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Taxation Without Liquidation: Rethinking "Ability to Pay"

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TAXATION WITHOUT LIQUIDATION: RETHINKING "ABILITY TO PAY"

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This Article proposes a novel way to tax wealth transfers. Specifically, it suggests that we divide all assets transferred by gift or bequest into two classes—illiquid assets and liquid assets. The recipient should include those assets in income but be allowed two options. With respect to illiquid assets, the recipient should be able to avoid immediate income inclusion if he takes the property with an income-tax basis of zero. With respect to liquid assets, the recipient should be allowed a full income-tax deduction if he rolls the gift or bequest into a deductible IRA. The combination of these simple rules would be much more equitable than our current system, and it would prevent people from having to sell illiquid assets to pay taxes.

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INTRODUCTION

> *[T]he most important aspect of great fortunes is not the luxury which they engender, nor yet the envy and discontent which they excite; it is the tremendous power which they give over men, and—it seems—over nations. We may well hesitate about depriving a man of what he himself has fought for and won by his ability or his luck. But to make his conquest hereditary, to put this enormous influence into the hands of a man who may be entirely unfitted for it, violates every principle of law and policy for which the government stands.*[1]

People think our tax system is a mess, and many books propose solutions to this purported problem.[2] Most major proposals either permanently repeal all federal wealth-transfer taxes[3] or retain some form

1. James M. Morton, Jr., *The Theory of Inheritance*, 8 HARV. L. REV. 161, 167 (1894).

2. *See, e.g.*, NEAL BOORTZ & JOHN LINDER, THE FAIR TAX BOOK: SAYING GOODBYE TO THE INCOME TAX AND THE IRS (2005); STEVE FORBES, FLAT TAX REVOLUTION: USING A POSTCARD TO ABOLISH THE IRS (2005); WILLIAM H. GATES, SR. & CHUCK COLLINS, WEALTH AND OUR COMMONWEALTH: WHY AMERICA SHOULD TAX ACCUMULATED FORTUNES (2003); MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008); MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH (2005); EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002).

3. *See, e.g.*, BOORTZ & LINDER, *supra* note 2, at 75 (arguing that we repeal our current federal tax system, including estate and gift taxes, and replace it with a flat-rate national sales tax); MCCAFFERY, *supra* note 2, at 6 (arguing that we repeal our current federal tax system, including estate and gift taxes, and replace it with a progressive national sales tax). Our current federal wealth-transfer taxes include the estate tax, the gift tax, and the generation-skipping-transfer tax. I.R.C. §§ 2001, 2501, 2601 (West 2008).

of wealth-transfer taxation with significant exemption amounts and, frequently, special protection for family farms and small businesses.[4] This Article takes a different approach. It proposes that we tax wealth transfers without any special carve-outs for farms and businesses. Instead, we should divide all wealth transfers into the following two asset classes: (1) cash or cash equivalents ("liquid assets"), and (2) everything else ("illiquid assets"). A different method of taxation should apply to each of these two asset classes. This approach is simple, it encourages savings, and it never would force people to borrow or sell assets to pay taxes.

Our tax system aims to tax people based on their ability to pay.[5] As a society, we believe that it is fairer to make a billionaire pay more taxes than a homeless person. As a result, we have not seen any modern proposal to charge a head tax on each person regardless of that person's wealth or income; even flat-tax proposals determine the tax owed based on a percentage of the taxpayer's income.[6] The difficulty lies in measuring a person's ability to pay. In doing this, should we consider all assets available to the taxpayer, such as real estate, or should we consider only the person's liquid assets, such as cash and publicly-traded securities?

Our current federal income-tax system generally does not distinguish between liquid or illiquid assets.[7] Unless there is a statutory exception,[8] it taxes all accessions to wealth regardless of whether the accession is of cash or in-kind assets.[9] This approach works well with an

4. *See, e.g.*, GATES & COLLINS, *supra* note 2, at 77, 139; GRAETZ, *supra* note 2, at 160.

5. *See* Joseph M. Dodge, *Further Thoughts on Realizing Gains and Losses at Death*, 47 VAND. L. REV. 1827, 1840 (1994).

6. *See, e.g.*, FORBES, *supra* note 2, at 60.

7. *See* I.R.C. § 61(a) (defining *gross income* as "all income from whatever source derived"). Despite this broad rule, our system does occasionally treat different types of assets differently. *See, e.g.*, *Burnet v. Logan*, 283 U.S. 404, 412 (1931) (treating a sale of stock differently when payment is contingent and deferred); *Bedell v. Comm'r*, 30 F.2d 622, 624 (2d Cir. 1929) (treating a conditional promise to pay differently).

8. Some exceptions include gifts and inheritances, I.R.C. § 102, the receipt of life insurance proceeds, *id.* § 101, and pre-death appreciation on capital assets. *Id.* § 102. In addition, the taxation of certain accessions to wealth is deferred for administrative convenience (the realization requirement) and for policy reasons (contributions to retirement plans). *See* WILLIAM D. POPKIN, FUNDAMENTALS OF FEDERAL INCOME TAX LAW 52–53, 606–09 (4th ed. 2002).

9. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). This modern broad view of income was "another important milestone in a long evolutionary process whereby an earlier, narrower view of income has been periodically 'altered largely as a consequence of a change in the Court's personnel.'" L. Hart Wright, *The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts*, 8 STAN. L. REV. 164, 201 (1955–56) (quoting *Rutkin v. United States*, 343 U.S. 130, 140

income tax on wages and on business income because the amount of tax owed is based upon the amount of wages or business income received, which is almost always cash.[10] Thus, in general, nobody should need to borrow or sell assets to pay taxes on wages or business income.

Gifts and inheritances are different from wage and business income because the assets transferred are frequently illiquid. Thus, the heir who receives valuable artwork, a home, a farm, or a business may need to sell or borrow against the inheritance to pay any taxes that might be owed. Most Americans are not affected by this because our tax system excludes gifts and inheritances from income for income-tax purposes.[11] Instead, we have a separate wealth-transfer-tax system applicable to gifts and bequests that targets the very wealthy.[12] This separate tax system exempts huge sums from these wealth-transfer taxes,[13] and the system contains special provisions for certain illiquid assets, such as farms and businesses.[14] Under this system, the transferor, or her estate, pays the transfer tax.[15] Recipients of assets received by bequest then take those assets with an income-tax basis equal to the assets' fair market value on the decedent's date of death (stepped-up basis at death),[16] while recipients of assets by gift take those assets with the transferor's basis (carryover basis).[17] This approach has not worked, in large part because opponents of wealth-transfer taxes have succeeded in convincing the general public that these taxes are forcing people to liquidate their

(1952) (Black, J., dissenting)); *see also* Joseph M. Dodge, *The Story of* Glenshaw Glass*: Towards a Modern Concept of Gross Income*, *in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES 15 (Paul L. Caron ed., 2002).

10. A notable exception is a barter transaction. This generally is taxable even if no cash is received. *See* Irs.gov, Barter Exchanges, http://www.irs.gov/businesses/small/article/0,,id=113437,00.html (last visited Oct. 20, 2008).

11. I.R.C. § 102.

12. *See id.* §§ 2001, 2501, 2601.

13. The lifetime exemption amount, not including "annual exclusion gifts" of $12,000 per donee, currently is $1 million for inter vivos gifts and $3.5 million for transfers at death. *See id.* §§ 2010(c), 2503(b), 2505(a)(1).

14. *See id*. §§ 2032A, 2057, 6166.

15. *See* STEPHANIE WILLBANKS, FEDERAL TAXATION OF WEALTH TRANSFERS 109–16 (2004).

16. I.R.C. § 1014(a). The basis technically is "stepped up" or "stepped down" to the assets' fair market value on the decedent's date of death under § 1014(a)(1) or, if the alternate valuation date is used on the decedent's estate tax return, the basis is the fair market value on the alternate valuation date under § 1014(a)(2).

17. *Id.* § 1015(a). It is also commonly referred to as a transferred basis or a substituted basis. If the transferred asset's fair market value is lower than basis at the time of transfer, the transferee takes the property with a carryover basis for gain purposes and a fair market value basis for loss purposes. *Id.*

inheritances.[18] As a result, we are at the brink of either having no wealth-transfer taxes or a transfer-tax system that would allow people to inherit millions of dollars completely tax free.

Several scholars have argued that we should abandon estate and gift taxes and, instead, tax the recipient by including gifts and inheritances in the recipient's income[19] or by separately taxing the receipt, rather than the transfer, of gifts or inheritances.[20] Other scholars have argued that we should treat death like a sale and impose a capital-gains tax on all untaxed appreciation at death.[21] None of the approaches addresses the liquidity issue in a way that will change the public perception of forced sales to pay taxes.

This Article proposes that we directly address this public perception issue. We can do this by treating all accessions to wealth, whether earned or inherited, similarly while also recognizing the unique liquidity issues that occur with gifts and inheritances. Specifically, this Article proposes that (1) the current wealth-transfer taxes, which include the federal estate and gift taxes and the generation-skipping-transfer tax ("GST tax"), should be repealed permanently;[22] and (2) exclusions of gratuitous receipts and life-insurance proceeds from income[23] should also be repealed. These income exclusions should be replaced with a provision that allows the transferee to exclude the receipt of illiquid assets from

18. Advocates of our current wealth transfer-tax system have failed to persuade the public that it is a system worth keeping. The success of the estate-tax repeal movement, which has achieved a large exemption amount and a one year repeal of the estate tax, is evidence of this failure. GRAETZ & SHAPIRO, *supra* note 2, at 32–33, 41–43.

19. *See, e.g.*, Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); Charles O. Galvin, *Taxing Gains at Death: A Further Comment*, 46 VAND. L. REV. 1525 (1993); Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1 (1992); John K. McNulty, *A Transfer Tax Alternative: Inclusion under the Income Tax*, 4 TAX NOTES 24 (1976).

20. *See, e.g.*, Lily Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* (N.Y.U. Law & Econ. Working Papers, Working Paper No. 100, 2007), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1104&context=nyu/lewp.

21. *See, e.g.*, Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001). In this article, Professor Dodge provides for the possibility of a limited exception to the general realization-at-death rule for certain illiquid assets, such as family farms and small-business interests. These assets would receive a carryover basis. *See infra* text accompanying note 154.

22. Currently, the Federal Estate Tax and GST Tax are repealed for one year—2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 39, 69. The Federal Gift Tax is not repealed. *Id.* A discussion of the details of the GST Tax is beyond the scope of this Article.

23. I.R.C. §§ 101(a), 102(a) (West 2008).

income. If the transferee does this, the stepped-up basis at death[24] and the carryover basis for gifts[25] should be replaced with a stepped-down-to-zero basis for gifts and bequests of these excluded illiquid assets. Finally, the recipient of liquid assets should be allowed an income-tax deduction for any portion of the gift or inheritance that he transfers to a deductible IRA.[26] The combination of these relatively simple rules would create a fair and simple wealth-transfer-tax system that would not force anybody to borrow or sell assets to pay taxes.

This Article is divided into five parts. Part I provides the historical framework that led to our current tax system. This history helps to explain why and how we should tax wealth transfers. Part II discusses the problems with our current wealth-transfer taxes. Part III discusses the variety of approaches, real and proposed, that now exist for taxing wealth transfers. Part IV discusses my proposal in detail. Part V concludes that the adoption of this proposal would result in a more equitable and simple system of wealth-transfer taxation.

I. HISTORICAL FRAMEWORK

Professor Michael Graetz of Yale has proposed an insightful and creative reformation of our current tax system that he calls the "Competitive Tax Plan."[27] At its most basic level, he proposes that we enact a federal value-added tax (VAT) and exempt families earning $100,000 or less in annual income from the income tax.[28] My proposal

24. *See supra* note 16.

25. There is also a limited carryover basis for assets transferred at death during the year 2010. *See* I.R.C. §§ 1014(f), 1022. This too should be repealed. *See infra* Part IV.C.1.

26. *See infra* Part IV.B.3. More specifically, the limitation on amounts that may be put into a deductible IRA in a given year should be increased by the amount of inheritance or gift included in the recipient's income in that year. Currently, the limitation on the amount that may be transferred to a deductible IRA each year is $5,000, with some exceptions and special rules. I.R.C. § 219(b)(5).

27. *See* GRAETZ, *supra* note 2, at 4. Although the most recent and complete statement of this proposal can be found in the cited book, this book was based on the following earlier essay, Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002). That essay was adapted largely from another Graetz book, MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE (1999), and the Erwin N. Griswold Lecture delivered to the American College of Tax Counsel in New Orleans, Louisiana on January 19, 2002. Graetz, 112 YALE L.J. 261, 261 n.†.

28. GRAETZ, *supra* note 2, at 83. More specifically, the Competitive Tax Plan proposes that Congress do the following: (1) enact a 10–14 percent VAT on a broad base of goods and services; (2) exempt all businesses with revenue of less than $100,000 per year from collecting this tax; (3) eliminate the income tax and income-tax-return filing requirements for families earning less than $100,000 per year and for individuals earning

ideally should be enacted in connection with a plan such as this because it would reduce the number of people directly affected by the proposal to a very small percentage of our population. Reducing the impact of this proposal is probably necessary to make it politically palatable. Graetz promotes his plan as an effort to return to the original purpose of the income tax.[29] A look at the history of our tax system uncovers our core tax-law values and provides insight into potentially better systems.

A. The 1894 Tax

Excise taxes and tariffs on imported goods, which were our main form of federal taxation at the founding of our country, were effectively consumption taxes.[30] Excise taxes and tariffs on luxurious imported items would have been paid by those with the greatest ability to pay.[31] As Thomas Jefferson wrote in 1790:

> [T]he collection of taxes . . . has been as yet only by duties on consumption. As these fall principally on the rich, it is a general desire to make them contribute the whole money we want, if possible. And we have a hope that they will furnish enough for the expenses of government and the interest of our whole public debt, foreign and domestic.[32]

In addition, because people generally would have purchased these luxury items only if they had the cash to buy them, liquidity to pay taxes

less than $50,000 per year; (4) lower the income-tax rate to a rate of 20–25 percent; (5) eliminate most deductions other than incentives for home ownership, charitable contributions, large medical expenses, and employer-sponsored retirement and health plans; (6) reduce the federal corporate income-tax rate to 15–20 percent; (7) do not make any changes to payroll taxes; (8) retain the federal estate and gift taxes, but increase the exemption amounts and provide special relief for family farms and small businesses; (9) either provide payroll-tax adjustments or a "smart card" to low-income people to avoid increasing taxes on them with the VAT; and (10) encourage states to do the same as the federal government. *Id*. *passim*. The exemption amounts of $50,000 and $100,000 would be adjusted for inflation. *Id*. at 107.

29. *Id.* at 87.

30. *See id*. at 64, 85. It is worth noting that individual states had different forms of taxation, including property taxes, that were not consumption taxes. The focus of this Article, however, is on our federal tax system.

31. This is by virtue of the fact that luxury items by their very nature can be afforded only by those who can afford such luxuries. Excise taxes, such as the infamous "Whiskey Tax," occasionally affected the nonrich. *See* Act of March 3, 1791, ch. 15, 1 Stat. 199. It is worth noting that the extensive use of whiskey as currency in rural Pennsylvania meant that a federal excise tax on whiskey effectively served as an income tax in these areas. *See* WILLIAM HOGELAND, THE WHISKEY REBELLION 64–70 (2006).

32. Letter from Thomas Jefferson to Comte de Moustier (December 3, 1790) *in* 18 THE PAPERS OF THOMAS JEFFERSON 119 (Julian P. Boyd ed., 1971).

would not have been a problem. By the 1860s, however, the government needed additional revenue to fight the Civil War, and it decided to seek it with an income tax and an inheritance tax.[33] These taxes, too, were focused on the wealthy, but they had the limited purpose of funding the war effort.[34] Not long after the war ended, these taxes were repealed.[35]

By 1890, it was apparent that wealthy industrialists did not spend all their wealth and were accumulating money tax free.[36] As the government's revenue needs increased, Congress, in 1890, merely expanded tariffs to reach more nonluxury items, thus affecting average Americans.[37] Specifically, these new import duties were levied on many "raw materials used by ordinary people . . . [including] wool, twine, barbed wire, iron fence posts, salt, and lumber."[38] Because these new taxes were imposed on nonluxury items, those with less ability to pay would have been forced to pay out a much greater percentage of their income and overall wealth to taxes than those who did not need to spend everything they made.[39] The enactment of an income tax was a deliberate effort to shift the bulk of the tax burden back to the wealthiest sector of our society by taxing unspent income of the wealthy while reducing tariffs on nonluxury items.[40] It was intended "to fund a reduction in tariffs and to counterbalance the effect of those taxes on consumption with a tax more closely linked to people's *ability to pay*."[41] As Senator John K. Shield said in 1913,

> It is a part of the history of this country that much of the personal property owned by everyone, and the great accumulations of wealth in the hands of the few, had for years

33. *See* Act of Mar. 2, 1867, ch. 169, 14 Stat. 471, 478, 480; Act of July 4, 1864, res. 77, 13 Stat. 417; Act of June 30, 1864, ch. 173, 13 Stat. 223, 281, 283; Act of July 1, 1862, ch. 119, 12 Stat. 473, 474; Act of August 5, 1861, ch. 45, 12 Stat. 292.

34. *See* WILLBANKS, *supra* note 15, at 4; *see also* RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 22–29 (1954).

35. Act of July 14, 1870, ch. 255, 16 Stat. 256.

36. MICHAEL KAZIN, A GODLY HERO: THE LIFE OF WILLIAM JENNINGS BRYAN 32 (2006).

37. *See* Wilson-Gorman Tariff Act, ch. 349, 28 Stat. 509, 551 (1894); McKinley Tariff Act, ch. 1244, 26 Stat. 567, 617 (1890).

38. KAZIN, *supra* note 36, at 32.

39. For a fascinating history of this movement, as well as the prominent role of William Jennings Bryan in it, see *id.* at 51–222.

40. *See* GRAETZ, *supra* note 2, at 85.

41. *Id.* (emphasis added). Somewhat weakening Professor Graetz's assertion that the income tax was meant to supplement the foundational consumption tax (i.e., tariffs on imported goods), Professor Kazin notes that William Jennings Bryan, the drafter of this tax act, "would have preferred a graduated income tax that would replace the tariff entirely." KAZIN, *supra* note 36, at 51.

> escaped taxation. They could not be taxed directly without apportionment, which was not deemed advisable. The income tax law of 1894 was enacted to remedy this injustice and to make this property bear its just proportion of the expenses of Government.[42]

The income tax thus was designed as a targeted, supplemental[43] tax on the unspent income of the wealthy as a way to return to a tax system based on ability to pay.

The 1894 income tax[44] was simple enough. The tax targeted the wealthy and would have only affected less than 0.2 percent of the population.[45] It was a flat 2 percent tax on income over $4,000.[46] Rather than provide for a separate tax on inheritances, as was done in 1862–71,[47] the 1894 tax took the unusual step of treating gifts and inheritances of personal property as income.[48] It is not entirely clear why this was done. Congress could have attempted to reach inheritances with a separate tax; perhaps it was viewed as simpler and fairer to group inheritances and business- and wage-income together.[49] The congressional record surrounding the 1894 tax act demonstrates that congressmen were aware that it was unusual to treat inheritances as income rather than to tax them separately:

> Mr. PLATT. I do not think there ought to be included in the yearly income which is to be taxed, either the real estate which may be received by devise or personal property which is received by inheritance or gift.
>
> Mr. HILL. I am going to make a motion also in regard to that provision.
>
> Mr. PLATT. I do not think it is any part of the yearly income. I think it is entirely foreign to the scheme of the bill. I wish to state, while I am up, that there is no feature of the English

42. S. Doc. No. 63-171, at 14 (1913).

43. It was supplemental because it was on top of the usual excise taxes and tariffs.

44. Tariff Act of 1894, ch. 349, 28 Stat. 509.

45. *See* Kazin, *supra* note 36, at 51, 61 (explaining that in a nation of seventy million people fewer than a hundred thousand Americans earned enough to qualify).

46. *Id*. at 51.

47. Act of July 14, 1870, ch. 255, 16 Stat. 256; Act of July 1, 1862, ch. 119, 12 Stat. 432, 483.

48. Tariff Act of 1894, 28 Stat. at 553. This act was held to be unconstitutional, on other grounds, in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 637 (1895). *See also* Kornhauser, *supra* note 19, at 13.

49. Looking at both types of accessions to wealth certainly gives a more accurate picture of the recipient's total ability to pay.

> income tax which is so odious in England as what they call the death duties. That is the name which they have given this sort of taxation in England. The death duties are very odious, and they ought to be odious in this country. They are no part of a person's real income.
> Mr. CHANDLER. There seems to be no doubt at all that the bill adopts an inheritance tax right into the body of it.
> Mr. HILL. And calls it an income tax.
> Mr. CHANDLER. It purports to be an income tax, but it is an inheritance tax upon personal property . . . . I think it is a fundamental error to undertake to put an inheritance tax into an income-tax bill.[50]

Why did Congress only include inheritances of personal property in income and not inheritances of real property? From the congressional record, there appeared to be concern that taxing inheritances of real estate would be an unconstitutional, unapportioned, direct tax. Specifically, Mr. Chandler said, "I think he is right in maintaining that you cannot in the pending bill constitutionally tax an inheritance of real estate."[51] There is little else in the historical record to explain the reason for the exclusion of real estate, but liquidity may have been a concern. A tax on an inheritance of real estate might force the heir to borrow against or sell the land. Whatever the reason, the system designed in 1894 created few liquidity problems.

The 1894 tax act ultimately died when it was held to be an unconstitutional direct tax that was not apportioned in accordance with population.[52] This ruling ultimately led to the 16th Amendment to the Constitution—a change that, beginning in 1913, allowed Congress to levy income taxes without apportionment.[53]

B. The 1913 and 1916 Taxes

The 1913 tax act, which is the direct precursor of our current tax law, did not include gifts and bequests in income.[54] This tax was graduated.[55] After a $3,000 exemption ($4,000 for a husband and wife

50. 26 CONG. REC. 6821 (1894).

51. *Id. But see Scholey v. Rew*, 90 U.S. (23 Wall.) 331, 347 (1875) (noting that capitation taxes and taxes on permanent real estate are the only taxes that must be levied in proportion to numbers).

52. *Pollack*, 158 U.S. at 637.

53. *See* KAZIN, *supra* note 36, at 222.

54. Revenue Act 1913, ch. 16, 38 Stat. 114, 167.

55. *See* 38 Stat. at 166.

filing together),[56] the tax started at rates ranging from 1 percent up to 6 percent, at income over $500,000.[57] In the early years of this tax (1918–32), only 5.6 percent of the United States population filed income-tax returns with a tax due.[58] This percentage dropped to only 3.7 percent of the total U.S. population from 1933–39.[59] Thus, this income tax, although affecting vastly more people than the 1894 income tax (which affected less than 0.2 percent of the population), still affected an extremely small percentage of our country's population.

The change in the treatment of gifts and inheritances from 1894–1913 arose not out of a desire to make gifts and inheritances tax-free transfers, but was a push to tax gifts and inheritances at a higher rate than wages and business income.[60] Specifically, U.S. Representative Cordell Hull, the floor manager of the bill, stated in 1913 that a tax on gifts and inheritances would need to have "rather highly graduated rates, so that this tax would properly be contained in a separate enactment."[61] As further evidence that this was at least one rationale for the change, Congress enacted the federal estate tax just three years later, in 1916.[62] This tax had much higher rates than the income tax.[63]

56. 38 Stat. at 168. In addition to the individual and spousal exemption amounts, there were deductions for business expenses; interest on debt, state, county, school, municipal, and school taxes; actual losses not compensated by insurances; worthless debts; and depreciation of business property. 38 Stat. at 167.

57. 38 Stat. at 166.

58. GRAETZ, *supra* note 2, at 86.

59. *Id*.

60. Another rationale commonly given for the § 102 exclusion of gifts and inheritances from income is, as Professor Joseph Dodge has said, because of "the early 20th century view that 'original endowment' (a form of 'capital') could not be income under an income tax." Dodge, *supra* note 21, at 431. Dodge also notes that "[t]he chief contemporary political argument against [a provision including gifts and bequests in income] was that it would have duplicated state inheritance taxes." *Id.* at 431 n.44. He also notes that "a proposal by Senator Norris to add an inheritance tax to the 1913 Act was defeated." *Id.*

61. 50 CONG. REC. 506 (1913); Wright, *supra* note 9, at 173–74.

62. Act of September 8, 1916, ch. 463, 39 Stat. 756. Another reason for the enactment of the federal estate tax three years later was falling revenue from tariffs and anticipated revenue needs to fight World War I. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 5 [hereinafter FEDERAL WEALTH TRANSFER TAX SYSTEM], *available at* http://www.house.gov/jct/x-108-07.pdf. The federal gift tax was enacted in 1924. *Id.*

63. *Compare* Revenue Act 1913, ch. 16, 38 Stat. 114, 167 *with* Act of September 8, 1916, ch. 463, 39 Stat. 756. The 1916 estate tax effectively exempted the first $50,000 of every estate from this tax. *See* FEDERAL WEALTH TRANSFER TAX SYSTEM, *supra* note 62, at 5. Rates ranged from 1–10 percent (on transferred assets in excess of $5 million). *Id*. The following year, to pay for World War I expenses, the top rate was increased to 25 percent on transferred assets in excess of $10 million. *Id.* During this time period, the top income-tax rate was 6 percent on incomes in excess of $500,000. *Supra*

The 1916 estate tax was different from the 1913 income tax because the tax base used to determine the amount of estate tax would have logically consisted of illiquid assets, such as farms, closely-held-business interests, tangible personal property, and the family home.[64] Although illiquid assets may increase the recipient's overall ability to pay, the recipient may need to sell or borrow against the asset to pay taxes. This forced sale or loan issue, whether real or perceived, has been a key force behind the movement to abolish the estate tax.[65]

C. Back to the Present

Professor Graetz's Competitive Tax Plan,[66] which looks to the past for guidance, retains the current federal estate and gift taxes, albeit with potentially larger exemption amounts and special rules for family farms and small businesses.[67] Graetz also appears to be open to the possibility of finding an alternate method to tax wealth transfers. Specifically, he discusses the following: "alternative ways of taxing *large* gifts or bequests of wealth,"[68] an accessions tax,[69] a federal inheritance tax,[70] or simply including "*large* bequests in the recipients' income."[71] These possible methods of taxing wealth transfers are discussed in detail later.[72] Graetz notes:

> It is feasible under either an accessions tax or an inheritance tax to vary the rate of tax depending upon the recipient's affinity to

text accompanying notes 56–57. The reasons for choosing an estate tax, which is a transferor-focused tax, over an inheritance tax, which focuses on the transferee, included (1) a belief that it would raise more revenue, (2) a belief that it would supplement state inheritance taxes, (3) the convenience of modeling our wealth-transfer taxes after the British system, and (4) the administrative convenience of placing filing burdens on one wealthy decedent rather than on many heirs. Batchelder, *supra* note 20, at 14.

64. The family home is an illiquid asset that has unique value in most families. *See* Ann Mumford, *Inheritance in Socio-Political Context: The Case for Reviving the Sociological Discourse of Inheritance Tax Law*, 34 J.L. & SOC'Y 567, 582–83 (2007).

65. *See* GRAETZ & SHAPIRO, *supra* note 2, at 63.

66. *See supra* note 28.

67. GRAETZ, *supra* note 2, at 160.

68. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, *supra* note 27, at 267 (emphasis added). It is worth noting that his focus is only on taxing large wealth transfers rather than all wealth transfers that might cause the recipient to exceed the regular income-exemption amount of his plan (i.e., $50,000 for singles and $100,000 for families).

69. *Id.*

70. *Id.* at 268.

71. *Id.* (emphasis added). It is worth noting that the focus again is on large wealth transfers.

72. *See infra* Part III.

> the transferor and to adjust the tax for other family circumstances. Neither tax, for example, need be imposed upon gifts or bequests of interests in a small business or farm until the asset is sold outside the family.[73]

Graetz subsequently notes that, although an accessions tax or inheritance tax

> would fit comfortably in the new tax system proposed here, no such separate rate tax is necessary. Much of the progressivity of the nation's tax system currently supplied by the estate tax could be maintained by treating *large* gifts and bequests as income to those families whose $100,000 family allowance does not exempt them from income tax. A flat tax of twenty-five percent would then apply to taxable transfers of large amounts of wealth. The size of gifts or bequests required to be included in the recipient's income should be set at a level that maintains at least half the revenue that the estate tax would have produced.[74]

Graetz does not specify what he means by "large" amounts of wealth being subject to the tax. He also does not elaborate on why he would use a different rate structure from the general income tax and why the gifts and bequests would not be treated like any other income of the recipient.[75]

Currently, about 130 million individual U.S. income-tax returns are filed each year[76] by about 195 million people.[77] This represents about 65 percent of our population, a vastly greater percentage of our population than would have been affected by the 1894 tax act (0.2 percent) and than was affected by the 1913 tax act in its early years (5.6 percent).[78] Graetz

73. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, *supra* note 27, at 268. Like many modern proponents of transfer-tax reform, Graetz demonstrates a willingness to treat family farms and small businesses as a different type of wealth subject to special privileges.

74. *Id.* at 299 (emphasis added) (citations omitted).

75. As Professor Joseph Dodge has noted, income-tax inclusion of gifts and inheritances "does not contemplate a separate rate schedule for gifts and bequests. Such a separate schedule would contradict a basic premise of the [income inclusion] proposal: that the source of receipts should not affect tax liability." Dodge, *supra* note 19, at 1190.

76. *See* GRAETZ, *supra* note 2, at 104–05.

77. *See* INTERNAL REVENUE SERV., PUB. 1304, INDIVIDUAL INCOME TAX RETURNS 2006, at 40 tbl.1.3, *available at* http://www.irs.gov/pub/irs-soi/06inalcr.pdf.

78. One hundred and ninety-five million divided by 305 million. *See* Census.gov, U.S. POPClock Projection, http://www.census.gov/population/www/popclockus.html (last visited Oct. 22, 2008).

estimates that his Competitive Tax Plan would reduce the number of federal individual income-tax returns filed each year by 100 million (to about 30 million).[79] This would free over 150 million people who currently pay income tax from paying any federal income tax at all, leaving only about 45 million people to pay federal income tax.[80] Thus, the percentage of people subject to the federal income tax would drop to about 15 percent of our population.[81] While still significantly more than the 5.6 percent of 1918 and vastly more than the 0.2 percent of 1894, 15 percent is much more in line with the original goals of the income tax than the 65 percent currently taxed on income.

This history is important because it reminds us that the focus of all taxes in this country is and has been on ability to pay. It also reminds us that a consumption tax on nonluxury items, without an additional tax on unspent wealth or income, generally will result in an increased concentration of wealth in a few hands. Additionally, this history reminds us that the first push for a permanent income tax in 1894 treated accessions to wealth, whether earned or inherited, equally with one significant exception: the receipt of real estate was not taxed.[82] As mentioned, this meant that liquidity rarely would have been an issue. The focus of that first income tax, therefore, was to impose a supplemental, nonconsumption tax on those with the greatest ability to pay without requiring them to borrow or sell illiquid assets. The 1913 and 1916 taxes expanded the supplemental-tax category to include an income tax on the wealthy and an estate tax on the very wealthy.[83] The latter of these two taxes, along with the later-enacted GST tax, has been targeted directly for elimination by some powerful and influential groups.[84]

II. PROBLEMS WITH ESTATE, GIFT, AND GST TAXES

A. Why Tax Wealth Transfers?

The reasons why people support transfer taxes vary. Some common reasons include ability to pay, equality of opportunity, and wealth redistribution.[85] The concept of ability to pay in this context has

79. *See* GRAETZ, *supra* note 2, at 104–05.

80. *See id.* at 84.

81. Forty-five million divided by 305 million.

82. Tariff Act of 1894, ch. 349, 28 Stat. 509.

83. *See* Act of September 8, 1916, ch. 463, 39 Stat. 756; Revenue Act 1913, ch. 16, 38 Stat. 114, 167,

84. *See generally* GRAETZ & SHAPIRO, *supra* note 2, at 6–7.

85. *See, e.g.*, Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469 (2007) (arguing that inheritance taxes help to provide greater equality of opportunity); *see also* Batchelder, *supra* note 20, at 6 (arguing that an inheritance tax

historically referred to the assets available to the recipient of gifts and inheritances, regardless whether those assets are liquid or illiquid.[86] Equality of opportunity and wealth redistribution are closely related and, in the interest of brevity, grouped together as "wealth redistribution" in this Article. Of course, wealth-transfer taxes also are a small but significant source of federal revenue.[87]

Public figures who support the estate, gift, and GST tax often seem to do so because they value wealth redistribution.[88] They want to minimize great concentrations of wealth, or an inequality of property ownership that starts at birth.[89] This goal has existed since very early in our country's history. As Thomas Jefferson said in 1785, "Another means of silently lessening the inequality of property is to exempt all from taxation below a certain point, and to tax the higher portions of property in geometrical progression as they rise."[90]

The reason to reduce inequality of property varies. Economist Henry Simons, for example, stated that there is something inherently "unlovely" about inequality.[91] Perhaps the strongest argument in support of wealth

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would "mitigate widening economic disparities, promote equality of opportunity, and make our tax system better attuned to an individual's ability to pay").

86. *See* Dodge, *supra* note 19, at 1188–90.

87. Net estate and gift taxes collected from 1999–2007 ranged from a low of $21.9 billion to a high of $28.9 billion per year. *Compare* INTERNAL REVENUE SERV., PUB. 55B, DATA BOOK 2007, at 3 tbl.1 (2008), *available at* http://www.irs.gov/pub/irs-soi/07databk.pdf, *with* INTERNAL REVENUE SERV., DATA BOOK 1999–2006, *available at* http://www.irs.gov/taxstats/article/0,,id=102174,00.html.

88. *See generally* GATES & COLLINS, *supra* note 2.

89. *Id.* People who espouse this view tend to also support progressive income-tax rates. *See* Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 270–73 (1983). The pros and cons of progressive taxation of income are beyond the scope of this Article. Due primarily to the fact that income taxation in this country has always included progressive rates, the conclusions assume that, above some exemption amount, there always will be at least some degree of progressivity in our income-tax system. For the classic article against progressive income taxation, see Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952). In the article the authors challenge all arguments for progressivity made in the name of equal sacrifice and ability to pay. *Id.* at 445–86. Instead, they argue that the only legitimate, albeit questionable, grounds for progressivity are based on an attempt to redistribute wealth. *Id.* at 465–66. Strong cases for progressive taxation include Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998), and Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 TAX L. REV. 51 (1999).

90. Letter from Thomas Jefferson to James Madison (October 28, 1785) *in* 8 THE PAPERS OF THOMAS JEFFERSON 682 (Julian P. Boyd ed., 1953).

91. HENRY C. SIMONS, PERSONAL INCOME TAXATION 18–19 (1938). This is not meant to be a comprehensive list of reasons why people support reducing an inequality of property. The list of conceivable reasons why people might support this is extensive. For example, the rich arguably should pay more taxes because they benefit more from a

redistribution as a worthy goal is the notion that concentrated wealth is a threat to democracy.[92] According to Professor Reuven Avi-Yonah of the University of Michigan, this is so because (1) great wealth can buy political favors, (2) great wealth can finance runs for political office, and (3) great wealth "degrades relationships among people (cultural, social, and political) and eventually undermines the sense of community on which a democratic polity must rest."[93] A less obvious reason why some wealth redistribution is good is because, as the wealthy Andrew Mellon said, "[It] mitigate[s] radical demands for restructuring the capitalist system."[94] Stated differently, the wealthy benefit from reduced wealth disparities because society is less likely to reach a breaking point in which most of the upper class's wealth is confiscated by masses of poor people.

To summarize, people generally rely on three broad categories of reasons to support taxing wealth transfers. First, our society is better, in terms of people starting off on relatively equal footing and in terms of having a strong democracy, if hereditary wealth disparities are minimized (wealth redistribution). Second, our tax system is fairer, and thus more likely to be respected, if people with the greatest ability pay the greatest share of taxes (ability to pay). Finally, these taxes raise revenue, reducing the stress on other revenue sources (revenue raising). Since 1916, the federal estate tax has been the primary means by which the federal government taxes wealth transfers.[95] This primary tax has been backed up by the later additions of the federal gift tax[96] and the federal generation-skipping-transfer tax.[97]

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stable society. In addition, a larger middle class, and therefore less inequality, arguably would benefit the economy as a whole. A separate article could conceivably be written on the pros and cons of these arguments.

92. *See* Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 YALE L.J. 1391, 1412 (2002). Supreme Court Justice Louis Brandeis said it best: "We can have a democratic society or we can have great concentrated wealth in the hands of a few. We cannot have both." JEFF GATES, DEMOCRACY AT RISK: RESCUING MAIN STREET FROM WALL STREET xxxv (2000).

93. Avi-Yonah, *supra* note 92, at 1412.

94. *Id.* at 1410.

95. *See* WILLBANKS, *supra* note 15, at 3–7.

96. The federal gift tax became effective in 1924, was repealed in 1926, and became effective again in 1932. *See* FEDERAL WEALTH TRANSFER TAX SYSTEM, *supra* note 62, at 5–6.

97. The GST was enacted in 1976. *See* WILLBANKS, *supra* note 15, at 6. Its purpose was to prevent wealthy families from avoiding the estate tax at each generation through the clever use of trusts. *See* Batchelder, *supra* note 20, at 15.

B. Analyzing Estate, Gift, and GST Taxes

Wealth-transfer taxes have strong opponents with compelling reasons for being against wealth-transfer taxes. According to Professor Stephen Vasek of the University of Kentucky, common reasons given for repeal of transfer taxes include the following:

> (1) to improve the low personal saving rate in the U.S.; (2) to perpetuate the basic "American dream" of providing for one's children and loved ones; (3) to reduce the complexity, compliance burdens, and administrative burdens of current tax laws; (4) to prevent the destruction of small businesses and family farms, and; (5) to end the "double" taxation of income, first under the income tax law and then again at death under the estate tax law.[98]

Another reason commonly given is that it is generally undesirable to tax capital rather than income or consumption.[99]

Rather than weighing each of the pro-wealth-transfer-tax arguments against the anti-wealth-transfer-tax arguments, it is more practical to analyze these taxes against the backdrop of traditional tax-policy principles: equity, administrative efficiency, and neutrality.[100] Often, these specific arguments fall within more than one category.[101]

98. Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955, ¶ 3 (2001). With respect to the incentive to save, see also Michael Boskin, *An Economist's Perspective on Estate Taxation*, *in* DEATH, TAXES, AND FAMILY PROPERTY 56, 62–64 (Edward C. Halbach, Jr. ed., 1977).

99. *See* C. Lowell Harriss, *Estate Tax Revision and Capital Needs in the 1970's*, *in* READINGS IN DEATH AND GIFT TAX REFORM 51, 51 (Gersham Goldstein ed., 1971).

100. *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 5 (5th ed. 1987); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). The terminology used and the groupings of items in each category sometimes vary, but the basic principle is consistent. For a more recent interpretation, see Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006) (identifying efficiency, equity, and administrability as the three traditional grounds for evaluating tax policy).

101. For example, the taxation of the transfer of small businesses has equity implications (i.e., it is unfair to tax somebody who inherits publicly traded stock but not tax somebody who inherits stock in a closely held business), but it also has efficiency implications (i.e., it does not make sense to charge an exorbitantly high tax on the transfer of a business if that tax would result in the destruction of the business and, as a result, a greater loss of long-term tax revenue).

1. EQUITY

The concept of *horizontal equity* requires that similarly-situated taxpayers bear similar tax burdens.[102] The concept of *vertical equity* requires that taxpayers who are not similarly situated bear tax burdens relative to their respective abilities to pay.[103] *Ability to pay* in this context generally does not consider liquidity, despite the fact that liquidity is a significant issue in the wealth-transfer-tax context.[104]

Our current wealth-transfer-tax system generally does not distinguish between transfers of cash or in-kind assets, with some special exceptions for family farms and small businesses.[105] This means that a recipient of the family home is treated as if she received cash. This rule is equitable considering that the beneficiary received something of value, but is inequitable considering that the beneficiary may need to quickly sell the home in a poor housing market or borrow against it to pay taxes.[106] A beneficiary who inherits cash would not need to do this. As Professor Edward McCaffery of the University of Southern California has correctly noted,

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102. *See* John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 545 (1993); Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L. J. 509, 546.

103. *See* sources cited *id*.

104. Professor Joseph Dodge, who prefers to use the term ethics rather than equity, has described the current view of ability to pay as follows: "The basic idea is that individual taxpayers should contribute to a government that performs redistributive and public good functions according to their respective abilities to pay. In general, 'ability to pay' refers to economic resources under the taxpayer's control, whether in cash or in kind." Dodge, *supra* note 5, at 1840. For a discussion of liquidity issues related to wealth transfers, see STAFF OF J. COMM. ON TAXATION, 110TH CONG., TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY: A DISCUSSION OF SELECTED AREAS FOR POSSIBLE REFORM 14, [hereinafter TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY], *available at* http://www.house.gov/jct/x-23-08.pdf.

105. *See* I.R.C. §§ 2032A, 2057, 6166 (West 2008); *see also* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 15.

106. Attorney Ronald Aucutt argues that a taxpayer does not have an ability to pay with respect to an appreciated asset until the taxpayer voluntarily realizes gain, usually by selling the asset. *See* Ronald D. Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 TAX LAW. 343, 347 (1989). Professor Dodge responds directly to this view by saying,

> But one can have realization without liquidity (for example, an exchange of publicly traded stock for nonpublicly held restricted stock) and liquidity without realization (any asset for which a ready market exists). Nor does the voluntariness of realizations have anything to do with whether the gains should be taxed, because the tax system itself (the realization rule) induces people to choose *not* to realize gains.

Dodge, *supra* note 5, at 1840–41 n.66.

> [A]ll of the problems that led the courts to create the realization requirement . . . are also present at death: assets are still hard to value, and there may be no cash on hand to pay the tax. It seems harsh to expect the bereaved to have to sell their inheritance in order to pay a tax on it.[107]

The modern assault on the estate tax should cause us to rethink this concept of ability to pay in the wealth-transfer-tax context. This certainly seems necessary from a political standpoint.[108]

The current transfer-tax system, like many reform proposals, attempts to make special rules that are applicable only to family farms and small businesses.[109] The complexity created by these special rules is immense, particularly when one considers that those forced to comply with these rules generally are small-business owners and farmers, and not large corporate accounting departments. Perhaps more importantly, special cutouts are not always equitable, for example, when comparing the beneficiary who receives publicly traded stock with the beneficiary who inherits an equally valuable family business. Both assets may have the exact same societal benefit, although the business or farm is treated more favorably, ostensibly because it creates jobs and its loss may disrupt the community,[110] but more likely because of what it

107. MCCAFFERY, *supra* note 2, at 31. *But see* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 15 ("The data suggest that many estates that are comprised largely of farms or other closely held businesses have enough liquid assets to satisfy estate tax liabilities.").

108. The heart of the argument for estate-tax repeal, which, although largely unsubstantiated, has proven to be very persuasive with most Americans, is that the estate tax forces heirs to sell assets, such as farms and family businesses, to come up with the cash to pay estate taxes. *See generally* GRAETZ & SHAPIRO, *supra* note 2. No new proposal to reform our wealth-transfer-tax system can ignore the political reality that people cannot be put into a position in which they might have to sell illiquid assets, including tangible personal property, such as art and musical instruments, real estate, and family businesses, to pay transfer taxes. These assets are unique because it might take a long time to sell them and pressure to sell quickly might greatly reduce the sales price below market value, they might have personal significance to the heir, and, in the case of businesses and farms, they might create jobs. The potency of this argument will make any modern reform effort impossible to enact if it fails to consider the forced-sale issue.

109. *See supra* text accompanying note 105; TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 3 ("The principal criticisms have been that the provisions are complex and distort taxpayers' behavior by encouraging them to hold active business assets rather than other assets."); *id.* at 23 ("A second broad criticism of sections 2032A, 6166, and 2057 has been that those provisions favor the holding of certain assets over other kinds of assets, thereby encouraging planning and distorting economic behavior."); *see also* James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 868 (2001) (explaining estate-tax provisions applicable to farms and small businesses).

110. TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 14.

symbolizes—freedom and the American way. Symbolic value is a weak basis for setting tax policy.

Our current transfer-tax system determines the amount of tax owed based on the size of the transferor's estate rather than on the amount that each beneficiary receives. Thus, a beneficiary who receives exactly one-tenth of a $10 million estate[111] will effectively pay more wealth-transfer taxes by receiving a smaller inheritance than somebody who is the sole beneficiary of a $1 million estate. This is because the estate tax is computed based on the total size of the estate, regardless how the estate is divided up.[112] This is not equitable. This phenomenon has efficiency implications as well, which are discussed later.

As mentioned, a concern raised by opponents of our current transfer-tax system is that it is a double tax; that is, the transferor pays taxes when she earns the money, and then the transferor is taxed again on the same money with transfer taxes when she gives it away.[113] There is some truth to this argument. With respect to the gift tax, this argument rings especially true, given that the tax is borne by the transferor.[114] With respect to the estate tax, although occasionally true, the double-tax argument is weaker for two key reasons. First, the person bearing the estate tax, in reality, is the beneficiary and not the decedent, who is not even alive at the time of payment.[115] Had that beneficiary worked for the decedent to earn the same money, say by building a home for the decedent, the money would be taxable to the beneficiary even though the decedent had already paid taxes on it. This is the norm as long as those

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111. This assumes that estate taxes are apportioned equally among the beneficiaries.

112. *See* I.R.C. §§ 2031, 2032, 2051 (West 2008); *see also* INTERNAL REVENUE SERV., U.S. ESTATE (AND GENERATION-SKIPPING TRANSFER) TAX RETURN, FORM 706 (Rev. Aug. 2008), *available at* http://www.irs.gov/pub/irs-pdf/f706.pdf (demonstrating that the estate tax is computed based on the total size of the estate). For this reason, a transferee-focused transfer tax will be far superior to a transferor-focused tax if a primary goal is to reduce concentrations of wealth. *See* Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. REV. 551, 560 (2003); Batchelder, *supra* note 20, at 39–40.

113. *See supra* text accompanying note 98.

114. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., DESCRIPTION AND ANALYSIS OF ALTERNATIVE WEALTH TRANSFER TAX SYSTEMS 19, [hereinafter ALTERNATIVE WEALTH TRANSFER TAX SYSTEMS], *available at* www.house.gov/jct/x-22-08.pdf. This makes it particularly interesting that the gift tax is not repealed under current law. An argument could be made that the gift tax is borne, at least in part, by the transferee because the donor would have given the money needed for taxes to the transferee. Given the tax benefit of holding on to assets until death, especially with the potential for estate-tax repeal, it seems unlikely that current donors would think in these terms.

115. *See* Dodge, *supra* note 112, at 556; Batchelder, *supra* note 20, at 5.

two taxpayers are not in the same taxable unit.[116] Second, in most cases, the stepped-up basis at death[117] minimizes any alleged double taxation that might occur.[118]

To summarize, our current transfer-tax system has severe equity problems. First, its efforts to protect family farms and small businesses result in unfair treatment of heirs of assets other than farms and businesses, such as publicly traded stock. Second, recipients of in-kind assets are treated very unfairly compared with recipients of cash because they may need to sell or borrow against those illiquid assets, often in unfavorable conditions and under time pressure. Third, the focus on the transferor's estate rather than on the amount each transferee receives is inequitable because a person who is the sole beneficiary of a moderately sized estate will often pay less tax than each of many beneficiaries of a much larger estate. Finally, particularly in the case of gift taxes, the transferor may be forced to pay double taxes on money because he chooses to give it away rather than spend it.

2. EFFICIENCY

Traditionally, efficiency concerns are judged in the following two principal ways: (1) indirect costs (i.e., costs to taxpayers for attempting to comply with the law), and (2) direct costs (i.e., costs to the government for administering the tax law).[119] Although these concerns are directly focused on administrative efficiency, this Article takes a broader view of efficiency concerns and also considers the broader societal costs of wealth-transfer taxes and failure to achieve a policy objective as efficiency issues. Thus, if a tax is specifically enacted with the purpose of increasing tax revenue by encouraging people to start taxable businesses, and if it fails to encourage people to start businesses, it would be an inefficient tax.

Wealth-transfer taxes currently collect approximately $22–29 billion each year,[120] or 1–1.5 percent of our federal revenue.[121] It is hard to know

116. *See* Dodge, *supra* note 19, at 1203–08 (discussing husband and wife as taxable unit and analyzing the consequences of including and excluding minor children in the taxable unit).

117. *See supra* note 16 and accompanying text.

118. This same benefit does not apply to inter vivos gifts. *See supra* note 17 and accompanying text.

119. *See* Donaldson, *supra* note 102, at 548; *see also* Schmalbeck, *supra* note 102, at 529–30; Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 409–29 (1987).

120. *See supra* note 87.

with certainty how efficient estate-tax collection is, but there is significant evidence that it is one of our least efficient taxes when considering the costs, direct and indirect, that go into each dollar collected. Professor Vasek notes that "the National Federation of Independent Business estimated that the government and individuals collectively spend some 65 cents for each dollar of estate and gift tax collected—that's $5–6 billion annually—for enforcement and compliance activities."[122] Professor McCaffery takes an even stronger stance on the issue:

> [N]early a century of experience with the estate tax has proven it to be a failure. The tax is porous and complex. It might even be counterproductive, costing the government money simply to have it in place. This is because the tax has a long-term effect on the incentives to work and save and because it encourages transactions—like complicated life insurance trusts—that cost the government income tax revenue. These costs may well outweigh the limited benefits of the tax.[123]

In addition to utilizing various trusts, very wealthy people commonly set up entities, such as limited liability companies and family limited partnerships, and engage in complex and expensive planning solely in an effort to reduce the value of their taxable estates.[124]

Our current wealth-transfer-tax system also appears to have broad societal costs. Although there is no compelling evidence of it, many people believe that the estate tax destroys family businesses, causes families to sell farms, and causes people to spend rather than save.[125]

121. *See* Nonna A. Noto, CRS Report for Congress: Estate and Gift Tax Revenues—Past and Projected in 2008, at 15 tbl.7 (2008), *available at* http://assets.opencrs.com/rpts.RL34418_20080319.pdf.

122. Vasek, *supra* note 98, at n.16 (quoting *Reducing the Tax Burden: Hearing Before the H. Ways and Means Comm.*, 105th Cong. 92 (1998) (statement of Rep. Jim McCrery)).

123. McCaffery, *supra* note 2, at 66; *see also* Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 Yale L.J. 283 (1994) (arguing for the abolishment of the estate tax).

124. *See* Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 Tax L. Rev. 241, 254–63 (1988); *see also infra* Part II.B.3; Taxation of Wealth Transfers within a Family, *supra* note 104, at 33–49.

125. *See* Dodge, *supra* note 5, at 1840 n.63 ("However, insofar as savings are target- or bequest-oriented, it is more logical to presume that the prospect of future death taxes would induce a person to save more to achieve the desired after tax result."); *see also* Taxation of Wealth Transfers within a Family, *supra* note 104, at 24; *supra* text accompanying note 98.

Assuming that these allegations are true, even to the smallest degree, it would weaken the efficiency rate even further.[126]

More troubling from an efficiency perspective is the issue of whether our wealth-transfer-tax system has had any success at carrying out its most significant goal—reducing concentrations of wealth. It certainly is not clear that these taxes do anything with respect to wealth redistribution other than make people feel like something is being done.[127] Furthermore, the basic design of the system is flawed if this is a goal. By basing the tax on the total size of the estate regardless how it is divided, our law does not encourage rich individuals to spread out their wealth by leaving smaller amounts to a large number of individuals.[128] A tax that would focus on the transferee and the amount received by each transferee would be far more efficient in this respect.[129]

To summarize, our current wealth-transfer-tax system has severe efficiency problems. First, the direct costs to the government of trying to enforce the tax law are extremely high with respect to the revenue the tax generates. Second, the money that people spend to avoid paying this tax is extremely high. Third, if it is true that businesses and farms are lost and people refrain from saving and investing, this would weaken the efficiency of our wealth-transfer-tax system. Finally, it is poorly designed to reduce large wealth disparities.

3. NEUTRALITY

The concept of tax neutrality suggests that the Internal Revenue Code (Code), to the extent possible, should not cause people to alter behavior solely for tax reasons unless there is a public-policy reason for

126. The weakening results from the fact that a loss of a business or farm or productive investments would serve to reduce the number of people working and paying taxes.

127. *See* EDWARD N. WOLFF, TOP HEAVY: THE INCREASING INEQUALITY OF WEALTH IN AMERICA AND WHAT CAN BE DONE ABOUT IT (2d ed. 2002); Joseph E. Stiglitz, *Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence*, 86 J. POL. ECON. 137, 137–50 (1978); *see also* McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, *supra* note 123, at 322–24; G.P. Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?* (pt. 1), 117 TR. & EST. 598 (1978); G.P. Verbit, *Do Estate and Gift Taxes Affect Wealth Distribution?* (pt. 2), 117 TR. & EST. 674 (1978). For evidence that the estate tax has reduced the net worth of wealthy individuals, see Wojciech Kopczuk & Joel Slemrod, *The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior*, *in* RETHINKING ESTATE AND GIFT TAXATION 299, 338–39 (William G. Gale et al. eds., 2001).

128. *See* Dodge, *supra* note 112, at 560–61. It is worth noting that the gift tax annual exclusion (currently $12,000) does encourage wealth dispersion. ALTERNATIVE WEALTH TRANSFER TAX SYSTEMS, *supra* note 114, at 17.

129. *See* Batchelder, *supra* note 20, at 39–40.

doing so.[130] Our current wealth-transfer system fails miserably at this. In large part this is because (1) estate- and gift-tax rates are high,[131] and (2) the focus of the tax is on the transferor and the value of the transferor's estate, rather than on the transferee and the value of the assets received by the transferee.[132] The former creates an incentive to find a way to reduce the taxes, and the latter creates a simple means to do it.

Tax-focused estate planning is not rocket science. As Professor McCaffery has said, "The basics of estate tax avoidance . . . are brutally simple: 1) Give early, 2) Give often, and 3) Give in trust."[133] At the high-end level, we add to this an effort to reduce the taxable value of assets held by the transferor while increasing the asset's actual value in the hands of the transferee after the tax is imposed.[134]

In general, a high-end estate plan will consist of one or more of the following techniques: a gifting program in which the client makes annual-exclusion gifts[135] to a trust for multiple beneficiaries,[136] life insurance held through an irrevocable trust that will not be included in the transferor's estate, the use of entities such as family limited partnerships to discount the value of assets held by the client,[137] sales

130. *See* Donaldson, *supra* note 102, at 550–51.

131. The top estate and gift tax rate is 45 percent through 2009 and 55 percent after 2010. INTERNAL REVENUE SERV., PUB. 950, INTRODUCTION TO ESTATE AND GIFT TAXES 2 (2008), *available at* http://www.irs.gov/pub/irs-pdf/p950.pdf. In 2010, the one year when the estate tax is repealed, the top gift tax rate is 35 percent. *Id.*; *see also* WILLBANKS, *supra* note 15, at 107.

132. *See* I.R.C. § 2033 (West 2008).

133. MCCAFFERY, *supra* note 2, at 68.

134. *See* Dodge, *supra* note 124, at 256. This is simple to do. For example, if Dad owns 100 percent of the stock of a closely held business worth $100 million, he can transfer 49 percent of the stock to Son in Year One, 49 percent in Year Two, and 2 percent in Year Three. In each case, the transfer is of a noncontrolling, illiquid interest in the business, which may result in a 30–40 percent lack-of-control and lack-of-marketability discount in the value for gift-tax purposes. This discount could easily result in a $20 million tax savings, despite the fact that Son ends up owning 100 percent of the business. This is a significant problem of having a transfer-tax system that is focused on the transferor and the transfer, rather than the recipient and the receipt.

135. These are gifts that do not reduce the lifetime gift tax, estate tax, or generation-skipping-transfer-tax exemption amounts. *See* WILLBANKS, *supra* note 15, at 185. The current amount that qualifies is $12,000 per donee per year. I.R.C. § 2503; Rev. Proc. 2005-70, 2005-47 I.R.B. 979, 984.

136. The gifts generally must be "present interest" gifts. I.R.C. § 2503. The most common way to handle this with a gift to a trust is to give each beneficiary a limited withdrawal power. *See, e.g.*, *Crummey v. Comm'r.*, 397 F.2d 82 (9th Cir. 1968) (holding that a limited withdrawal power held by a beneficiary of a trust makes the beneficiary's interest a "present interest").

137. *See* Dodge, *supra* note 124, at 254–63.

transactions to freeze value,[138] charitable trusts,[139] and trusts that make generation-skipping transfers in a way that avoids the imposition of the generation-skipping transfer tax.[140] If the client is married, the plan will also commonly utilize a trust for the spouse that is specially designed to qualify for the marital deduction.[141] Although a certain portion of the planning is not tax motivated, there is no question that most of these complex arrangements are made for the purpose of minimizing or avoiding transfer taxes. This violates the neutrality principle.

III. ALTERNATE APPROACHES TO TAXING GIFTS AND INHERITANCES

The prior Part demonstrated that our current estate, gift, and generation-skipping-transfer taxes are not an equitable, efficient, or neutral way to tax wealth transfers. Does a better alternative exist? If not, then we might need to accept our current system, despite its many flaws. There are, however, several alternatives.

A. No Tax

One way to deal with wealth transfers is to not tax them at all. Congress and President George W. Bush took a huge step in this direction in 2001 by enacting the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[142] One of the most significant changes made by this tax cut was the repeal of the federal estate tax for the year 2010.[143] The GST tax is also repealed for that one year.[144] Unlike the estate tax and GST tax, the gift tax is not repealed; instead, the applicable exclusion amount with respect to gifts is "permanently" fixed at $1 million.[145]

EGTRRA also makes some significant changes to the stepped-up-basis-at-death[146] rule during the year 2010. As mentioned, through 2009, all assets in a decedent's estate generally receive an increase or decrease in income-tax basis to the assets' fair market value on the decedent's date

138. *See id.* This also may incorporate statutorily permissible retained interests, such as Grantor Retained Annuity Trusts (GRATs) and Grantor Retained Unitrusts (GRUTs). *See* I.R.C. §§ 2702(a)–(b) (authorizing the use of GRATs and GRUTs).

139. *See* Dodge, *supra* note 124, at 354.

140. *See id.* at 355–60.

141. *See id.* at 345–53.

142. Pub. L. No. 107-16, § 1, 115 Stat. 38.

143. *Id.* § 501, 115 Stat. at 69; *Id.* § 542, 115 Stat. at 76.

144. *Id.* § 501, 115 Stat. at 69.

145. *Id.* § 521, 115 Stat. at 71–72. Nothing is truly permanent in tax law, but there has not been a significant push to repeal the gift tax.

146. *See supra* note 16 and accompanying text.

of death.[147] This unlimited basis step-up simplifies basis tracking for the beneficiaries and reduces the effect of alleged double taxation.[148] In 2010, the unlimited step-up in basis is repealed when the estate tax is repealed.[149] Instead of an unlimited step-up at death, EGTRRA provides that assets passing from the decedent to any person other than to the decedent's spouse will receive a step-up of up to $1.3 million; assets passing to the decedent's spouse will receive a step-up of up to $3 million.[150]

Another more extreme approach to wealth-transfer taxation, which has not yet received serious consideration by Congress, would be to repeal the estate, gift, and GST taxes while also fully retaining the stepped-up basis at death.[151] This approach would effectively make whole families the taxable unit regardless of the age of its members, with tax forgiveness on appreciation at each generation.[152] Thus, once income enters a family it would be free from all future taxes, including on appreciation, until it is transferred out of the family. This approach would remove any conceivable wealth-transfer-tax reason for having to sell a family farm or business upon transfer to heirs. It would also create two tax classes of people in our society: those who receive significant tax-free inheritances and those who work and pay taxes.

147. *Id.*

148. According to attorney Steven Akers, "The general purpose of the stepped-up basis rule is to avoid double taxation, subjecting the same property to both estate taxation and income taxation when the asset is sold after the decedent's death." Steve R. Akers, *Estate Planning under the 2001 Tax Act*, *in* ALI-ABA COURSE STUDY MATERIALS, PLANNING TECHNIQUES FOR LARGE ESTATES (Nov. 2001). According to Professor Zelenak, "[The] [s]tepped-up basis at death . . . serves an important simplification purpose by avoiding proof of basis problems for small estates . . . ." Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 423 (1993).

149. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 541, 115 Stat. 76. Although this is not necessarily the case, if estate and gift tax repeal under EGTRRA is made permanent, the repeal of the unlimited step-up (and step-down) in basis also presumably would become permanent.

150. *Id.* § 542, 115 Stat. at 76–81.

151. In reality, the "limited" step-up of 2010 is not very far off from this approach, at least with respect to the stepped-up basis at death. First, the step-up is so large that, in the vast majority of cases, people will still have a full stepped-up basis at death. Enough deferral rules are in place that taxes could be deferred indefinitely with recurring "limited" step-ups at each generation. *See, e.g.*, I.R.C. § 1031 (West 2008) (allowing for nonrecognition of realized gain if the proceeds of sale are invested in like-kind property).

152. This is a bit of an oversimplification because wealth transfers are not always limited to intra-family transfers. A person's descendants, however, are commonly viewed as the natural objects of his bounty. *See* Morton, *supra* note 1, at 167; *see also* Dodge, *supra* note 19, at 1203–08.

B. Death as a Realization Event

Canada currently has no wealth-transfer tax; instead, it taxes accrued gains on all wealth transfers at the time of transfer, effectively treating death as a realization event, much like a sale.[153] Professor Joseph Dodge of Florida State University has made a very persuasive argument for making death a realization event in the United States as well. Specifically, he states that:

> According to optimal taxation theory, death is the ideal time to impose a disproportionately heavy tax, since the tax would affect economic choices only minimally. Yet the most neutral income tax with respect to investments would be one that abolished the realization principle entirely and with it the preference for capital gains. Thus, as a general proposition, unrealized appreciation and depreciation, at least of liquid assets and perhaps of all assets, should be incorporated into the tax base annually. The deemed-realization rule lies far closer to that norm than a carryover basis rule, which would allow indefinite deferral of gain . . . . [A] deemed-realization rule would have the salutary effect of increasing revenue that can be balanced by lower rates in general and/or the elimination of preferences for capital gains.[154]

As Dodge notes in a later article, the deemed-realization approach suffers from two problems: (1) there would be a need to value assets at death to determine the amount of gain to recognize, and (2) liquidity to pay taxes can be an issue.[155] Dodge's later article attributes most of the public resistance to wealth-transfer taxation to concern about double taxation[156] rather than concern about liquidity except, perhaps, with respect to family farms and small businesses.[157] As the later article notes:

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153. David G. Duff, *The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand*, 3 Pitt. Tax Rev. 71, 85–107 (2005).

154. Dodge, *supra* note 5, at 1840 (citations omitted).

155. Dodge, *supra* note 21, at 446.

156. *Id.* at 429. It seems that the two most common arguments against estate taxes are that they are double taxation and that they force people to sell family farms and businesses, which is effectively a liquidity concern. There are no conclusive studies that demonstrate which is a greater concern to the general public, although Professors Michael Graetz and Ian Shapiro have noted that one of the most significant reasons for the recent success of estate-tax-repeal proponents is that estate-tax supporters have failed to adequately address the issue of forced sales of farms and small business, even though there is little evidence that it actually happens. *See* Graetz & Shapiro, *supra* note 2, at 32–40; *see also* Taxation of Wealth Transfers within a Family, *supra note* 104, at 15, 25. This information suggests that actual forced sales of businesses and farms are far

> The liquidity demands under a deemed-realization system would be significant but would be much reduced relative to the liquidity demands under the current estate tax, due to basis and loss offsets and substantially lower tax rates. In addition, most primary residence deemed-realization gains could be brought within the exemption rule of § 121.
>
> As under the current estate tax, the liquidity problem for estates would be most acute in the case of closely held (that is, "family") farms and business interests, which also may possess a low basis. One approach might be to carry over existing estate tax rules that allow for actual-use valuation (of real estate). If this is deemed insufficient, a more comprehensive solution would be to carve out a carryover-basis exception for such assets within the deemed realization system.[158]

Although I am unaware of any empirical studies on the issue, I believe that this downplays the magnitude of the public's perception regarding forced sales or loans to pay taxes.[159] If, for example, a person were to die owning a few highly appreciated investment properties, the heirs would need to either borrow or sell the assets to pay deemed-realization taxes. Stories such as this would rally the political forces against deemed realization despite the theoretical soundness of the approach. In addition, specific provisions applicable to family farms and businesses contain the same problems that virtually every wealth-transfer–tax-reform proposal has: (1) they are extraordinarily complex,[160] and (2) they are unfair to people who happen to not be born into farming or business families.

less significant in the push for estate-tax repeal than is the public perception that these forced sales are occurring.

157. Dodge, *supra* note 21, at 448.

158. *Id.* (citations omitted).

159. *See* GRAETZ & SHAPIRO, *supra* note 2, at 32–40.

160. *See, e.g.*, I.R.C. § 2032A (West 2008) (allowing business and farm assets to be valued at their actual-use value rather than at highest- and best-use value, provided that various complex requirements are met); *Id.* § 2057 (allowing a deduction for qualified family-owned-business interests, provided that certain complex requirements are met, for decedents dying after December 31, 1997, before January 1, 2004, or after December 31, 2010); *Id.* § 6166 (allowing a deferral of estate taxes with respect to closely-held-business interests at below-market interest rate, provided that certain complex requirements are satisfied). As should be readily apparent, efforts such as these to make special rules for small businesses and farms have created extraordinary complexity for small-business owners and farmers. In addition, there are many questions that policy makers need to answer and that evade simple but fair answers. For example, what is a small business? How many nonfamily members can be owners before it ceases to be a family business? Similar issues apply to farms. *See* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 22–23.

C. Accessions Tax

Although we have never had an accessions tax in this country, it is an approach with many benefits. An accessions tax is based on the cumulative amount of gifts and bequests received by a particular beneficiary during the beneficiary's lifetime.[161] Three common justifications for an accessions tax are (1) inequality of opportunity, (2) removing the tax disincentive for gainful employment, and (3) reducing concentrations of unearned wealth.[162] A key benefit of an accessions tax over the estate tax is that, like any transferee-focused tax (including an income-inclusion system and an inheritance tax), it encourages wealth dispersion, thereby helping to reduce concentrations of wealth.[163]

Despite its benefits, an accessions tax has many problems. First, although it attempts to tax windfalls, it usually contains a large exemption amount that dilutes any purported benefit of wealth redistribution.[164] Second, it fails to accurately account for and reduce wealth concentrations because it does not look at the recipient's other wealth or income.[165] Finally, an accessions tax shares some of the same problems described by Vasek with respect to the current estate- and gift-tax system.[166] Most importantly, whether true or not, people will perceive it as a threat to family farms and small businesses.

D. Income Inclusion

There have been many proposals over the years, including the 1894 tax act, to include gifts and inheritances in income.[167] The rationale for this approach is that gifts and inheritances are accessions to wealth and thus, under the Haig-Simons definition of income,[168] should be taxable like any other income.[169] Some advocates of this approach have suggested that gifts and inheritances should be taxable to the recipient

161. *See* Dodge, *supra* note 19, at 1178 n.9. *See generally* Harry J. Rudick, *A Proposal for an Accessions Tax*, 1 TAX L. REV. 25, 32 (1945); Harry J. Rudick, *What Alternative to the Estate and Gift Taxes?*, 38 CAL. L. REV. 150, 167–68 (1950).

162. *See* Dodge, *supra* note 112, at 560.

163. *See id.* at 561.

164. *See id.* at 558.

165. *Id.* at 562.

166. *See supra* text accompanying note 98.

167. *See supra* note 19 and accompanying text.

168. Under this definition, income is defined as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." SIMONS, *supra* note 91, at 50.

169. Kornhauser, *supra* note 19, at 28; *see* Dodge, *supra* note 19, at 1183.

without any deduction to the transferor.[170] Others have suggested that a deduction should be allowed to the transferor, and the gift or bequest should be included in the transferee's income.[171] Others have advocated for our current approach, which does not give the transferor a deduction and does not include gifts or bequests in the recipient's income.[172]

The income-inclusion approach is the most equitable of the alternative ways to tax wealth transfers because it treats everybody equally. It does, however, have some serious drawbacks. First, it suffers from the same liquidity issues as our current system. Thus, the public perception that it destroys family farms and businesses would continue. Second, because it normally has no special exemption, like the current estate tax has, many more people would be affected by it. This makes the income-inclusion approach a much harder sell from a political standpoint. Third, it raises questions about the taxable unit and how to treat support obligations with respect to a spouse and minor children.[173] Finally, with our progressive income-tax rates, it raises the problem of income bunching because inheritances would tend to bunch a lot of income into one year, potentially pushing the recipient into a higher-than-usual income-tax bracket. Commonly, the proposed solution to this last issue is income averaging;[174] however, income averaging would add significant complexity to the system.[175]

E. Inheritance Tax

Inheritance tax is a broad term that some people use as a synonym for *accessions tax*[176] and that others use to refer to any recipient-focused wealth-transfer tax, including both an accessions tax and an income-inclusion approach.[177] This view would include the hybrid income-inclusion and accession-tax system recently proposed by Professor Lily Batchelder of New York University.[178] I use the term *inheritance tax* to refer to any tax based on the amount that a particular beneficiary receives as a result of a decedent's death or by lifetime gift.[179] The biggest

170. *See* Kornhauser, *supra* note 19, at 28.

171. *See id.* at 28–29.

172. *Id.* at 28.

173. These issues are addressed very thoroughly by Professor Dodge. *See* Dodge, *supra* note 19, at 1202–08.

174. *See id.* 11181 & n.21, 1190 & n.64.

175. *See infra* Part IV.B.3.

176. ALTERNATIVE WEALTH TRANSFER TAX SYSTEMS, *supra* note 114, at 7.

177. *See* Batchelder, *supra* note 20, at 7; *see also* Dodge, *supra* note 112, at 562.

178. *See* Batchelder, *supra* note 20. The idea of combining the two was proposed in very general terms by Professor Dodge. *See* Dodge, *supra* note 112, at 551.

179. *See* Dodge, *supra* note 19, at 1178 n.8.

problem with most common forms of inheritance taxes is that the tax base that is used usually is only based on the inheritance received, and is not related to the transferee's other income, wealth, or gratuitous accessions.[180] Batchelder's hybrid approach attempts to address this issue.

Batchelder proposes that we permanently repeal the estate tax and replace it with a system in which gifts and inheritances are included in the recipient's income and, in addition, subject to a 15 percent accessions tax.[181] Under her hybrid proposal, which she refers to as an inheritance tax, each transferee would have a $2.3 million exemption from both the income inclusion and the 15 percent tax.[182] Recipients would take inheritances with a carryover basis.[183] Her proposal is expressly "motivated by the view that large gifts and bequests should be taxed to mitigate widening economic disparities, promote equality of opportunity, and make our tax system better attuned to an individual's ability to pay."[184] She believes that an inheritance tax would do a better job than our current system at reducing wealth concentrations, in large part because a transferee-focused tax would "reward donors who give more broadly."[185] I agree.

Like all wealth-transfer-tax proposals, however, Batchelder's proposal presents problems. First, its effort to utilize a carryover-basis regime most likely would not work.[186] Dodge has identified the significant arguments against a carryover basis, and they are worth

180. Dodge, *supra* note 112, at 562.

181. Batchelder, *supra* note 20, at 2.

182. *Id.*

183. *Id.*

184. *Id.* at 6. She follows this sentence with the following sentence: "The estate tax does a good job at accomplishing all of these objectives." *Id.* This conclusion is not explained or shown to be supported by data. If the estate tax does a good job at this, we should not see widening economic disparities that we need to mitigate. These widening disparities in large part have led me to conclude that the estate tax is ineffective at accomplishing this goal. A counterargument to this assertion is that wealth inequality in this country would be even greater than it currently is without wealth-transfer taxes. *See* GATES & COLLINS, *supra* note 2, at 24–25.

185. Batchelder, *supra* note 20, at 2.

186. As mentioned, we currently are scheduled to have a limited carryover basis appear during the one year of estate-tax repeal, although it seems unlikely that that regime will last if it ever takes effect. *See supra* note 25. For counterarguments, see Bernard Barnett, *The Return of Those Two "Dirty Words": Carryover Basis*, 139 TR. & EST. 32 (2000); Krisanne M. Schlachter, Note, *Repeal of the Federal Estate & Gift Tax: Will It Happen and How Will It Affect Our Progressive Tax System?*, 19 VA. TAX REV. 781, 799 (2000). In 1976, Congress adopted a carryover-basis rule. FEDERAL WEALTH TRANSFER TAX SYSTEM, *supra* note 62, at 7. It, however, was repealed before it went into effect due to outcries about the difficulty of tracking basis. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 96 Stat. 229; *see* FEDERAL WEALTH TRANSFER TAX SYSTEM, *supra* note 62, at 7–8.

repeating here.[187] Specifically, a carryover-basis approach fosters horizontal inequity among beneficiaries;[188] it creates complex fiduciary problems in determining which assets, with which built-in gain, to distribute;[189] it opens the potential for mistakes by testators, who might not consider built-in gain issues;[190] it would increase the "lock-in effect" compared to the current rule because beneficiaries would seek to postpone realization, possibly for generations;[191] and it would cause people to assert that basis cannot be determined.[192]

Second, Batchelder's proposal is complex, which is likely to make it politically unpopular. For example, it uses market value to determine the amount of inheritance tax owed.[193] This makes sense from an equity perspective, but it creates the potential for double taxation to the same beneficiary—first when she inherits an appreciated asset and is taxed on that receipt, and then again when she sells it. To resolve the problem, the heir is taxed on accrued gain when he or she sells the property but can deduct from the capital gain "the share of her inheritance that the accrued gain represented at the time of receipt, multiplied by her inheritance tax rate at that time."[194] The proposal also identifies problems with tracing basis for certain assets, like baseball-card collections, and suggests a limited stepped-up basis for these assets.[195] In short, the use of carryover basis, although appealing from an equity perspective, has several difficulties that ultimately would result in significant complexity.

Third, the proposal creates the same liquidity problems, particularly with respect to family businesses and farms, as our current estate tax. Batchelder attempts to minimize this, but the solution is complex, which would generate public resistance to the proposal. Specifically, heirs would be allowed

187. Dodge, *supra* note 21.

188. *Id.* at 440.

189. *Id.*

190. *Id.*

191. *Id.* at 442,

192. *Id.* at 443, 448–50.

193. Batchelder, *supra* note 20, at 21.

194. *Id.*

195. *Id.* This approach of looking to the estate's other assets to see if there is enough liquidity to pay taxes is problematic because it does not appear to fully appreciate the political problems of doing this. As mentioned, under current law, many estates consisting of farms and closely held businesses have enough other liquid assets to satisfy estate-tax liabilities. *See* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 3, 15, 25. The problem is that heirs of these estates assert that taxes prevent them from meeting day-to-day business needs, investing, and expanding the business. *Id.* at 3, 15. Regardless whether this is true, the general public will likely believe it to be true, and this will generate resistance to her proposal.

> to choose to defer taxes due on illiquid assets at a market rate of interest until disposition, no matter how far in the future. This deferral election would only be available to the extent that the tax could not be paid with other inherited liquid assets, after leaving a reasonable cushion.[196]

She goes on to note that heirs would need "to provide the IRS with periodic valuations of the illiquid asset(s), and the IRS would have a secured interest in the asset."[197] I like that her proposal treats farms and businesses no differently from other illiquid assets,[198] although I wish she would expand her definition of illiquid-assets.[199] In short, the complexity of this provision will create the same political problems that we have under the current estate tax.

Finally, Batchelder focuses on the very wealthy by using a $2.3 million exemption.[200] She acknowledges that she does this under the assumption that revenue neutrality would be politically necessary.[201] My concern is that an exemption this large does little to help level the playing field at birth, and it seems a lot like our current system, which has not done much to level the playing field.

F. Consumption Tax

As the history of our current tax system demonstrates,[202] a consumption tax without a supplemental income tax or wealth tax fails to base the amount of tax owed on ability to pay because wealthy people tend to spend a small percentage of their wealth, allowing their wealth to compound tax free, while poorer people tend to spend everything they have.

Currently, there are two broad types of consumption taxes that are popular. First, we see direct consumption taxes in which the tax is

196. Batchelder, *supra* note 20, at 22.

197. *Id.* at 23.

198. *Id.*

199. Specifically, she notes that "illiquid assets could be defined fairly broadly" and "could include closely held businesses, real property held for investment purposes, and collectibles." *Id.* She would not, however, include in the definition of *illiquid assets* "property used in part for personal consumption, because its value will tend to decline as it is consumed." *Id.* (citing Dodge, *supra* note 19, at 1199). This is a valid point, but it aims to increase tax revenue at the expense of a great deal of complexity. This Article's proposal accepts a relatively small loss of tax revenue in the interest of simplifying our tax system.

200. *Id.* at 19.

201. *Id.* She also acknowledges that "$2.3 million is a lot of money," and that "an argument could certainly be made that this exemption is too high." *Id.*

202. *See supra* Part I.

imposed on actual purchases.[203] This can take the form of retail-sales taxes on a tax base that may or may not include services, and that often have specific exclusions for basic necessities, including food and services such as medical care.[204] It can also take the form of a VAT, which often also has certain exclusions that result in a tax on less than the full consumption base.[205] This type of consumption tax does not need to separately consider gifts and inheritances; they are merely taxed if and when spent on consumption by the recipient.[206]

The second common type of consumption tax looks a lot like an income tax. This method takes all accessions to wealth in a given year and subtracts out assets transferred to savings or investment; what is left is deemed to be taxable consumption.[207] The primary benefit of this type of consumption tax is that it allows the tax system to retain a progressive rate structure.[208] Under this type of consumption tax, cash gifts and inheritances are generally included in the recipient's income, and the recipient receives a deduction if the cash is invested in business or investment property.[209] Likewise, if *business* or *investment* property is received directly by gift or bequest, it is not included in income, and the recipient takes the property with a zero basis.[210] All personal assets that are inherited or received by gift or inheritance, including a personal residence and tangible personal property, will be included in the recipient's income with no deduction.[211]

The primary problem with all consumption-tax approaches is that they return us to a system in which the wealthy have even greater

203. *See* BOORTZ & LINDER, *supra* note 2.

204. GRAETZ, *supra* note 2, at 68.

205. *Id.* A good description of a common credit-method VAT can be found in GRAETZ, *supra* note 2, at 65–66.

206. *See* BOORTZ & LINDER, *supra* note 2, at 74–75.

207. *See* MCCAFFERY, *supra* note 2, at 15. Other variations of this idea include the "USA Tax" sponsored by Senators Nunn and Domenici, *see* GRAETZ, *supra* note 2, at 76, and Steve Forbes's proposed flat tax. *See* FORBES, *supra* note 2, at 59–66.

208. *See* MCCAFFERY, *supra* note 2, at 78–88.

209. Dodge, *supra* note 19, at 1199; *see also* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) (explaining how a consumption tax might fit within a structure that resembles an income tax). Under this approach, using the cash to buy a personal residence, for example, would not allow for a deduction.

210. Dodge, *supra* note 19, at 1199. Thus, if the recipient receives the family home, a personal use asset, it will be included in the recipient's income with no corresponding deduction.

211. *Id.* Dodge notes that a tax deferral for personal assets that are consumed (i.e., giving those assets a zero basis and not including the value of the assets in the recipient's income) would result in what is effectively tax forgiveness. *Id.* at 1119 n.113.

opportunities to amass large amounts of wealth.[212] In addition, consumption taxes generally hurt lower-income people, who obviously must spend a greater percentage of their income on consumption. It is conceivable under a consumption tax that wealthy families would keep property invested and growing for generations. This does nothing to reduce wealth concentrations and the problems that come with it.[213] In short, a consumption-tax approach puts us back to where we were before the income tax was enacted.[214]

IV. MY PROPOSAL

My proposal differs from any of the proposals discussed earlier. It shares some elements of the income-inclusion approach and the consumption-tax approach, but it cannot accurately be described as a hybrid of the two.

A. In General

The basic proposal is extremely simple. Essentially, all assets transferred by gift or bequest are divided into the following two classes: (1) cash or cash equivalents ("liquid assets"), and (2) everything else ("illiquid assets"). Each class is treated differently.

With respect to liquid assets, they generally should be included in the recipient's income in the year of receipt. However, in order to ensure that recipients of liquid assets are treated as equitably as possible compared to recipients of illiquid assets, the recipient of liquid assets should be allowed an income-tax deduction for any portion of the gift or inheritance that she transfers to a deductible IRA. This has the added benefit of encouraging the recipient to save for retirement by treating her like an employee who may contribute wages to a deductible retirement plan.[215] In essence, the recipient may choose to either (1) pay taxes currently or (2) defer taxes and subject the assets to the IRA rules. It also ensures that these assets will be taxed eventually, either when taken as a

212. *See generally* KAZIN, *supra* note 36, at 32–65 (describing the growing concentration of wealth in the hands of a wealthy few under a consumption tax).

213. *See supra* text accompanying notes 102–105.

214. *See supra* Part I.A.

215. A distinction, however, is that retirement-plan contributions are subject to specific dollar limits on the amount that may be contributed each year while this proposal would allow an unlimited contribution and deduction, up to the amount of gift or inheritance included in income, for the year of receipt of the gift or inheritance. *See, e.g.*, I.R.C. §§ 402(g), 415.

required minimum distribution from the IRA, or when distributed as Income in Respect of a Decedent (IRD)[216] after death.

With respect to illiquid assets, the recipient should have the option of either (1) deferring all taxable gain until the asset is sold, if ever, and taking the asset with a basis of zero, or (2) including the value of the asset in income in the year of receipt and taking the asset with a fair-market-value basis. With respect to deferring the gain, the basic idea is that tax basis is stepped down to zero and taxes will not be owed until the asset is sold, at which time the sales proceeds would be fully taxable as ordinary income to the seller. If the recipient should choose to include the value of the property in income, he would take the property with an income-tax basis equal to the property's fair market value, and all future gain on sale would be capital gain.

B. Cash and Cash Equivalents

Cash and cash equivalents differ from all other types of receipts because if a tax is owed on the receipt, it is not difficult to obtain money to pay taxes. More specifically, no borrowing or lengthy, uncertain sales period is required. Assets that fall into this category certainly would include cash and publicly traded securities. It might be expanded to include other assets, such as gold bullion, if those other assets always have a ready market, sales generally occur within twenty-four hours of the attempt to sell, and those assets are not tangible personal property, such as wedding rings or collectibles, that commonly have sentimental value within families.

A pure income-inclusion approach would require cash and its equivalent, as well as other gifts in kind, to be included in the recipient's income in the year of receipt, with the possible exception of allowing for income averaging to reduce the effect of bunching income into higher income-tax brackets.[217] A consumption-tax approach to gifts and inheritances would allow the deferral of tax until the money is spent, potentially allowing for eternal deferral of taxes on liquid assets.[218] This proposal adopts aspects of both approaches.

216. I.R.C. § 691 (West 2008). In general, IRD is income that never was taxed to the decedent during life and, therefore, is taxed to the recipient of that income as ordinary income after the decedent's death.

217. *See* Dodge, *supra* note 19, at 1181 & n.20, 1190 & n.64; *see also infra* Part IV.B.3 for a discussion of income averaging.

218. *See supra* text accompanying notes 207–214.

1. SPOUSES AND CHILDREN

The treatment of transfers to spouses and children, particularly minor children, is complicated by the fact that transferors may have a duty to care for those people.[219] In this respect, the gift or bequest may benefit the transferor at least as much as the transferee. Because of this unique situation, some special rules are needed. The basic approach should be that transfers actually received outright by somebody within a current taxable unit of the transferor[220] should not be taxable income to the recipient.

The taxable unit of the transferor should be defined to include the transferor's spouse[221] and dependents. With respect to a spouse, other scholars have already set forth good reasons for treating them as part of the transferor's taxable unit, and this Article contributes little to what has already been written on the topic.[222] As Professor Dodge has said, "Spouses pool resources, expenses, and decisionmaking."[223] Other than with respect to employee death benefits and life-insurance proceeds, as described earlier, the beginning and end of marriage, as well as transfers during marriage, should not give rise to taxable income.[224] Payments after divorce should be treated exactly as they are under the current Code; that is, alimony payments should be deductible by the payor and includable in the payee's income.[225]

Dependents, such as minor children, present a challenge. It is likely that families will try to arrange their affairs so as to avoid inclusion of wealth transfers in children's income. This risk, however, should be weighed against the fact that tax rules should be as administratively efficient and simple as possible.[226]

219. For a summary of state laws dealing with minor-child-support obligations, see Ncsl.org, Termination of Child Support and Support Beyond Majority, http://www.ncsl.org/programs/cyf/educate.htm (last visited Oct. 24, 2008).

220. Whether or not the person is in a taxable unit of the transferor should be determined at the time of outright receipt by the transferee. In this respect, our system should be hard to complete in the sense that transfers in trust or with split interest gifts, with the transferor retaining any interest, should not be treated as transfers until they come out of trust or the split-interest becomes absolute outright ownership by the transferee.

221. Although the author personally hopes that *spouse* will eventually be expanded to include a domestic partner, such an addition from the outset is not politically wise and would be the death knell of this proposal.

222. *See, e.g.*, Dodge, *supra* note 19, at 1203–05.

223. *Id.* at 1203.

224. *Id.*

225. *Id.* at 1204 (citing I.R.C. §§ 71(a), 215, 682(a)).

226. *See supra* Part II.B.2.

It seems that the best way to address the issues of administrative efficiency and simplicity is to work toward uniformity. Some groundwork is already in place with respect to the concept of what it means to be a dependent for income-tax purposes. Specifically, section 201 of the Working Families Tax Relief Act of 2004 revised code section 152 to create a uniform definition of *dependent*.[227] Although it might ultimately prove to be unwise to simply adopt the whole definition for purposes of determining who is in the taxpayer's taxable unit, the definition is helpful and, perhaps, could be adopted at least in part.

The new version of section 152, which is not without its problems,[228] identifies *dependent* as either a "qualifying child" or a "qualifying relative."[229] Under the definition, the following four criteria must be met to be a *qualifying child*: 1) the qualifying child must be the taxpayer's biological child, stepchild, adopted child, foster child, brother, sister, or a descendant of one of these people;[230] 2) the qualifying child must live with the taxpayer for more than six months during the year;[231] 3) the qualifying child must be either under age nineteen on the last day of the year, under age twenty-four on the last day of the year and a full-time student for at least five months out of the year, or any age and totally and permanently disabled;[232] and 4) the person must not provide more than half of her own support during the year.[233]

Under the new definition of *dependent*, the following five criteria must be met to be a *qualifying relative*: 1) the qualifying relative must earn less than $3,200 in income during the year;[234] 2) the taxpayer must provide more than half of the qualifying relative's total support during the year;[235] 3) the qualifying relative must be related to the taxpayer in certain ways or must have the same principal place of abode as the taxpayer;[236] 4) the qualifying relative, if married, cannot file a joint

227. Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169.

228. *See* Letter from Francis X. Degen, President, National Association of Enrolled Agents, to Mark W. Everson, Commissioner, Internal Revenue Service (Feb. 6, 2006), *available at* http://www.naea.org/MemberPortal/Advocacy/Comments/Everson_Letter_Feb_2006.htm.

229. I.R.C. § 152(a) (West 2008).

230. *Id.* § 152(c)(1)(A), (c)(2).

231. *Id.* § 152(c)(1)(B).

232. *Id.* § 152(c)(1)(C), (c)(3).

233. *Id.* § 152(c)(1)(D).

234. *Id.* § 152(d)(1)(B).

235. *Id.* § 152(d)(1)(C).

236. *Id.* § 152(d)(1)(A). Specifically, she must be the taxpayer's child, descendant of a child, brother, sister, stepbrother, stepsister, father, mother, ancestor of a father or mother, stepfather, stepmother, niece, nephew, uncle, aunt, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law, or anybody

income-tax return with her spouse;[237] and 5) the qualifying relative must be a citizen or resident alien of the United States, Canada, or Mexico.[238]

It seems politically necessary to include qualified children in the taxpayer's taxable unit because there would be public outcry if taking care of one's minor children were to result in taxable income to the children. Qualified relatives are more complicated. They would include adult, college-aged children who make little money and who live away at college year-round. They would also include an aging mother or grandmother, for example, who makes little money but receives gifts from her adult child.

The potential for tax-motivated wealth transfers to a qualifying child seems relatively low if the exclusion from the child's income is only available for outright transfers to relatively young children, as described later.[239] Most taxpayers simply are unlikely to make large outright transfers to their immature children solely to avoid taxes. The potential for tax-motivated transfers to a qualifying relative, including an adult child, seems very high. This leaves two options. First, the proposal could require that, in order for a dependent to be part of a taxpayer's tax unit, the dependent must be a qualifying child. Second, the proposal could alternatively define a dependent to be part of the taxpayer's tax unit if the dependent is either a qualifying child or qualifying relative. In either case, a support limitation, described shortly, should be added. Thus, the dependent would only be in the taxpayer's taxable unit to the extent that amounts transferred to that dependent do not exceed her support needs. In addition, with respect to qualifying relatives, it would be prudent to add an annual dollar limit, such as $50,000, on the amount that may be excluded from a qualifying relative's income.

Longstanding case law addresses the concept of support of dependents in the gift-tax context. Specifically, in *Converse v. Commissioner*,[240] the IRS Commissioner conceded that the taxpayer's support of his dependent child was not a gift for gift-tax purposes.[241] The rationale for this rule is that support of a dependent child is not a gift to the child because the transfer fulfills the transferor's legal obligation to support the child; the transfer represents, thus, consumption by the transferor rather than a gift to the child.[242] To determine what constitutes

with the same principal place of abode as the taxpayer. *Id.* § 152(d)(2). Thus, a nonrelated person actually can qualify as a qualifying relative.

237. *Id.* § 152(b)(2).

238. *Id.* § 152(b)(3)(A).

239. *See infra* Part IV.B.4.

240. 5 T.C. 1014 (1945).

241. *Id.* at 1016.

242. *See* Rev. Rul. 68-379, 1968-2 C.B. 414.

support, it is necessary to look to state law[243] and possibly to the economic circumstances of the transferor and transferee.[244]

In the context of this proposal, the purpose of adding a support limitation would be to limit the amount that a dependent could exclude from income. In the context of a qualifying child, the rule could, for example, say that a qualifying child is included in the transferor's taxable unit for all transfers that do not exceed amounts necessary to support the qualifying child in her accustomed standard of living. The support obligation applicable to a qualifying relative is different from one applicable to a qualifying child because the taxpayer usually does not have a legal obligation to support a qualifying relative. This is more akin to support limitations commonly found in irrevocable trust agreements. This limitation is not tied to any legal duty of the transferor; it solely would be added to prevent families from using the qualified-relative exception to make large wealth transfers to family members.[245] As mentioned, it also would be wise to include an annual dollar limit on the maximum that may be excluded from a qualifying relative's income. If this proposal were adopted in connection with Professor Graetz's Competitive Tax Plan, for example, a $50,000 limitation for a single recipient would make sense because that is the income exemption under his proposal.

My proposal does not impose a tax when the dependent leaves the taxable unit. Although a tax at that time would increase federal revenue, it seems unlikely to be well received by the general public. A key problem with including dependents in the taxpayer's taxable unit, with no tax upon departure from the taxable unit, is that it potentially gives the taxpayer an incentive to make transfers to family members earlier than she otherwise would in order to avoid generating taxable income to the recipient. This result is minimized with a support limitation and can be minimized further by making it difficult to complete gifts for tax purposes, as discussed later.[246] Doing so would mean that most transfers through trusts would not accomplish the transferor's tax-avoidance objectives. In addition, the possibility of deferral by rolling gifts into an IRA is likely to minimize the incentive to make outright transfers.

243. *See* WILLBANKS, *supra* note 15, at 136.

244. *Id.*

245. This would include adult children who have low incomes, even if they do not live with the transferor.

246. *See infra* Part IV.B.4.

2. EDUCATION AND MEDICAL EXPENSES

Current law provides that payments directly to a medical or educational institution to pay medical or educational expenses on behalf of another person are not taxable gifts.[247] This is generally permitted because people often provide basic necessities to their adult children and other relatives.[248] It seems that there is no good reason to discontinue this kind of encouragement. Thus, this same exclusion should be made to apply to income inclusion under this proposal. A wholesale adoption of the rule currently contained in section 2503(e) as an exception to income inclusion of liquid assets would be the easiest way to do this.[249] This also could expressly allow for an exclusion for payments directly to section 529 Plans and prepaid tuition plans.[250]

3. INCOME AVERAGING V. IRA ROLLOVER

Proposals to include gifts and inheritances in income generally either (1) include all receipts in income in full in the year of receipt,[251] or (2) provide for all income to be averaged over some period of time to reduce the effect of placing the recipient in a higher tax bracket due to bunching a lot of income into one year.[252] The problem with including all receipts in income in full in the year of receipt is that people will perceive it as unfair to tax somebody at a much higher rate because she receives an inheritance in one year. In addition, the well-advised person would save taxes by making wealth transfers over a long period of time rather than at death. This is likely to raise complaints about compliance costs.

The problem with income averaging is complexity or, perhaps more importantly, its perceived complexity. The basic idea sounds simple enough with respect to the inclusion of gifts and bequests in income: take the amount of gift or inheritance received and divide that amount by the number of years over which the income may be averaged to determine the amount that must be included in income each year.[253] In practice, however, there are numerous complicating factors. For example, it is a realistic possibility that recipients of gifts and inheritances may spend the money or invest in assets that decline in value prior to paying their tax

247. I.R.C. § 2503(e) (West 2008).

248. *See* WILLBANKS, *supra* note 15, at 134.

249. Agency and judicial interpretations of this rule should also be adopted wholesale as well.

250. *See* I.R.S. Priv. Ltr. Rul. 200602002 (Sept. 6, 2005).

251. *See* Dodge, *supra* note 19, at 1190 & n.64.

252. *Id.* at 1181 & n.21.

253. *See id.* at 1181 n.21.

liability.[254] As a result, the government will need to attempt to collect from people who may no longer be solvent. As Professor Richard Schmalbeck has said,

> By its very nature, any averaging device involves multiyear accounting in one form or another. This is inevitably troublesome in a tax system whose rules are otherwise organized on the basis of an annual accounting requirement. While the law is quite clear concerning permissible choices as to filing status, determination of marital status, and applicability of any particular rate structure, all these concepts have to be redefined to deal with a multiyear income-averaging formula.[255]

Schmalbeck notes that the complexities involved in prior, now repealed, income-averaging attempts[256] made it highly probable that taxpayers would "make mistakes . . . be intimidated by the averaging schedule . . . and have no sense of the significance of each step in the process."[257] He goes on to note that, "Of course, these facts, together with the magical savings of several hundreds of dollars of tax per eligible taxpayer, make income averaging a great boon to the tax return preparation industry. Indeed, that industry may be the principal beneficiary of the averaging provisions."[258]

Although income averaging limited to gifts and inheritances over a short duration is likely to be much simpler than past income-averaging efforts,[259] the general public still will view it as unduly complicated. As Professor Neil Buchanan astutely noted with respect to economist

254. This is a particular problem because the tax liability with income averaging is determined up front rather than on a year-to-year basis.

255. Schmalbeck, *supra* note 102, at 529 (citations omitted).

256. The Revenue Act of 1964 allowed eligible taxpayers to elect to average their income over several years. Pub. L. No. 88-272, § 232, 78 Stat. 19, 105–12 (codified as amended at I.R.C. § 1302); *see* Schmalbeck, *supra* note 102, at 510. The rules were simplified by the Tax Reform Act of 1969. Pub. L. No. 91-172, § 311, 83 Stat. 487, 586–88 (1969) (codified as amended at I.R.C. § 1302); *see* Schmalbeck, *supra* note 102, at 510–11. In the 1981 tax year, more than 6.5 million taxpayers elected to apply income-averaging, resulting in a tax savings of almost $4 billion dollars. *Id.* at 511. These comprehensive income averaging provisions were repealed in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, Title I, § 141(a), 100 Stat. 2085, 2117; *see* Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 HARV. J. ON LEGIS. 395, 420 (2003).

257. Schmalbeck, *supra* note 102, at 532.

258. *Id.*

259. As Batchelder notes with respect to her Targeted Averaging proposal, "[A] short time period is simpler because it requires fewer calculations and records of income from past years." Batchelder, *supra* note 256, at 423.

William Vickrey's[260] famous "cumulative lifetime averaging" of income proposal, "[S]implicity is probably best understood—at least in the context of tax reform—not in the mathematical or analytical sense but in the on-the-street sense that a simple tax system is one that is easy to understand, easy to administer, and easy to obey."[261] Even strong advocates of income averaging accept that it requires some amount of record keeping on the part of taxpayers.[262] Regardless of the actual simplicity of the system, the public is likely to perceive income averaging as extremely complicated.[263] In today's political climate, this perception can effectively foreclose any possibility of passing reforms that include income averaging. Although income averaging in some situations may be justified if there is a strong public-policy reason for doing so and if there is no better option,[264] this must be approached with care. With respect to gifts and inheritances, there is a much better option—the IRA rollover.

Under current law, each individual may transfer $5,000 into a deductible IRA each year if the individual is not a participant in an employer-sponsored retirement plan or if the individual is a participant in such a plan but has an adjusted gross income of less than $52,000.[265] An

260. William Vickrey was a well-known economist who won, with James Mirlees, the 1996 Nobel Prize in Economics (technically called the "Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel"). Press Release, Royal Swedish Acad. of Sci., The Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel for 1996 (Oct. 8, 1996), *available at* http://nobelprize.org/nobel_prizes/economics/laureates/1996/press.html.

261. Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151, 1207 (2006).

262. William Vickrey, *Averaging of Income for Income-Tax Purposes*, 47 J. POL. ECON. 379, 394 (1939).

263. *See* Buchanan, *supra* note 261, at 1207.

264. Batchelder provides a good example of a situation in which a form of income averaging may be warranted. *See generally* Batchelder, *supra* note 256 (arguing that poorer people generally would pay lower taxes if they could use her proposed form of income averaging).

265. I.R.C. § 219(b) (West 2008). The $5,000 amount is increased for individuals age fifty or older or who participated in the 401(k) plan of a bankrupt employer. *Id.* § 219(b)(5)(B)–(C). These provisions were added by the Pension Protection Act of 2006. Pub. L. No. 109-280, § 831(a), 120 Stat. 780, 1002. For individuals who participate in employer-sponsored retirement plans, the $5,000 contribution limit phases out over an income range of $52,000 to $62,000. I.R.C. § 219(g)(8); Rev. Proc. 2006-53, 2006-48 I.R.B. 996. This provision was also added by the Pension Protection Act of 2006. § 833(b), 120 Stat at 1003. Spouses, who are not participants in employer-sponsored retirement plans, may each make contributions to his or her own IRA up to the annual individual contribution limit (i.e., $5,000). I.R.C. § 219(c). For spouses, who are both participants in employer-sponsored retirement plans, the annual contribution limits are reduced to zero over a modified adjusted gross income between $83,000–103,000. *Id.* § 219(g)(8). This provision was added by the Pension Protection Act of 2006. Pub. L. No. 109-280, § 833(b), 120 Stat at 1003; Rev. Proc. 2006-53. Numerous special rules, all

individual who establishes such an IRA generally cannot take distributions before age fifty-nine-and-a-half,[266] and must begin taking required minimum distributions (RMDs) out of the IRA beginning no later than April 1 after the calendar year in which the owner turns age seventy-and-a-half.[267] The amount of these distributions generally is computed to pay out over the individual's life expectancy.[268] Assuming that the individual only made deductible contributions to the IRA, then distributions from it are fully taxable as ordinary income to the individual or the beneficiary.[269]

If the individual dies before the IRA balance has been completely distributed, the remaining funds get paid to the individual's beneficiary.[270] If that person is the deceased individual's spouse, she may take a full nontaxable distribution if she rolls the funds into her own IRA or she may elect to treat the inherited IRA as her own; either way, she will compute the payout based on her own life expectancy and, in many cases, may defer taking RMDs until she turns age seventy-and-a-half.[271] If the designated beneficiary is anybody other than a spouse, no rollover is allowed, payment must begin (or continue) immediately, and the payout generally can be spread out over the beneficiary's own life expectancy.[272] As mentioned, all payouts from the IRA after the individual's death that are IRD (i.e., all payouts other than those resulting

beyond the scope of this Article, apply to determine contribution limits. *See generally* I.R.C. § 219.

266. I.R.C. § 72(t)(2)(A). In general, distributions before age fifty-and-one-half will be subject to a 10 percent penalty tax on top of the ordinary income tax that is owed, subject to certain exceptions (with respect only to the 10 percent penalty) if the distribution (1) is upon the death or disability of the participant, (2) is pursuant to a qualified domestic relations order, (3) does not exceed deductible medical expenses, (4) is made as a result of an IRS levy on the account, (5) is a "qualified hurricane distribution," (6) is a "qualified reservist distribution," (7) is used to pay medical-insurance premiums if the beneficiary is unemployed, (8) is used to pay "qualified higher education expenses," (9) is used to pay "first time homebuyer expenses," or (10) is a return of a nondeductible IRA contribution. I.R.C. § 72(t).

267. Treas. Reg. § 1.408-8, Q&A (3) (2008).

268. *See generally* I.R.C. §§ 401(a)(9)(A), 408(a)(6), 408(b)(3). The computation of payout periods from a deductible IRA is beyond the scope of this Article.

269. *Id.* § 691. The rule is more complex if the individual has made any nondeductible contributions to the IRA, in which case distributions are handled like annuity payments. *See generally id.* §§ 72, 408(d)(1).

270. *See id.* §§ 401(a)(9)(A), 408(a)(6).

271. *See* Treas. Reg. 1.408-8, Q&A (5)(a) (2004).

272. *See generally* Treas. Reg. § 1.408-8. The details of these payout rules are beyond the scope of this Article. However, it is worth noting that, in certain circumstances, a five-year payout will be required. *See generally* I.R.C. § 401(a)(9); Treas. Reg. § 1.408-8.

from nondeductible contributions) are taxable as ordinary income to the recipient.[273]

Under my proposal, sections 101 and 102 would be modified so that recipients, other than somebody in the transferor's taxable unit,[274] include all gifts and bequests of cash or cash equivalents in income in the year of receipt[275] with one key special rule: recipients would be allowed to roll an unlimited portion of any gift or bequest, other than IRD, into a deductible IRA by April 15 of the year following the year of receipt. Thus, the recipient could deduct the amount rolled into the IRA from her income for the year. IRD is treated differently because it never was included in the transferor's income, and the purpose of this proposal is not to allow unlimited deferral of taxes except where necessary to prevent a forced sale. To allow for this policy to work, the IRA contribution limit[276] should be increased for each individual by the amount of gift or inheritance that she receives that year, less any portion of the gift or inheritance that is IRD. This would prevent families from using IRAs to make repeated intergenerational gifts and avoiding taxes eternally. The basic idea is that the IRA rules for members of the taxpayer's taxable unit, such as a spouse, should not change from the current rules at all. Non-IRD that the spouse or minor child receives is not taxable income to that person. IRD, which has never been taxed to the transferor, is taxable income to the beneficiary, just as it is under current law.

With respect to anybody outside the taxpayer's taxable unit, who would generally be taxed on a gift or inheritance of liquid assets, the recipient should have the option of rolling that gift or inheritance, or any portion of it, into a deductible IRA, provided that the inheritance is not IRD. This approach allows people who inherit liquid assets to defer taxes somewhat like recipients of illiquid assets, and it also will encourage donees and heirs to save in a simple, established manner and in a way

273. I.R.C. § 691.

274. *See supra* Part IV.B.1. This would include spouses and dependants. Dependants would include qualifying children and qualifying relatives, provided that the amount transferred to the dependant does not exceed her support needs. In addition, qualified relatives would not be in the taxpayer's taxable unit to the extent that the transfer exceeds a dollar limitation, such as $50,000.

275. As Professor Dodge has persuasively argued, life insurance proceeds, deferred-compensation-plan proceeds, and employee death benefits should be treated as income to the recipient except to the extent that the recipient, or a person in the same tax unit as the recipient, has paid insurance premiums or made plan contributions out of amounts previously taxed to the recipient, or to a person in the same taxable unit as the recipient. Dodge, *supra* note 19, at 1200–02.

276. I.R.C. § 219(b)(1).

that will ultimately result in full taxation of the gift or inheritance. If they prefer to not contribute to an IRA, they pay the tax immediately.[277]

IRD cannot be rolled into an IRA because it was never taxed to the decedent. This special rule would prevent liquid assets from being rolled forward indefinitely without taxation. The whole proposal merely allows an individual to defer taxes for her lifetime, but not forever. This is admittedly in contrast to the ability to defer taxes on illiquid assets forever, but that distinction is necessary to prevent a forced sale or loan to pay taxes.

4. THE TRUST PROBLEM

Trusts and other ways in which transferors can retain control over gifts create unique issues with respect to income inclusion of gifts of cash or cash equivalents. This proposal treats dependents as part of the transferor's taxable unit. Because of this, transferors have a tax incentive to make gifts to their children while they are still dependents. This incentive is counterbalanced by the fact that, in my years of estate planning experience, most parents hesitate to make outright gifts to their dependent children out of concern that the children will squander their inheritances. This issue is removed if the parent can make the gift in a way in which the parent retains control over the gift, such as a trust or a custodianship. This proposal deals with all these transfers in the same general way.

This problem can be remedied by adopting a hard-to-complete gift rule similar to that advocated by Professor Dodge with respect to reforming our current estate- and gift-tax system.[278] The details of such a rule are beyond the scope of this Article; however, the basic idea of how it would apply to this proposal is simple enough. In general, the grantor-trust rules of sections 671–78 of the Code should be expanded so that virtually any retained control or interest by a living transferor would result in our income-tax law treating the arrangement as if no transfer had been made for income-tax purposes. The basic idea is that tax law must look to the moment of actual, outright receipt by a living beneficiary when determining if a gift or inheritance is included in the transferee's income. The concept of outright receipt should be extremely limited, and it should not be expanded to include general powers of appointment. If outright receipt does not occur until a time when the recipient is no longer the transferor's dependent, then the asset, at its actual value at the time of outright transfer, will be fully includable in the

277. More specifically, they would pay the tax by April 15 of the year following the year of receipt.

278. *See* Dodge, *supra* note 124, at 308–09.

recipient's income. Before such time, the assets shall be treated for income-tax purposes as if still fully owned by the transferor.

Testamentary transfers, transfers without any sort of retained control that would cause the transferor to continue to be treated as the owner for income-tax purposes, and transfers that occur upon termination of retained control are more difficult. The challenge lies in determining how to tax the transfer of trust corpus, as well as income earned with respect to the transferred assets, after they have left the transferor's control but before they have been received outright by the ultimate transferee. One possibility is to allow tax deferral until ultimate distribution. This is the approach originally suggested by Dodge, other than with respect to large trusts.[279] Specifically, he suggested several years ago that deferral generally, other than with respect to large trusts, will not result in much revenue loss, particularly given that the rule against perpetuities commonly limits the duration of these trusts, resulting in taxation of the full distribution upon termination of trusts.[280] This situation has changed somewhat since he suggested this because states have since begun to repeal or expand their rules against perpetuities.[281] With respect to large trusts, he suggested that a simple withholding tax may be appropriate.[282]

To keep everything simple, my proposal treats testamentary transfers, transfers without any sort of retained control, and transfers that occur upon termination of retained control, as fully taxable to the recipient trust if it has any noncharitable beneficiaries (including contingent beneficiaries) and if the transferred item is a liquid asset.[283] Receipt of liquid assets by a fully charitable trust would be tax exempt. Receipt of illiquid assets would not be taxable, but basis would be stepped down to zero, as described later. The trust would then be treated as a separate taxpayer, fully taxable at trust income-tax rates as under current law. When an outright distribution is ultimately made to a living, breathing beneficiary, that beneficiary should be taxed on the full amount

279. Dodge, *supra* note 19, at 1196–97.

280. *Id.* at 1195–96.

281. *See, e.g.*, S.D. CODIFIED LAWS § 55-1-23 (2008) (repealing South Dakota's Rule Against Perpetuities); ALASKA STAT. § 34.27.051 (2007) (expanding Alaska's Rule Against Perpetuities to 1000 years).

282. Dodge, *supra* note 19, at 1197. Professor Dodge has changed his mind since he wrote this. *See* Dodge, *supra* note 124, at 308–09. *See also* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 33–36.

283. A similar rule should apply to custodians and guardians. This proposal is similar to Professor Batchelder's proposal with respect to trusts except that her proposal treats trusts with one noncharitable beneficiary differently from trusts with multiple noncharitable beneficiaries. *See* Batchelder, *supra* note 20, at 24. This proposal would treat them the same.

received but allowed a credit equal to the amount of taxes paid that are allocable to property distributed to that beneficiary.[284]

5. A *CRUMMEY* PROBLEM

In order to avoid having every small gift, such as birthday and Christmas gifts, treated as taxable, Congress enacted the gift-tax annual exclusion of section 2503(b). This annual exclusion, which is adjusted for inflation, currently removes all present-interest gifts of $12,000 or less per year, per donee from the present gift-tax regime.[285] This rule, more than anything else under current law, encourages wealthy individuals to disperse their wealth among many beneficiaries, which is good. The problem, as any estate planner knows, is that wealthy families use this rule for tax-planning purposes, and they commonly give the maximum amount that they can each year and then continue to give birthday, Christmas, and other gifts that are often quite extravagant. This problem was greatly exacerbated with the case of *Crummey v. Commissioner*.[286]

In *Crummey*, the court held that gifts to trusts count as present-interest gifts if the beneficiary has an immediate right to withdraw the funds from the trust, even for a limited duration.[287] This rule has made annual-exclusion gifts to trusts for minor beneficiaries a core component of estate planning for wealthy families. A rule such as this cannot, and need not, be extended to this proposal.

My proposal solves the problem completely with respect to gifts from parents to their dependent children. These transfers generally would not result in taxable income to the dependent. With respect to gifts to nondependents, say from a grandparent to a grandchild, it gets trickier. If these gifts are not cash or cash equivalents, then they will not be taxable to the recipient until, and if, they are sold, as discussed later.[288] If, however, these gifts are cash or cash equivalents, they will be taxable to the recipient or, if the recipient is a dependent child, to her parent, subject of course to the possibility of rolling the gift into an IRA. To prevent this from happening with respect to small gifts, the proposal

284. A similar approach, albeit utilizing withholding by the grantor or his estate rather than tax payments by the trustee, is advocated by Professor Batchelder with respect to trusts with multiple beneficiaries. *Id.* The main difficulty with this approach lies in devising a system to fairly allocate the credit.

285. I.R.S. § 2503(b) (West 2008); Rev. Proc. 2001-59.19(1), 2001-2 C.B. 623. Thus, these gifts do not utilize any of the donor's lifetime gift-tax exemption amount and they do not require the filing of gift-tax returns.

286. 397 F.2d 82 (9th Cir. 1968).

287. *Id.* at 88.

288. *See infra* Part IV.C.

would allow for a very small de minimus exception. Specifically, an outright gift of $600 or less in cash or cash equivalents per year, per donor should not be includable in the recipient's income.[289] This rule specifically should not allow any exception for gifts to trusts, thus avoiding the *Crummey* problem. Grandparents could make small cash gifts to their grandkids, or unlimited noncash gifts, without any income-tax implications. Larger gifts would be taxable to the recipient, or the recipient's parents, unless they choose to roll the gift into an IRA. In addition, payments directly to medical and educational institutions for medical expenses and tuition would not be taxable to the recipient regardless of the size of the payment.

C. Anything Other than Cash or Cash Equivalents

Most wealth-transfer-tax-reform proposals allow special carve-outs for family farms and businesses.[290] This approach treats people who are not in farming or business families unfairly. In addition, these rules are extremely complex.[291] There is a much simpler approach available that would prevent every single recipient of illiquid assets from having to sell the asset to pay taxes.

1. STEPPED-DOWN-TO-ZERO BASIS

As mentioned, current law provides that lifetime gifts receive a carryover basis[292] and assets transferred at death receive a basis equal to the asset's market value on the transferor's date of death.[293] The unlimited step-up in basis is repealed during the one year (2010) that the

289. This amount matches the Form 1099 reporting requirement. *See* INTERNAL REVENUE SERV., 2008 INSTRUCTIONS FOR 1099-MISC 5, *available at* http://www.irs.gov/pub/irs-pdf/i1099msc.pdf. Specifically, transferors of nonemployee compensation of $600 or more per year currently are required to report the transfer to the IRS and provide the recipient with a Form 1099-MISC showing the amount that has been reported. *Id*. This reporting requirement currently does not apply to gifts. *Id.* The de minimus exception of this proposal would expand the applicability of this reporting requirement to include gifts. In short, the amount to be excluded from income under the de minimus exception should be tied directly to the Form 1099-MISC reporting requirement. Thus, the $600 amount would be increased in the future if and when the Form 1099-MISC reporting requirement increases.

290. *See* Dodge, *supra* note 19, at 1200 n.114 (noting that a special exception may be necessary for family farms and businesses). Professor Dodge leaves open the possibility of extending a special rule to personal residences as well. *Id.*

291. *See* I.R.C. §§ 2032A, 2057, 6166 (West 2008).

292. *Supra* note 17 and accompanying text.

293. *Supra* note 16 and accompanying text.

estate tax is repealed.[294] Instead of an unlimited step-up at death, for decedents dying during that one year, assets passing from the decedent to any person other than the decedent's spouse will receive a step-up of up to $1.3 million; assets passing to the decedent's spouse will receive a step-up of up to $3 million.[295] Neither the carryover nor the step-up approach makes sense.

The biggest problem with a carryover basis, particularly with respect to transfers at death, is that it is extremely burdensome to track basis on property acquired by another person, potentially generations ago. The biggest problem with a stepped-up basis at death is that it creates what is commonly called the "lock-in effect;" that is, people hold on to assets until death because they know that all the tax on the gain will be forgiven.[296] The solution to these problems is a stepped-down-to-zero basis that would apply to either gifts or transfers at death.

The stepped-down-to-zero basis would apply to all transfers of illiquid assets to people outside the transferor's taxable unit, if the recipient does not include the value of the asset in her income in the year of receipt. Thus, a gift at death or during life, of a primary residence, investment real estate, an heirloom, a piano, furniture, or a grandmother's wedding ring would not result in any immediate income tax to the recipient unless the recipient elects to include it in income, and the recipient would take that asset with an income-tax basis of zero.[297] If the asset is never sold, even for generations, it will never be taxed. If the recipient includes the value in income, then the amount included in income would be the recipient's income-tax basis in the asset, and future gain in an appreciating asset generally would be capital gain. The purpose of this rule is merely to get at the recipient's true ability to pay without borrowing or selling assets. The goal is to stop the tax-motivated

294. I.R.C. §§ 1014(f), 2210. Although this is not necessarily the case, if estate- and gift-tax repeal under EGTRRA is made permanent, the repeal of the unlimited step-up (and step-down) in basis is also likely to become permanent.

295. I.R.C. § 1022.

296. *See* POPKIN, *supra* note 8, at 497.

297. This also means that an asset that ordinarily would be eligible for depreciation will no longer be depreciable because it will have a basis of zero. The basis technically should be stepped down to the greater of (1) zero, or (2) the amount of debt assumed by the transferee in connection with the transferred asset. This special rule is necessary to prevent an heir from having to recognize an artificially high gain upon sale. For example, assume a person in the 35 percent income-tax bracket inherits a home, and nothing more, worth $200,000 and subject to a $180,000 mortgage. If the person takes the home with a zero basis and sells it a year later for $200,000, she will have $200,000 of ordinary income, resulting in a tax of $70,000 (i.e., 35 percent of $200,000). This tax is three-and-a-half times the true value of the inheritance she received. Instead, she should take the property with a $180,000 basis (i.e., the amount of debt to which the property is subject). She would then only have $20,000 of gain upon sale, and a tax of $7,000 (i.e., 35 percent of $20,000).

sale of assets in connection with gifts. The concept also makes intuitive sense because the recipient personally has invested nothing in the asset.

2. TAXING GAIN UPON SALE

When any asset received by gift or inheritance and not included in the recipient's income is subsequently sold by the recipient or any successor transferee, she will report all gain as ordinary income at that time.[298] Another approach would be to treat all gain up to the value on the date of transfer to the recipient as ordinary income with any additional gain as capital gain. This approach is problematic for two reasons. First, it is complex. As should be apparent by now, a fundamental goal of this proposal is to avoid complexity. Second, it is unfair to recipients of liquid assets who choose to roll those assets into an IRA because everything that comes out of an IRA is taxable as ordinary income.[299]

This potential for multigenerational deferral of taxes on illiquid assets is not entirely equitable to recipients of liquid assets, who may only defer taxes for the maximum time allowed under the current IRA rules, but I believe it is necessary. There are two possible ways to remove the inequity to recipients of liquid assets, but neither is appealing. First, we could allow for unlimited intergenerational rollovers of IRA assets. This would effectively convert this proposal into a consumption tax. The problem with doing that is that it would bring us back to the problems of the early 1890s; that is, the wealthy could easily avoid taxation of all capital appreciation forever. Second, we could impose a tax on the value of the illiquid asset at the earlier of the date of sale or the date of the recipient's death. The problem with this approach is that it will create the same liquidity problems we have under our

298. A significant additional difference between this proposal and a consumption-tax approach is that, with a consumption-tax approach, "[d]eferral treatment cannot be conferred upon personal assets which represent ongoing consumption." Dodge, *supra* note 19, at 1199. As Professor Dodge correctly notes, "Deferral for personal assets that are used up through consumption would amount to tax forgiveness." *Id.* at 1119 n.113. This is completely correct and a valid concern, but, in the interest of simplicity, this proposal does not make any distinction between personal assets and business or investment assets. Although this approach will result in reduced federal revenue, it should not result in significant tax evasion. It seems very unlikely that a transferor would invest a significant amount in wasting personal assets for the sole purpose of having her heirs avoid taxes, especially given that the deferral option is available. People despise tax complexity. In fact, the survival of particular taxes, such as wealth-transfer taxes, may be dependent on their being extremely simple. It is easy to imagine the complexity that would result if, for example, a person dies owning assets that are part investment and part personal-use assets.

299. *See supra* Part IV.B.3.

current wealth-transfer-tax system; that is, people will be forced to sell assets or borrow to pay taxes. Thus, in the face of these two difficulties, this proposal allows a degree of inequity, as well as revenue loss, by giving the recipient of illiquid assets the option of deferring taxes until actual sale of the asset. To minimize the impact of this special rule and to prevent this from becoming a consumption tax with respect to illiquid assets only, deferral cannot be extended beyond actual sale by reinvesting the proceeds in like-kind property.[300]

3. TAX-FREE EXCHANGES

Several Code sections expressly allow for nonrecognition of realized gains.[301] The usual policy reason given for these deferral provisions is because we do not want to discourage the taxpayer from moving money from one investment to a more economically prudent similar investment.[302] In the case of my proposal, that policy reason is outweighed by principles of equity. More specifically, the initial deferral of gain on receipt of an inheritance is allowed for one reason only—because the taxpayer should not be forced to sell the asset (or borrow against it) to pay taxes. If, however, the sale occurs independently of a need to pay taxes, the taxpayer should be forced to pay up what is owed. In short, liquidity has ceased to be an issue.

An argument could be made that this rule would create a lock-in effect because taxpayers will have to pay taxes if they sell the asset. This problem, however, will be reduced significantly from its current state with repeal of the stepped-up basis at death.[303] In fact, the stepped-down-to-zero basis at death may reverse the lock-in effect for assets with any income-tax basis, say from additional capital contributions, because holding on to assets until death would then result in more tax than selling and paying an immediate tax.[304]

Personal residences do not generally qualify for tax-free exchange treatment because they are personal-use assets rather than assets held for

300. This additional deferral is generally allowed under rules such as section 1031. *See* I.R.C. § 1031(a) (allowing a deferral for trade or business or investment property other than inventory, stock, bonds, and similar assets). Unlimited deferral of taxes through reinvestment of the proceeds upon sale would be a consumption-tax approach. This proposal rejects that approach and, instead, focuses on the liquidity issue.

301. *See, e.g.*, I.R.C. §§ 351(a), 1031(a), 1032(a), 1033(A), 1035(a), 1036(a), 1037(a), 1041(a), 1042(a), 1043(a).

302. *See* POPKIN, *supra* note 8, at 497.

303. *See* Dodge, *supra* note 21, at 442.

304. This would occur because tax basis would be lost if the asset is held on to until death.

investment.[305] Instead, the first $250,000 of gain ($500,000 for a married couple filing jointly) on the sale of a primary residence is exempt from income tax.[306] Because this is a targeted tax exemption that requires the taxpayer to live in the home two out of the five years prior to sale, it seems that this rule should apply to residences received by gift or inheritance, provided that the recipient meets the two-out-of-five-year requirement. A contrary rule would compel people who inherit the family home to sell the home immediately upon receipt and to invest the proceeds in a new residence, which would make it possible for that beneficiary to receive tax-free gain on the new property once it appreciates in value.

4. UNTAXED GAINS AT DEATH

One difference between this proposal and others is that this approach technically fails to tax the gain that was built into property owned by the decedent at her death.[307] Suppose, for example, that Elderly Woman owns a piece of real estate worth $200,000 with a $100,000 income-tax basis. If she sells the property before death, she will owe $15,000 of capital-gain tax, and her son will inherit $185,000 in cash, which he may roll into an IRA. Assuming he does not roll it into an IRA, he will owe taxes on an additional $185,000 of ordinary income. Assuming he is in the 35 percent bracket, his federal tax liability[308] will be $64,750, and he will be left with $120,250 free and clear.

If, on the other hand, Elderly Woman holds on to the property until death, her son will inherit property worth $200,000 with an income-tax basis of zero. If he sells the property immediately, he will have $200,000 of ordinary income under my proposal. This will result in a $70,000 tax liability for him, and he will be left with $130,000 free and clear. The different result is due to the fact that this proposal does not treat Elderly Woman as if she had sold the property unless she actually sells it.

A possible approach to taxing gifts and inheritances would be to treat property owned by a decedent as if it were sold at her death (i.e., deemed realization in addition to income inclusion by the recipient), resulting in immediate capital-gain liability to the estate. This approach, when combined with income inclusion to the recipient, would result in

305. *See* INTERNAL REVENUE SERV., PUB. 544, SALES AND OTHER DISPOSITIONS OF ASSETS 11 (2007), *available at* http://www.irs.gov/pub/irs-pdf/p544.pdf; Rev. Proc. 2005-14, 2005-1 C.B. 528.

306. I.R.C. § 121.

307. For a proposal that taxes the built-in gain to the estate or transferor as well as the receipt of gifts and inheritances as income to the beneficiary, see Kornhauser, *supra* note 19, at 54.

308. For simplicity, assume that he lives in a state without a state income tax.

the beneficiary ending up with $120,250 whether or not Elderly Woman sold the property. This is a more equitable and technically correct approach. In the interest of keeping the system simple and avoiding forced sales or loans, however, this proposal foregoes the tax revenue that might be gained from this approach.

5. POTENTIAL FOR TAX AVOIDANCE

The biggest problem with this proposal is that it creates an incentive to convert liquid assets to illiquid assets because illiquid assets allow for the deferral of taxes over multiple generations[309] while liquid assets only allow deferral over one generation. Because of this, astute planners are likely to suggest that clients put cash and publicly traded stock inside a closely-held-business entity (an illiquid asset) in an effort to permanently defer taxes. To prevent this, the proposal must include an antiavoidance rule that would treat cash and publicly traded securities held within a closely-held-business entity, beyond the reasonable business needs of that entity, as liquid assets. Although this goes against the proposal's focus on simplicity, it is necessary to prevent people from evading taxes.

Of course, at an even more basic level, it could be argued that this proposal will distort taxpayers' behavior by giving them an incentive to sell liquid assets and reinvest the proceeds in illiquid assets, such as real estate, farms, and closely held businesses.[310] Although this may be true, virtually all tax laws have some degree of incentive effects. For example, special rules applicable to family farms and small business under our current estate-tax law encourage taxpayers to invest in those assets.[311] In addition, the stepped-up basis at death encourages elderly people to hold on to assets that they might otherwise choose to sell. With respect to this proposal, the incentive effect does not seem very significant, at least with respect to appreciating assets, because the only benefit of investing in those illiquid assets is to defer taxes over various generations rather than over the owner's child's lifetime, as would be possible with a rollover into an IRA. It seems unlikely that a significant number of people would choose to invest in illiquid assets rather than liquid assets, which provide

309. This assumes that some future recipient of an illiquid asset will eventually sell it. This is a reasonable assumption because the usual exponential growth in the size of a family over time will likely cause there to be an increase in the number of owners of an asset over generations. Because these owners will have different cash needs and desires, somebody in a family is likely to eventually choose to sell the asset.

310. They initially may also choose to invest in illiquid assets rather than liquid assets. This Article does not consider whether investments in illiquid assets are more beneficial to society that investments in liquid assets.

311. *See* TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY, *supra* note 104, at 3.

much greater flexibility, solely to defer taxes over more than one generation.

The incentive to invest in illiquid assets is arguably exacerbated with respect to personal-use illiquid assets. As mentioned, these assets will tend to decline in value as they are consumed.[312] This, of course, effectively will result in tax forgiveness, rather than deferral, for those assets.[313] Despite this tax-avoidance potential, it seems even less likely that individuals would invest in significant amounts of wasting personal-use assets to avoid taxes. Although a small amount of this may occur, such as giving an automobile to a child, it will not create widespread tax avoidance. In addition, to the small extent that this does occur, I believe that the benefits of having a simple system outweigh the potential revenue loss. Said differently, it will greatly simplify our transfer-tax system if taxpayers do not need to distinguish between personal-use illiquid assets and business- or investment-use assets; the benefits of this simplicity greatly outweigh the relatively small potential revenue loss.

CONCLUSION

I have, for many years, been a strong advocate of our transfer-tax system because I strongly believe in the goals that underlie it. Specifically, I believe that our society is stronger if each individual's wealth and income is more closely tied to her personal achievements than to the family into which she was born. Although it is impossible to remove all privilege at birth and although income frequently bears little correlation to personal achievements, it is a worthy goal to try to level the playing field.

For many years, I believed that an estate tax focused on the wealthy did a relatively good job of reducing this birth privilege. Recently, however, I have begun to question this for several reasons. First, I saw the very wealthy find ways to avoid or greatly reduce transfer taxes. Second, I saw the anti-estate-tax movement gain widespread popular support to the point at which the system's continued existence has been called into question. Third, I saw estate-tax-exemption amounts increase to levels at which huge amounts of financial advantage can be transferred between generations with no tax whatsoever. Thus, with very basic planning, a married couple will be able to pass $7 million tax free to their child in 2009. A child born into a working-class family, on the other hand, will need to pay state and local income taxes as well as social-security taxes on what little she might earn in wages. Realistically, she will have no chance to compete with the $7 million child. That rich child

312. *Supra* note 196.

313. *See* Dodge, *supra* note 19, at 1199.

will be able to pay millions of dollars in cash for a house and will have plenty left to live extremely well, while the working-class girl may not be able to save up enough to buy a house. The rich child also will be able to pay private school tuition, attend schools that open doors of opportunity, and purchase political influence or political favors. This kind of wealth disparity is a threat to a stable society.

Because of these observations, I have come to the conclusion that we need to re-examine our wealth-transfer-tax system. Specifically, we should find a new system that will not create popular support for abolishing all wealth-transfer taxes. This popular support for repeal will exist as long as there is a widespread belief that people need to sell assets, especially farms and family businesses, to pay taxes. More specifically, our current system should be replaced with a system that is transferee-focused. That will encourage wealth dispersion as well as reduced tax-planning opportunities. This transferee-focused system should aim to treat everybody equally, regardless whether they inherit a family farm or family artwork, and it should be designed so that nobody will need to sell illiquid assets or borrow against those assets to pay taxes. My proposal does just that.

Although no transfer-tax proposal will ever be perfect, this proposal is a step in the right direction. It is simple and it would be easy to administer. It taxes heirs more like wage earners, which is much more equitable than our current system. It is impossible to predict the revenue impact of this proposal because that will depend in large part on whether taxpayers choose to roll gifts and inheritances into IRAs, whether they choose to include illiquid assets in income, and when they ultimately sell those illiquid assets. That being said, it seems likely that tax deferral through IRA rollovers will increase federal revenue as people retire and begin to withdraw inheritances from IRAs. As an added benefit, this resulting increase in tax revenue is likely to come at a time when our social-security system will be feeling its greatest financial strain.