion since 2000, or one-third of the total estate and gift taxes collected over this period. Press reports based on SEC filings detail the extensive use of GRATs by the very wealthy: Sheldon Adelson (Las Vegas Sands) used 25 GRATs to give $7.9 billion to his heirs and avoid $2.8 billion in gift taxes; Charles Ergen (Dish Network) and Ralph Lauren funded more than $300 million in GRATs; and Lloyd Blankfein (Goldman Sachs) funded more than $50 million in GRATs. For several years, Obama has proposed limiting the use of GRATs to shelter assets from the estate and gift taxes by requiring them to have a minimum term of 10 years; a maximum term of the life expectancy of the grantor (plus 10 years); an initial remainder interest value of greater than zero; and annuity payments that decline during the term of the trust. These changes are projected to increase revenues by $3.9 billion in the 2014-2023 period.

We propose a more robust reform than the president’s to more effectively curb this abuse. The staff of the Joint Committee on Taxation and commentators point out that the president’s proposed minimum 10-year GRAT term would do nothing to stem the growing use of GRATs by younger billionaires, like Facebook’s Dustin Moskovitz, Sheryl Sandberg, and Mark Zuckerberg. A different approach would be to tax the creation of a GRAT as a gift of an option akin to a stock appreciation right, so that a taxable gift would be deemed to occur on its creation. We believe a more fundamental approach would be to refuse to treat the creation of a GRAT as a completed gift and instead adopt a wait-and-see approach and impose the gift tax on the value of the property that passes to the remaindermen. We plan to explore this issue in a subsequent article. In the meantime, as a simpler, stop-gap measure, we suggest imposing a lifetime cap on the amount that can be transferred to a GRAT. Although the precise amount of that cap is open to debate, we suggest an amount tied to the exemption amount of the unified credit — currently $5.34 trillion.


Conclusion

In the years after the publication of Cooper’s article in 1977, Congress plugged many of the estate and gift tax loopholes that were exploited by wealthy taxpayers of that generation. In recent years, Congress has not attended to new avenues of estate and gift tax avoidance. Like Jack Nicholson returning home to his dying father in *Five Easy Pieces,* if Cooper returned home to the estate and gift taxes of 2014, he would find them in need of major surgery to ensure their survival. These “five easy pieces” of estate and gift tax reform are offered here as initial steps to restore the estate and gift taxes to health.

Addressing International Income Inequality in a Time of Crisis

By Karen B. Brown

Karen B. Brown is the Donald Phillip Rothschild Research Professor of Law at George Washington University, where she teaches federal income, corporate, and international taxation. She would like to thank Paul L. Caron; the Pepperdine University School of Law; its dean, Deanell Tacha; the *Pepperdine Law Review*; and Tax Analysts for the opportunity to participate in the symposium “Tax Reform in a Time of Crisis.” This article is dedicated in loving memory to her father, Kenneth A. Brown Sr., the smartest and most loving man she’s ever met, a devoted father, and true friend to all in need, who loved God with all of his heart.

In this article, Brown urges the United States not to undertake major tax reform without considering the impact on more vulnerable economies, especially those in the Caribbean.

This article was presented on January 17 at a symposium in Malibu, Calif., sponsored by Pepperdine University School of Law and Tax Analysts. Twenty of the nation’s leading tax academics, practitioners, and journalists gathered to discuss the prospects for tax reform as it is affected by two crises facing Washington: dangerously misaligned spending and tax policies, resulting in a crippling $17.4 trillion national debt; and the IRS’s alleged targeting of conservative political organizations. A video recording of the symposium is available at http://new.livestream.com/pepperdinesol/taxreform.

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In today’s global marketplace, there is fierce competition among countries for investment capital to fuel economic growth. Even among the highly developed, high-income economies of many of the OECD member states (including the United States), political leaders feel pressure to implement or shore up policies to attract or retain increasingly peripatetic multinational enterprises. Increased investment by businesses in the form of infrastructure (for example, bricks-and-mortar locations for production), research and development of intellectual property, organizational and management expertise, etc., is equated with exports of goods and services, creation of jobs, and technological innovation and dominance. Not surprisingly, tax law has figured prominently in efforts to provide investment-friendly locales. Not long ago, to stem