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FOREWORD: THE INTERACTION OF TAX PLANNING AND TAX POLICY

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The Tax Reform Act of 1976 represents the first comprehensive revision of the federal taxes on the transfer of wealth in almost 35 years. From the date of passage, however, the transfer tax aspects of the 1976 Act have proved to be frustrating to tax planners and disappointing to those concerned with tax policy. Both the disappointment and the frustration, I believe, have their origins in the same underlying causes and, indeed, may be viewed as opposite sides of the same coin.

The fundamental problem with the transfer tax provisions enacted in 1976, extensive as the changes were, is that the provisions that emerged represent only partial steps toward a more rational and equitable transfer tax system. In most instances, therefore, the 1976 Act changes must be viewed only as intermediate steps toward a more completely realized transfer tax structure.

A number of factors in the 1976 legislative experience operated to produce a set of transfer tax provisions that appear destined to be impermanent:

> 1. Revenue constraints in some instances prevented full implementation of a more comprehensive policy, for example, in the marital deduction area.
>
> 2. The lack of adequate technical analyses and empirical studies in some instances resulted in only partial implementation of more comprehensive policies that were approved in principle, for example, in the generation-skipping area.
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> 3. The lack of detailed studies and analyses which prevented complete implementation of needed structural revisions, for example, in the areas of retained voting stock and jointly owned property, and the failure to address still other structural defects, for example, the 5% reversionary requirement in section 2037.
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> 4. The lobbying pressures generated by specific groups, notably farm families, which produced new distortions in the tax system as, for example, the special valuation rules in section 2036A, and which reduced the scope of the transfer taxes by increasing the $60,000 exemption level to over $175,000.

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5. The inability to reach consensus on the extent of changes in certain areas where there was agreement on the necessity for change, resulting in halfway measures acceptable really to no one, as, for example, the carryover basis provisions.

6. The unusual legislative procedure employed to consider the transfer tax provisions, namely the failure to provide full Senate consideration, both in committee and on the floor, of the measures passed by the House.

From the standpoint of the tax planner, as the articles in this volume illustrate, the resulting incomplete and partially realized policy decisions reflected in the 1976 Act have generated substantial uncertainty and have produced stresses on family estate planning that are artificial at best. From the standpoint of tax policy, the existing transfer tax provisions fall considerably short of a rational transfer tax structure. On the other hand, the problems of the tax planner and the policy maker, viewed in historical perspective, are at least understandable when the 1976 Act changes are viewed as an intermediate step moving the United States from an incomplete transfer tax structure to a more fully developed system.

The articles in this volume are thus valuable because of the guidance and assistance they provide to the tax advisor in working with 1976 Act changes, and because they illuminate for the policy maker the partial nature of the solutions adopted in 1976 and the steps that must be taken in the future to bring to statutory fruition the policies on which the 1976 reforms were grounded. Accordingly, as always, the dynamic interaction between tax planners and tax policy makers continues. Incompletely realized policies produce unnecessary complexities and discontinuities for the tax planner; the tax planning responses developed by the tax advisors in turn reveal to policy makers both the problems with the existing provisions and the necessity for more complete and rational statutory formulations.

The following remarks are intended to indicate in a brief and preliminary way some of the lessons to be absorbed as one views the 1976 Act changes from the perspective provided by the tax planners writing in this volume. One thesis is that the task of the tax planner could be made more rational and more simple by a transfer tax statute that fully implements comprehensive and comprehensible tax policies. The second thesis is that the problems faced by the tax planners in attempting to develop estate plans under existing rules should reveal to the policy maker the areas that need attention, both to curb abuses and to provide a coherent framework within which tax collection and tax planning can function at an optimum level.

Definition Of The Taxable Unit: The Marital Deduction. One of the structural problems that must be resolved in implementing a tax on wealth transfers is the definition of the taxable unit. In the case of single persons, of course, the individual is the unit and transfers from that unit are subject to tax. In the case of married couples, the question that must be resolved is whether each spouse is to be treated as a separate taxable unit for transfer tax purposes or whether the two spouses are to be treated as a single taxable unit, with only transfers out of that unit subjected to tax.

There is nothing in the nature of a transfer tax system as such that dictates which of the two treatments with respect to married couples should be adopted. Different countries can and do give different answers to the question, the decisions appearing to rest largely on nontax views that the country holds with respect to marital rights and relationships, on the sexual pattern of holdings of wealth, and on marriage itself.

One model for the treatment of marital couples is the community property system. Under such a regime, property acquired during marriage is treated as being owned one half by each spouse from the date of acquisition. Transfers between the spouses and by each spouse are therefore included in the transfer tax base of the transferring spouse. In a rough way, a 50% marital deduction conforms to this view.

On the other hand, the Tax Reform Studies and Proposals released by the Treasury Department in 1969 moved toward regarding a married couple as a single taxpaying unit for transfer tax purposes.[1] Under the unlimited marital deduction proposal recommended by the Treasury, interspousal transfers would not be subject to tax and only transfers outside the unit would incur transfer tax liability. As will be discussed below, the 1969 Treasury proposals stopped short of full implementation of the concept of the married couple as a single taxable unit.

The Tax Reform Act of 1976 mixed the two views of the marital unit, predictably resulting in discontinuities and a lack of rational cohesion in the provision. For estates up to $250,000 (in excess of the exemption level), the unlimited marital deduction concept advocated by the Treasury in 1969 was adopted. However, for estates above $500,000, the 50% deduction-community property model was retained. No model exists to describe the situation for treatment of the marital unit where the family estate is between $250,000 and $500,000!

As the article by Wilson C. Piper and Marion R. Fremont-Smith[2] graphically illustrates, this muddled situation presents both planning complexities and planning opportunities. The difficulties are compounded by the fact that the gift tax marital deduction does not conform to the estate tax marital deduction. Hence the complex interaction between the desires to achieve, on the one hand, optimal transfer tax deferral and, on the other, the lowest aggregate overall tax burden on property passing to the next generation, analyzed in detail in the Piper and Fremont-Smith article, is the inevitable result.

The 1976 legislation appears, however, to represent a movement toward an unlimited marital deduction as the preferred solution to the definition of the taxable unit issue. Presumably, revenue constraints prevented adoption of a completely unlimited marital deduction. The solution adopted does solve one problem experienced mostly in smaller sized estates. In such estates, where the surviving spouse consumed amounts of the estate in excess of the marital deduction allowable to the estate of the first

[1] HOUSE WAYS AND MEANS COMM. AND SENATE FINANCE COMM. 91ST CONG. 1ST SESS., U.S. TREAS. DEPT. TAX REFORM STUDIES AND PROPOSALS 357-66, 377-80 (Comm. Print 1969) [hereinafter "1969 TREASURY PROPOSALS"].

[2] See p. 403 *infra*.

spouse the transfer tax was imposed on property that in fact did not pass to the next generation. By effectively allowing an unlimited marital deduction for smaller sized estates, the 1976 legislation eliminated this problem. But the conceptual issue of proper definition of the taxable unit is a broader one and the present system seems unlikely to represent a permanent resolution.

Adoption of a 100% marital deduction would of course provide complete deferral of transfer tax until both spouses have died and the property passes on to another taxable unit, usually the next generation. On the other hand, providing complete transfer tax deferral to married couples does not resolve all of the taxable unit problems. For example, if the theory underlying the unlimited marital deduction is that husband and wife constitute a single taxable unit, the question whether a single rate schedule should apply to all transfers from that unit must be faced. That is to say, even if an unlimited marital deduction were enacted, the potential for reducing aggregate transfer taxes on the unit would continue if each spouse were permitted to start at the bottom of a separate rate schedule with respect to transfers by him or her. Indeed, in some respects, an unlimited marital deduction that is not accompanied by a requirement that the spouses use a single rate schedule intensifies the problems of the tax advisor because decisions would be required upon the first spouse's death as to the amount that should be subject to tax at that time and the amount on which tax deferral should be accepted. The resolution of such issues not only would involve complex mathematical computations based on some rather heroic assumptions concerning life expectancy, need for funds, inflation, etc., but also some of the attributes normally employed in Las Vegas.

Thus, estate planning will continue to be unnecessarily complex and hazardous until the movement to an unlimited marital deduction is completed. But, more intensive analysis and study by the Treasury is required with respect to the resolution of other matters involved in the taxable unit issue:

1. Should a single rate schedule and exemption level be applied to a married couple so that all transfers from the unit, whether by the husband or by the wife, are taxed on a cumulative basis?

2. If the answer to the first question is in the affirmative, further questions must be faced as to the proper application of such a taxable unit definition to the situations of divorce (i.e., is this a taxable event or not, and if not, is a mechanism required to retain the existing transfer tax potential as to the post-divorce assets owned by each spouse, i.e., what transfer tax base does each spouse have for subsequent transfers), and marriage itself (i.e., is marriage a taxable event for transfer tax purposes since two separate taxable units are now transferring their assets into a new taxable unit, or is some mechanism for deferral of the tax appropriate at this point until there are actually transfers out of the new unit, i.e., what is the transfer tax base of the marital unit).

3. Do changing patterns of cohabitation require a revision of the tax definition of a "married couple"? And what will that definition be?

Resolution of the above issues will not be a simple matter. But the push towards an unlimited marital deduction must at bottom be based on the concept that the marital unit constitutes a single taxable unit for transfer tax purposes. If this is the concept, then the stated questions must be directly faced, appropriate data gathered, and the requisite technical analysis undertaken to insure that a comprehensive and workable definition of the taxable unit issue emerges.

The Concept Of Periodicity: The Generation-Skipping Tax. Another structural issue that must be resolved in the proper implementation of a transfer tax is the time period within which the tax will be levied. In the context of a transfer tax, the concept of periodicity requires that a tax be imposed on transfers of property *at least* once each generation. Failure to apply such a concept of periodicity results in an inevitable impairment of the equity of a transfer tax system. For example, if a given amount of wealth under one family arrangement is subject to transfer tax on three occasions over a 100 year period and a wealth accumulation of equal amount by another family is taxed only once each 100 years because of estate planning conducted by the second family, it is apparent that the two family accumulations of wealth are treated inequitably as compared to each other. As the ultimate imposition of the transfer tax depends on an unpredictable event, death, it is not possible to achieve complete equity in a transfer tax system in terms of frequency of imposition of the tax; on the other hand, it nonetheless seems apparent that equity does require some reasonable equivalence of time of imposition of the tax on two families, each transferring equal amounts of wealth.

Prior to the Tax Reform Act of 1976 the only real constraint on the time period within which collection of a transfer tax was insured was the applicable period of the Rule Against Perpetuities. As the article in this volume by Thomas R. Belknap[3] indicates, for properly advised families wealth could be kept outside the transfer tax system for periods of 100-150 years. Even though no wealth transfer tax was imposed on the intervening generations under such family arrangements, the skipped generations nonetheless could receive substantial—indeed near total—economic enjoyment of the family wealth.

The generation-skipping tax imposed by the Tax Reform Act of 1976 represents the first congressional attempt to introduce a formal element of periodicity into the federal transfer tax. The broad policy behind the 1976 legislation emerged relatively clearly: Wealth should be taxed once each generation regardless of the form of transfer that might be selected for nontax reasons by a particular donor or testator. However, as the Belknap article clearly demonstrates, the technical implementation of this policy is so deficient that only a relatively few unlucky or ill-advised families will ever incur any generation-skipping tax in fact. The real result of the 1976 legislation is the creation of a series of artificial barriers around which the estate planner must carefully chart his client's course. But under the guidance of an experienced navigator, the family estate will likely emerge in the hands

[3] See p. 433 *infra*.

of a suceeding generation 100 years hence with little or no more transfer tax imposed than would have been true under pre-1976 law. The way has been made more difficult, but the burden—with the possible exception of increased attorneys' fees—has not been made significantly heavier.

Thus, while the 1976 generation-skipping legislation represents a significant congressional policy commitment to achieve greater equity in the transfer tax system, the Belknap article indicates that serious and probably fatally defective gaps exist in the coverage of the generation-skipping tax. These gaps are embodied in the exemptions from the tax provided by the statute and include:

1. The failure to tax outright nontrust gifts to grandchildren or more remote generations.
2. The failure to tax trusts that completely skip the intervening generation (i.e., the so-called "layered" trust).
3. The $250,000 per child exemption for transfers in trust for grandchildren.
4. The ability to employ children of the grantor as trustees, under certain conditions, with the power to accumulate or distribute the income and principal of the trust to descendants of the grantor.
5. The exemption for distributions of income that constitute generation-skipping transfers.
6. The exemption for trusts created before April 30, 1976, which permits some existing trusts to avoid the imposition of the transfer taxes until well into the 21st century.

The article by Mr. Belknap thus serves not only as a roadmap to tax advisors representing clients potentially subject to the generation-skipping tax, but also as a guide to the Treasury Department for areas in which it needs to develop further data and more comprehensive statutory formulations necessary to implement fully the policies on which the 1976 generation-skipping tax legislation was based.

The Concept Of Periodicity: Transfers Of Wealth That Avoid The Tax On The Generation That Creates The Wealth. Most discussions of estate planning commence with the assumption that the tax advisor is dealing with a person who has accumulated significant amounts of wealth and who desires to pass that wealth on to the surviving spouse and/or succeeding generations at the minimum tax cost. But there is another aspect to the "generation-skipping" problem that the articles by Frederick G. Corneel[4] and Lawrence I. Silverstein[5] illuminate. They discuss tax planning methods—primarily developed in the context of income tax planning rather than estate and gift tax planning—that permit the person who is in the process of creating wealth to transfer future increments in that wealth tax-free. Under these arrangements, the donor retains a relationship with the property transferred which enables him by his efforts to continue increasing the value of the property in the hands of the transferee. But that increased value falls outside the

[4] See p. 509 *infra.*
[5] See p. 467 *infra.*

reach of the transfer tax. Congress in its 1976 actions to amend section 2036(a)(1) took a quick glance through the door that opens on to this promised land in which the parent or grandparent who is in the process of making an asset — such as the stock in a closely held corporation — continually more valuable through his or her own efforts is simultaneously transferring that increased value to succeeding generations at no transfer tax cost.

One familiar vehicle employed to achieve this result is the so called *Dean-Hartzell* recapitalization.[6] Under this plan, the older generation owning stock in a closely held corporation freezes estate tax values at present levels by retaining preferred stock (perhaps voting) equal to the total current value of the corporation, and transferring the common stock in which all future growth will inhere to children or grandchildren, or to a trust for them. The donor will continue to manage the affairs of the corporation, but the transfer in value effected through his or her efforts will go untaxed. As the student note[7] in this volume indicates, Congress caught a glimpse of the world of this type of generation-skipping transfers when it addressed the problem created by the Supreme Court decision in *United States v. Byrum.*[8]

Again, however, probably because tax technicians have not really explored the area, the amendment to section 2036(a)(1), providing that a transfer of stock with retention of the voting rights will require inclusion of the transferred stock in the donor's gross estate, will cause difficulty only for the ill advised. As Mr. Corneel points out, if the donor's tax advisor simply uses the device of a recapitalization in which voting stock is retained and nonvoting stock is transferred, presumably the amendment to section 2036(a)(1) will not offer any obstacle. And, as his article points out, the recapitalization is only one of several techniques by which the donor can insure that all future growth in existing assets will occur in the hands of the heirs and beneficiaries of the donor, even though that future growth is attributable solely to efforts of or actions taken by the donor.

Research is in an embryonic state on the scope of the problem that exists as the result of tax planning devices developed to enable owners of property to transfer future increases in value of that property free of transfer tax.[9] Careful and detailed research is required to develop the types of devices employed to reach this result, to identify those situations in which a transfer tax should apply, and to devise statutory formulae that will, with the requisite precision, differentiate those situations which should be encompassed by the transfer tax and those which should not.

It is, however, imperative that such research and analysis begin in earnest. A mature and fully developed transfer tax system that effectively deals with traditional generation-skipping transfers inevitably will be re-

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[6] *See* Dean v. Commissioner, 10 T.C. 19 (1948) (A); Hartzell v. Commissioner, 40 B.T.A. 492 (1939) (A).

[7] See p. 597 *infra*.

[8] 408 U.S. 125 (1972).

[9] *See, e.g.*, S. SURREY, W. WARREN, P. McDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION 956-62 (1977) [hereinafter WEALTH TRANSFER TAXATION]; Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

quired to deal with transfers that skip the generation that is in the process of creating the wealth. To put the matter another way, if the United States had in place a properly implemented generation-skipping transfer tax, enormous pressure would be placed on devices that would skip the wealth-creating generation. Thus, research on the types of transfers that produce this latter result must be the inevitable concomitant of research for more effective statutory responses to the traditional generation-skipping problem.

In this regard, the planning techniques suggested by Messrs. Corneel and Silverstein reveal two promising avenues for research:

> 1. Development of more refined valuation techniques than are presently available.
>
> 2. Development of more stringent "hard to complete gift" rules whereby the date of death value would be included in the gross estate of the donor in any situation in which the donor has retained the power or the ability to contribute to the post-gift increase in value and thus to affect the beneficial enjoyment of the property.

Development of legal rules to implement either approach will present difficult conceptual and practical problems. But the lesson implicitly offered by the tax planners for the tax policy makers is that it is essential that the requisite data gathering and analysis be undertaken.

Definition Of The Tax Base. As in the case of the income tax, the provisions that make up the estate, gift and generation-skipping tax portions of the Internal Revenue Code—the transfer tax system—are in fact of two quite separate types. One set of provisions consists of those rules that are necessary to implement the normative structure of a transfer tax, i.e., the transfers covered, the rates of tax to be applied, the definition of the taxable unit, the time period within which the tax is to be imposed, and the administrative provisions necessary to implement the tax. But another set of provisions performs quite a different function: These provisions are designed to provide federal financial assistance or incentives for particular types of transferors or property transferred. The latter set of provisions encompasses the "tax expenditure" structure of the transfer tax system.[10] Congress in the 1976 Act did not deal comprehensively with either component of the transfer tax system. It did address, however, particular items within each component.

One new provision intended to constitute part of the normative structure was section 2518. As the article by William Schwartz indicates,[11] the 1976 amendments reflect an effort by Congress to provide a uniform definition of a qualified disclaimer and to bring to an end uncertainties which had plagued the area for many years. On the other hand, as the Schwartz article also points out, section 2518 does not completely or satisfactorily achieve either objective. The Ways and Means Committee did not appear to have provided for it the conceptual framework within which to analyze the disclaimer question. While Congress did provide some greater certainty, it did so by liberalizing the disclaimer rules. It is clear that the policy objec-

[10] For a discussion of the tax expenditure concept in the context of the transfer tax system and the formulation of a tax expenditure budget for that system, see WEALTH TRANSFER TAXATION, *supra* note 9, at 881-92.

[11] See p. 551 *infra*.

tive could also have been achieved by tightening the then existing disclaimer rules. The crucial question which should have been presented to Congress by the Treasury and the Joint Committee staff was, therefore, which was the proper direction to take—liberalization or restriction—in a properly structured transfer tax system.

The matter may be examined by comparing the following cases.[12]

> *Case 1:* A by will leaves nothing to B and $200,000 to C, B and C each possessing $100,000 estates prior to A's death.
>
> *Case 2:* Before his death, A consults with B and B indicates that he prefers that A leave his entire $200,000 estate to C, B feeling that he had a sufficient estate for his own needs.
>
> *Case 3:* A by will leaves $100,000 to B and $100,000 to C; five years later, B decides that he does not need his $100,000 bequest because of his other assets and makes a gift in that amount to C.
>
> *Case 4:* The same as case 3, except that immediately after A's death, B effectively disclaims his $100,000 bequest and, pursuant to A's will, the $100,000 goes to C.

It is clear that there is no gift by B to C in either Cases 1 or 2. It is equally clear that B has made a gift to C in Case 3. The disclaimer rules adopted in 1976 assume that Case 4 is more like Cases 1 and 2 than like Case 3. Is the matter, however, so clear? In Case 1, B's estate remains at $100,000, C's estate is increased by $200,000 and no action on B's part affects that fact. In Case 3, B's action has transferred $100,000 to C, with a resulting gift tax. In Cases 2 and 4, B's action in conjunction with A's effects a $100,000 transfer to C, yet no gift tax results. If one feels that no gift should result in Case 2, should the tax result differ in Case 4 because B in effect has been given a second chance to evaluate his decision by virtue of the disclaimer rules? In Case 4, B can be regarded as having received the $100,000 and then transfering it to C, through the medium of A's estate, and the $100,000 will in fact go to C who is the object of B's bounty (as in Case 3).

Obviously, the congressional desire for "uniformity" could have been achieved in 1976 by tighter rather than by liberalized disclaimer rules. It is not totally self-evident that in the range of the cases presented above, Case 4 should bear no gift tax, whereas Case 3 should. Further study on the issue by the Treasury Department is warranted, taking into account the kinds of problems and opportunities discussed by Mr. Schwartz under the 1976 Act rules.

Another structural issue partially addressed by Congress in the 1976 Act was the disparity in the tax base that existed between gift transfers and transfers at death. Two aspects of this disparity—lower gift tax rates and separate rate schedules for lifetime and death transfers—were resolved by providing for a single unified rate structure cumulatively applicable both to lifetime and deathtime transfers. The third disparity that existed prior to the 1976 Act was not, however, completely resolved. Transfers at death are grossed-up by the estate tax itself; however, transfers during life are subject

[12] *See* WEALTH TRANSFER TAXATION, *supra* note 9, at 194-95.

to tax only on the net amount transferred to the donee and do not include the amount of the gift tax. Obviously, the burden of the two taxes is not neutral when comparing lifetime and deathtime transfers.

Congress recognized this problem in 1976, but attempted a solution only in the case of transfers made within three years of death. Under section 2035(c), discussed in a student note,[13] the gross estate includes not only the value of property transferred within three years of death but also the gift tax paid thereon. The technique adopted in section 2035(c) is not a true gross-up solution.

In a correctly implemented gross-up system, the amount of a gift, regardless of when made, would include not only the amount received by the donee, but also the gift tax imposed on the transaction as well. At the same time, if a completed gift were made, all future appreciation in the value of the property transferred would be eliminated from the donor's gross estate. Under section 2035(c), by contrast, the gift itself is not grossed-up by the gift tax paid, thus permitting a deferral of tax for up to three years. Instead, the gift tax is computed only on the net amount received by the donee and, equally inconsistent with a proper gross-up technique, appreciation in the value of the property transferred within three years of death remains in the gross estate. Perhaps a rough trade off is involved here, i.e., the failure to apply a proper gross-up technique is offset by requiring inclusion of the post-gift appreciation in value in the donor's gross estate. But, as the student note indicates, this partial solution to a structural problem inevitably brings with it unnecessary complexities and difficulties. Again, while the underlying policy issue addressed by Congress was clear, that is, gross-up is the proper rule for lifetime transfers, additional statutory amendments are necessary to implement a correctly structured system to tax all lifetime transfers on a grossed-up basis.

Congress in the 1976 Act also addressed certain items in the tax expenditure component of the transfer tax system. For example, as discussed in the article by Judith Lidsky,[14] the exemption for qualified annuities under section 2039(c) and (e) was expanded. This expansion, which will produce an estimated revenue loss in fiscal 1979 of $85 million, was unaccompanied by any analyses of the role which the exemption would play in the overall transfer tax system or evaluations of the provisions as a method of encouraging and supplementing private retirement plans. For example, it seems clear that the section 2039(c), (e) exemptions will be of benefit only to a rarified stratum within the already highly rarified group of estates that incur estate tax liability. By virtue of the exemption level that will reach $175,625 in 1981, 98% of decedents each year will pay no estate tax. The section 2039(c), (e) exemptions obviously provide no benefits to these estates. Moreover, as the Piper and Freemont-Smith[15] article demonstrates, the exemption will not be of any benefit for estates up to $425,000 where the marital deduction is employed, and indeed, with more sophisticated planning, it is possible that the exemption would prove of no benefit for estates up to $600,000 in value where a surviving spouse is involved. Thus, at

[13] See p. 577 *infra*.
[14] See p. 531 *infra*.
[15] See p. 403 *infra*.

best, the section 2039(c) and (e) exemptions provide a federal financial benefit to supplement death benefits payable to the wealthiest one to two percent of the people in the country. As one point of comparison, it seems unlikely that Congress would amend the social security system to exclude surviving beneficiaries of the bottom 98% of the population from receiving death benefits, and provide death benefits only to the beneficiaries of the wealthiest two percent of the decedents dying each year.[16]

One clear task for the Treasury Department is the identification and quantification of tax expenditures within the existing transfer tax system. Moreover, studies must be commenced to evaluate such programs under criteria applied to direct spending programs in the same budget areas. By fiscal 1981, existing tax expenditures in the transfer tax system will total an estimated $3.3 billion (a figure which will be very close to the revenues actually *collected* through the transfer taxes in that year).[17] The expenditures of federal funds at this level simply cannot continue unexamined and unevaluated as have the tax expenditures in the transfer tax system to date.

Level Of Taxation. The question of the appropriate level of the transfer tax burden raises two issues: (1) the point at which positive rates should commence (i.e., the extent of the exemption), and (2) the configuration of positive rates applied above the exemption level. The Tax Reform Act of 1976 addressed both these issues by substantially increasing the exemption level and modifying the positive rate structure.

The 1976 Act replaced the existing $60,000 estate tax exemption (and $30,000 gift tax exemption) with a unified transfer tax credit that, when fully phased in by 1981, will be $47,000. This is the equivalent, though not identical in effect, of a $175,625 exemption. Two questions may be raised about the unified transfer tax credit. First, was it appropriate to substitute a credit for the exemption? Second, was the exemption level created by the credit appropriate?

As to the first question, the House Ways and Means Committee Report indicated that the estate tax exemption should be replaced by a tax credit because the value of the credit will not increase as a function of the decedent's estate tax bracket as does an exemption.[18] It is difficult to discern a conceptual basis for the use of the tax credit as a substitute for a basic transfer tax exemption other than a desire to have wealthier estates incur a disguised tax increase relative to smaller estates.[19] The Ways and Means Committee Report asserted, in effect, that an estate in a 70% estate tax bracket derives a relatively greater benefit from an exemption than does an estate that achieves a maximum estate tax bracket of, say, 37%. It then concluded from this fact that the exemption should be changed to a credit to eliminate this effect, i.e., a credit would give the same dollar benefit to the 37% bracket estate as to the 70% bracket estate. The problem is

[16] A similar lack of analysis accompanied the introduction in the 1976 Act of new tax expenditures for farm owners (section 2032A) and orphans (sections 2057). *See* FEDERAL WEALTH TAXATION, *supra* note 9, at 1097-1109, 875-78.

[17] *Id.* at 881-92.

[18] *See* H.R. REP. NO. 1380, 94th Cong., 2d Sess. 15-16, *reprinted in* [1976] U.S. CODE & CONG. AD. NEWS 3356.

[19] The textual material between notes 19 and 20 was taken directly from WEALTH TRANSFER TAXATION, *supra* note 9, at 830-31.

that the same statement can be made about every tax bracket below 37%. The following analysis indicates, for example, that taxation of $5,000 at a 32% rate provides a relatively greater benefit to the 70% bracket estate than to the 37% bracket estate.

It was asserted that taxation of $60,000 at the zero rate provided by the prior exemption was "worth" $42,000 to the 70% bracket estate (70% times $60,000), but only $22,200 to the 37% bracket estate (37% times $60,000). But, by the same analysis, taxation of $5,000 at 32% is "worth" $1,900 to the 70% bracket estate, but only $250 to the 37% bracket estate. The "worth" figure is derived by subtracting the bracket under consideration (zero or 32% in our examples) from the maximum marginal rate achieved by the estate (70 and 37% in our examples). In other words, one concludes mathematically that a $60,000 exemption is "worth" $42,000 to the 70% bracket estate by subtracting zero from 70 and multiplying the difference by the amount of property in the estate taxed at the zero rate. The same mathematical calculation shows the "worth" to the 70% bracket estate of having each block of property in the estate taxed at the brackets below 70%. Thus, for the 70% bracket estate, taxation of $5,000 at 32% is "worth" $1,900, because the benefit is computed by subtracting 32% from 70% and multiplying the difference by $5,000. This "worth" may then be compared to that computed for the 37% bracket estate in the same fashion, i.e., 37% minus 32% times $5,000 equals $250, which is the "worth" to the 37% bracket estate of applying a 32% rate to $5,000 of assets (rather than its top marginal rate of 37%).

Under the above analysis, it would be as logical to replace the 32% bracket with a tax credit as it was to replace the exemption (the zero rate bracket) with a tax credit. But no one ever suggests such action with respect to any of the positive rate brackets. Or, to put the matter another way, replacing the exemption with a credit placed an absolute dollar limit on the "benefit" of the zero rate bracket. But why should such a limit be placed on the zero bracket as opposed to some other rate bracket?

The "relative worth" argument thus does not directly support the conclusion that the prior exemption should have been replaced with a tax credit. The "relative worth" analysis applies to every tax bracket below 70% and simply describes an effect inherent in a progressive rate structure. It is perfectly appropriate to employ a zero rate bracket in a progressive transfer tax structure. Hence, under the "relative worth" argument, it was as inappropriate to replace this bracket with a tax credit as it would have been to replace any other tax bracket.[20]

The issue that Congress should have addressed in 1976 was the proper width of the zero bracket provided by an exemption as compared to the width of the positive tax brackets and the effect of this differential on the relative distribution of estate tax liabilities as between estates of different sizes. Such an analysis might well have led to a restructuring of the positive rate structure (as Congress did in 1976), but not to the adoption of a tax credit in lieu of the exemption. Application of proper tax principles would recognize the propriety of employing an exemption as a zero bracket and would focus attention on the appropriate width of that bracket in a transfer tax structure employing progressive positive rates. The political

[20] *Id.* at 830-31.

difficulty and the revenue cost of increasing the exemption plus increasing rates on the wealthiest estates apparently led Congress to achieve the same result by a less direct technique.

Of equal concern was the failure of Congress in the 1976 Act to reach a consensus on the proper role that a transfer tax should play in the United States. The increase in the exemption level from $60,000 to $175,625 means that by 1981 less than 2% of decedents dying each year will incur a transfer tax liability. Even under the prior $60,000 exemption, only 7% of decedents each year paid an estate tax. These figures bring home an important point. Estate planners are accustomed to speaking of "small" and "medium sized" estates. But we must keep in mind that the universe to which these terms apply is a highly rarified one. The "small" estate to which the estate planners refer is the estate that ranges from perhaps $175,000 to $400,000. But this is an accumulation of wealth that 98% of Americans will never reach. Only 2/10 of 1% of adult decedents leave "middle sized" estates—those over $500,000. These facts simply reflect that the ownership of wealth in the United States is highly concentrated. The top 2.5% of households own 45% of the total wealth; the top 7.5% control about 60% of the total wealth; and the top 20% of households own about 70% of the total wealth of the country.[21]

When these data are taken into account, the action of Congress in increasing the $60,000 exemption to a level equal to $175,625 seems dubious indeed. Prior to 1976, one would have thought that in the wealthiest country in the world, the problem was that its one tax on wealth covered *only* 7% of the population. Instead, Congress viewed the problem from the opposite end of the telescope, i.e., that in the wealthiest country in the world a wealth tax covering 7% of the population was too expansive in its scope.

A number of potential objectives can be assigned to a transfer tax—generation of government revenues, redistribution of wealth, reenforcement of a progressive income tax system, limiting inheritance to increase equality of opportunity and to enhance the incentive for each generation to produce its own economic resources, etc. The seeming inability to reach a national consensus on which of these objectives should be accomplished by a wealth transfer tax system in the United States, accompanied by a rational and comprehensive statutory structure to achieve the identified objectives, inevitably has resulted in a transfer tax structure that is less than optimal from any standpoint. This in turn means that the task of the tax planner will continue to be a difficult and hazardous one as compromises and half-way measures proliferate in our transfer tax structure.

The Taxation Of Accrued Gains In Property Transferred At Death Or By Gift. The most controversial of the changes enacted in 1976 affecting estate planning was one associated with the income tax, rather than with the transfer taxes. This change, of course, was the application in section 1023 to transfers at death of the carryover basis concept. Of all the provisions discussed in this volume, section 1023 in its enacted form appears least likely to survive for any significant period of time. This prediction of a short life for present section 1023 is founded on the view that carryover basis represents an answer to an important question, that is, what is the proper income tax

[21] *Id.* at 832.

treatment of accrued gains on property transferred at death or by gift, but it is an answer which no one suggested should be adopted. At one pole were the tax reformers who asserted, consistent with the 1969 Treasury Tax Reform Studies and Proposals,[22] that the correct solution was the imposition of an income tax on gains in property transferred at death or by gift. At the other extreme were those who desired to retain the exemption from tax accorded by section 1014, especially vocal in this group being representatives of farm interests. Carryover basis is an answer to the income tax problem; but it is an answer that has few visible supporters.

Moreover, the impermanent nature of the solution to the problem contained in section 1023 is likely to be emphasized by the already identified difficulty—some would say impossibility—of working with the various adjustments to the decedent's basis in an asset. Even if the section is amended to correct its rather patent technical deficiencies (as has been recommended by the Treasury Department), it seems unlikely that any "clean-up" measure will reduce the efforts either of tax reformers to proceed on to a system of full taxation of gains at death or of those who seek to return to the complete exemption system of section 1014.[23] As the Silverstein article reveals,[24] such a continuing unsettled state in the legislative arena inevitably produces corresponding uncertainties and complexities for the tax planner who must develop estate plans today for an uncertain future.

In this area, as in those previously mentioned, it is essential that the Treasury Department develop more precise data than has to date been available concerning the extent of the appreciation in assets—and the type of property that constitutes the appreciated assets—transferred at death or by gift. Congress in the 1976 Act expressed dissatisfaction with the inequities created by the old exemption system embodied in section 1014; but it was not prepared to adopt a system for taxing accrued gains at death or by gift which is at once more equitable and workable. The stakes in the issue are very large—the failure to tax accrued gains at death will involve a revenue loss in fiscal 1979 of an estimated $9 billion, and this figure is estimated to increase to over $13.5 billion by fiscal 1983.[25] With such amounts involved, it is clear that even a carefully worked out, comprehensive and administerable system for taxing accrued gains on transfers at death or by gift will not be easily enacted; but it is even more clear that the failure to develop such a set of provisions can only result in a prolongation of the uncertainties and complexities that beset tax planners at the present time.[26]

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[22] 1969 TREASURY PROPOSALS, *supra* note 1, at 107-10, 331-40.

[23] *Compare* 123 CONG. REC. S11,408 (daily ed. July 1, 1977) (Senator Kennedy proposed full taxation of accrued gains in property transferred at death or by gift) *with* 123 CONG. REC. E1,603 (daily ed. March 18, 1977) (Representative Conable urged repeal of section 1023 and a return to the step-up in basis system for assets transferred at death).

[24] See p. 467 *infra*.

[25] STAFF OF THE JOINT COMM. ON TAX., 95TH CONG., 2d SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES 6 (Comm. Print March 14, 1978).

[26] The articles in this volume discuss various types of uncertainties confronting tax advisors after the 1976 changes in this and the other areas previously discussed, including those caused by new concepts, incomplete or complex statutory formulations of the new rules, etc. In addition, another type of uncertainty is involved for tax planners: When the future changes that seem inevitable are made, to what extent will (or should) arrangements entered

Conclusion. While there is thus much to criticize in the congressional resolution of issues dealing with the transfers of accumulated wealth in the 1976 Act, there are also hopeful signs both for tax planners and tax policy makers.[27] On major issues such as generation-skipping, the marital deduction, and the income taxation of accrued gains on property transferred at death or by gift, Congress clearly recognized the inadequacies and inequities of the pre-1977 law. In each of these areas, the 1976 Act reflects congressional movement toward more rational and equitable tax policies. In each case, however, various pressures and lack of adequate technical support produced only partial implementation of the policy goals identified. The legislative draftsmen can write a statute that is only as sound as the policy instructions given to them by the tax writing committees and the research that has preceded the legislative consideration of the problem. The inadequacies, complexities and, in some instances, outright errors contained in the 1976 legislation reflect this fact. From the standpoint of the estate planner, these statutory deficiencies produce both unnecessary frustrations and complexities, with resulting increased costs to clients, and new opportunities for planning for tax minimization.

The articles in this symposium volume represent a resource equally valuable for tax planners who must of necessity work with the tools given to them in the 1976 Act—inadequate and lacking in rational coherence in many instances as those tools may be—and for those responsible for formulating tax policy who should discern from the problems and opportunities encountered by tax planners the areas in which detailed study and research are required if the United States is to move toward a mature system of taxation of transfers of accumulated wealth.

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into currently be "grandfathered"? That is, how far can tax planners rely on the continued applicability of existing law to estate plans developed under existing rules? See Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

[27] For a discussion of the 1976 Act, see Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303 (1976).