Estate Tax Repeal Under EGTRRA: A Proposal for Simplification

Sergio Pareja
University of New Mexico

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ESTATE TAX REPEAL UNDER EGTRRA:
A PROPOSAL FOR SIMPLIFICATION

Sergio Pareja*

Editors' Synopsis: This Article generally discusses the Economic Growth and Tax Relief Reconciliation Act of 2001 and proposes a relatively simple change that would simplify and reduce the costs of estate planning. Specifically, the Article proposes that the first spouse's unused basis step-up should be transferred to the surviving spouse automatically at the death of the first spouse.

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* Sergio Pareja is an attorney at the law firm of Holme, Roberts & Owen, LLP in Denver, Colorado. He primarily practices in the areas of estate and gift tax planning, advising fiduciaries, general income tax planning, and estate and trust administration. Mr. Pareja received his B.A. degree from the University of California at Berkeley in 1991 and his J.D., cum laude, from Georgetown University Law Center in 1996.
I. INTRODUCTION

In 2001, Congress and President George W. Bush enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").\(^1\) One of the most celebrated changes of this $1.35 trillion tax cut was the repeal of the federal estate tax in 2010. Although this repeal currently is scheduled to last for only one year (2010), possibly all or some of the provisions of EGTRRA, including estate tax repeal, may be made permanent. Regardless of whether repeal is made permanent, the mere possibility of repeal for any amount of time will alter the estate plans of large estates.

Among the many arguments for estate tax repeal, one of the most compelling is that repeal will reduce the complexity of the Internal Revenue Code (the "Code") and thereby simplify estate planning.\(^2\) Arguably, this simplification will eliminate the tax-motivated need for estate planning, saving people large amounts of money that otherwise would go to attorneys' fees.\(^3\) This money, the argument goes, will be reinvested in the economy.\(^4\) Unfortunately, at least as to basic estate

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2 For the major arguments for repeal, see discussion infra Part II.C.
3 See infra Part II.C.
4 See infra Part II.C.
planning and estate administration for wealthy families with highly appreciated assets, this argument lacks merit.

During repeal, a new estate planning technique, one that this Article's author calls the "step-up trust," which will supplant the current "credit shelter trust," will plague married taxpayers of significant wealth. This new technique will be the method of choice for a wealthy married couple to take full advantage of a new $1.3 million step-up in income tax basis for assets passing to someone other than a surviving spouse. Although somewhat different from a credit shelter trust, this new technique will share many of the same characteristics of a credit shelter trust, including expenses and administrative difficulties.

This Article does not address the issue of whether estate tax repeal under EGTRRA should be made permanent from a tax policy perspective. Instead, this Article assumes that estate tax repeal will occur for at least one year, whether or not this is sound tax policy. In that context, this Article proposes a relatively simple change to EGTRRA, which will help simplify and reduce the costs of estate planning: the first spouse's unused basis step-up should be transferred to the surviving spouse automatically at the death of the first spouse.

II. OVERVIEW OF REPEAL UNDER EGTRRA

A. EGTRRA in General

President Bush signed EGTRRA on June 7, 2001. This tax law made many significant changes to the Code. Absent further legislation, each of these changes "sunset" or expires at midnight on December 31, 2010, at which time the Code is reinstated exactly as it was prior to the enactment

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6 See id.
7 See id.
8 Many articles address the issue of whether estate tax repeal under EGTRRA is wise from a tax policy perspective. See, e.g., Stephen Vasek, Death Tax Repeal: Alternative Reform Proposals, 92 TAX NOTES 955 (2001).
9 Congressional leaders should consider the issues raised in this Article even if repeal lasts only one year. Furthermore, Congress should consider these issues any time Congress proposes to alter the unlimited step-up in income tax basis at death.
of EGTRRA.\textsuperscript{11} The following list, quoted from CCH's 2002 U.S. Master Tax Guide, "highlights some of the new and more immediate changes" of EGTRRA:

(1) a new 10\% [income tax] bracket and reductions to other brackets for 2001 and beyond;

(2) the eventual repeal of the itemized deduction and personal exemption phaseouts;

(3) increases to the child tax credit for 2001 and beyond;

(4) changes to the dependent care credit and the adoption credit, as well as the creation of a new credit under the general business credit for employers providing child care;

(5) changes to the student loan interest deduction and education IRA rules, as well as a new 2002 "above-the-line" deduction for higher education expenses;

(6) numerous changes implementing the eventual repeal of the estate and generation-skipping transfer taxes;\textsuperscript{12}

(7) numerous changes regarding pension contributions, funding, distributions, and rollovers;

(8) a short deferral period for all or a part of the required corporate quarterly estimated tax payments due in September 2001 and 2004; and

(9) increases to the [Alternative Minimum Tax] exemption amounts for 2001-2004.\textsuperscript{13}

B. Specific Estate, Gift, and Generation-Skipping Transfer Tax Changes Under EGTRRA

Under EGTRRA, the Estate Tax Exclusion Amount is increased in stages through the year 2009. In 2003, the Estate Tax Exclusion Amount is $1 million.\textsuperscript{14} In 2004 and 2005, the Estate Tax Exclusion Amount is

\textsuperscript{11} See id. at § 901. There is currently one exception to this sunsetting. On December 17, 2002, President Bush signed a measure into law that repeals the sunset of one provision of EGTRRA that exempts Holocaust survivors and their heirs from paying taxes on restitution claims. Before the bill reached the President, the House approved the bill on June 4, 2002 with a 392-1 vote and the Senate approved the bill on November 20, 2002 with a unanimous vote. \textit{See Patti Mohr, Bush Signs Tax Exemption for Holocaust Survivors' Restitution Claims}, 2002 TNT 243-1 (Dec. 17, 2002).

\textsuperscript{12} For a detailed description of the significant Estate, Gift, and Generation-Skipping Transfer Tax changes under EGTRRA, see discussion infra Part II.B.

\textsuperscript{13} CCH, INC., 2002 U.S. MASTER TAX GUIDE ¶ 1.

\textsuperscript{14} See I.R.C. § 2010(c) (2001).
$1.5 million. In 2006 through 2008, the Estate Tax Exclusion Amount is $2 million. In 2009, the Estate Tax Exclusion Amount is $3.5 million.

Unlike the Estate Tax Exclusion Amount, the Gift Tax Exclusion Amount does not change. This amount is fixed "permanently" at $1 million.

In addition to the changes to the Estate Tax Exclusion Amount, EGTRRA gradually decreases the top estate and gift tax rates through 2009. The new scheduled top rates and the years in which they go into effect are as follows: 50% in 2002, 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006, and 45% in 2007 through 2009.

Apart from the changes to the Estate Tax Exclusion Amount and the estate tax rate changes, EGTRRA also increases the generation-skipping transfer ("GST") tax exemption amount (the "GSTT Exemption Amount") in stages through 2009. In 2002, the GSTT Exemption Amount was $1.1 million. In 2003, it is $1.12 million, an inflation-adjusted amount. In 2004 and 2005, it is $1.5 million. In 2006 through 2008, it is $2 million. In 2009, it is $3.5 million.

The changes described above, which will occur through 2009, are insignificant compared to the change that will occur in 2010. In that year, the estate tax and the GST tax are repealed, but the gift tax is not repealed. As mentioned above, this repeal currently is scheduled to last for one year because all EGTRRA changes expire at midnight on December 31, 2010. However, President Bush and a significant number

15 See id. 16 See id. 17 See id. 18 See id. § 2505(a)(1). 19 This statement makes the unrealistic assumption that there will be no future tax legislation. Nevertheless, the law now provides that the Gift Tax Exclusion Amount is a fixed number ($1,000,000). See id. 20 See id. § 2001(c). EGTRRA also reduces the top state death tax credit (12% in 2002, 8% in 2003, and 4% in 2004) until its complete repeal in 2005. See id. § 2011(b)(2). Starting in the year 2005, a deduction replaces the state death tax credit. See id. § 2058. 21 See id. §§ 2631(c), 2010(c). 22 See id. § 2631(c)(1)(B); see also CCH, INC., 2003 U.S. MASTER TAX GUIDE ¶ 2943. 23 See I.R.C. §§ 2631(c), 2010(c). 24 See id. 25 See id. 26 See id. § 2210. 27 See Economic Growth and Tax Relief and Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, § 901 (2001). As mentioned above, there is currently one exception to this sunsetting. See supra note 11.
of members of Congress would like to make all provisions of EGTRRA permanent. At this point, predicting with certainty whether they will be successful is impossible. Thus, repeal may or may not last beyond 2010.

C. Reasons for Estate Tax Repeal

According to Professor Stephen Vasek of the University of Kentucky College of Law,

Reasons given for repeal of death taxes [under EGTRRA] include: (1) to improve the low personal savings 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.

With respect to reducing the complexity and the compliance and administrative burdens of current tax laws, 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 to $6 billion annually—for enforcement and compliance activities." Others have also argued that EGTRRA will simplify estate planning so that less money will be lost to estate planning attorneys. As stated by Senator Grassley at a May 21, 2001 U.S. Senate hearing on EGTRRA, "[P]robably the money that is wasted in this country on estate tax planning is the biggest waste of the productive resources in this country that you can

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28 See, e.g., Patti Mohr & Warren Rojas, GOP Leaders Call Election Victory a "Referendum" on Bush Policies, 2002 TNT 216-1 (Nov. 6, 2002):

Senate Finance Committee ranking member Charles E. Grassley, R-Iowa, who is expected to resume his post as the committee chair in the next Congress, outlined a new agenda. . . . Grassley also said he will push to make last year's tax cuts permanent. "The tax cuts help taxpayers across the board with child care, rate cuts, education incentives, and retirement savings incentives," he said. "They help to create jobs. . . . If we don't make the tax cuts permanent, small businesses will pay a tax penalty of almost 15 percent in 2011."

Id. at ¶ 7-9.

29 Vasek, supra note 8, at 956.

30 Id. at 956 n.16 (quoting Hearing Before the House Comm. on Ways and Means on Reducing Tax Burdens, 105th Cong., 105-97 (1998) (statement of the Hon. Jim McCrery)).
U.S. Representative Cox stated that "[c]omplete and immediate Death Tax repeal is the single most effective growth measure we can enact to direct resources away from non-productive tax planning and toward job-creation, higher wages, and lower prices for consumers." In a press release, White House Press Secretary Ari Fleischer stated that "[t]he other big area of simplification [of the Code], which is major, is repeal of the death tax." Implicit in each of these statements is the notion that repeal of the estate tax will eliminate the need to pay estate planning attorneys for tax planning. These savings, in turn, will be reinvested in the U.S. economy.

D. Income Tax Changes at Death Under EGTRRA

Under current law (through 2009), a beneficiary of a decedent’s estate generally takes a basis in the inherited property equal to the property’s fair market value as of the decedent’s date of death. In addition to saving income taxes when an estate consists predominantly of appreciated assets, the unlimited step-up in basis simplifies basis tracking for the beneficiaries.

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33 Ari Fleischer, The White House Regular Briefing, FEDERAL NEWS SERVICE, Feb. 26, 2001, at ¶ 74. In this speech, Mr. Fleischer went on to state that the estate tax, the death tax, is one of the largest loopholes in the code, that invites CPAs and lawyers to figure out ends around, which complicate the tax code. If there is anybody who has a lot to lose in the President’s budget proposal, it’s tax lawyers and accountants. If you repeal the death tax, a lot of them are going to lose their ability to carry out their livelihood, which is to help people avoid paying taxes.

Id.

34 Presumably estate planning will continue to be necessary for nontax reasons, such as the selection of the recipients of one’s assets, as well as the timing and manner of receipt (i.e., through a trust for minor beneficiaries).
35 See I.R.C. § 1014 (Supp. 2001). The basis is stepped up or stepped down to the assets’ fair market value on the decedent’s date of death under I.R.C. § 1014(a)(1), or, if the alternate valuation date is used on the decedent’s estate tax return, the basis is stepped up or stepped down to the fair market value on the alternate valuation date under I.R.C. § 1014(a)(2).
of the estate and reduces the effect of double taxation. EGTRRA significantly changes this current law in 2010.

Under EGTRRA, the unlimited step-up in basis is repealed when the estate tax is repealed. Instead of an unlimited step-up at death, EGTRRA provides that 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. These changes will completely change the way estate planning will be done in a post-repeal world.

III. ESTATE PLANNING AFTER REPEAL

A. In General

Estate planning attorneys already are discussing ways to plan in anticipation of, as well as after, repeal. For large estates with highly appreciated assets, this is more difficult than planning prior to repeal. Prior to repeal, the most basic of estate planning tax concepts was and is the credit shelter trust.

B. Credit Shelter Trusts Before Repeal

Credit shelter trusts (or "family trusts" or "bypass trusts") are familiar to all estate planning attorneys. The origin of credit shelter trusts, as they now exist, traces back in great part to the passage of the Tax Reform Act of 1976 (the "1976 Act"). The 1976 Act was significant with respect to

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36. "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." Steven Akers, Planning for Large Estates, ALI-ABA, 1, 7 (Nov. 2001). According to Professor Lawrence Zelenak, the stepped-up basis at death serves an important simplification purpose by avoiding proof of basis problems for small estates. See Lawrence Zelenak, Taxing Gains at Death, 46 Vand. L. Rev. 361, 363 (1993).

37. See I.R.C. §§ 1014(f), 2210 (2002). 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.

38. See id. § 1022.

39. This assumes that the estate is large enough and has enough appreciation for income taxes to be an issue.

40. See, e.g., Hastings & Covey, supra note 5, at 48-49.


42. See Jay A. Soled, A Proposal to Make Credit Shelter Trusts Obsolete, 51 Tax Law.
credit shelter trusts because (a) it unified gift and estate taxes and (b) it expanded the marital deduction to the greater of one-half of a decedent's estate or $250,000. This change was significant because for the first time a decedent could potentially leave his or her entire estate to a surviving spouse without paying any estate tax (if the decedent had total assets of $250,000 or less). By doing this, however, a decedent would be in effect "wasting" his or her unified credit, which after the 1976 Act was set at $30,000.

As a result of the 1976 Act, estate planning attorneys began drafting credit shelter trusts to absorb the first-spouse-to-die's unified credit. The basic idea was to draft the trust so that the surviving spouse would have as much access to the trust as possible without resulting in inclusion of the assets of that trust in the surviving spouse's estate upon the surviving spouse's subsequent death. Although the surviving spouse could not have absolute control over the credit shelter trust without the entire trust being included in the surviving spouse's estate, the trust could be structured to provide the surviving spouse, at most, with an income interest, a right of withdrawal (typically limited to the greater of $5,000 or 5% of the trust assets), a special power of appointment, and a right to distributions of principal either in the trustee's discretion or based on an "ascertainable standard." The surviving spouse could even be designated as the sole

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83, 84-86 (1997).

43 Prior to the 1976 Act, the marital deduction had been limited, since 1948, to one-half of a decedent's estate (i.e., there was no unlimited marital deduction). See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(1), 90 Stat. 1520, 1846 (1978); Revenue Act of 1948, 62 Stat. 168 (1949).

44 See Tax Reform Act of 1976 § 2001(a)(1), 90 Stat. at 1848. For example, a decedent with an estate of $250,000 or less might leave his or her entire estate to the surviving spouse. This would result in no estate tax at the first spouse's death. However, if the surviving spouse's estate were to exceed the amount shielded by his or her available credit at that spouse's later death, then an estate tax at that time could have been avoided or, at least, reduced. In the year that the 1976 Act went into effect (1977), a $30,000 unified credit was available to shield an estate of $120,667 from taxes. The credit amount gradually increased through 1987 when it reached $192,800, shielding an estate of $600,000 from taxes. The credit stayed at $192,800 until 1998. The current system has replaced the unified credit with an "exemption equivalent amount" based on the amount shielded by the credit. The total amount that can be shielded by transfer during life or at death is currently $1 million. At present, therefore, the idea is to avoid wasting the first-spouse-to-die's $1 million exemption. See I.R.C. § 2010(c) (2000).

45 See Soled, supra note 42, at 85.

46 The objective is to ensure that the surviving spouse is not treated as holding a general power of appointment over the trust by virtue of his or her degree of control over
trustee with a power to make distributions of principal as long as distributions were made in accordance with an ascertainable standard.\(^{47}\) As mentioned above, the Estate Tax Exclusion Amount and Gift Tax Exclusion Amount are currently both equal to $1 million.\(^{48}\) A use of a taxpayer’s Gift Tax Exclusion Amount during life effectively reduces, dollar for dollar, that taxpayer’s available Estate Tax Exclusion Amount at death. This means that, under current law,\(^{49}\) each taxpayer may give a total of $1 million to others during life or at death without incurring any gift or estate taxes.\(^{50}\) If this $1 million is not used during life or at death, it is wasted because the unused portion cannot be left to anyone, including a surviving spouse, at death.\(^{51}\) Because of this, credit shelter trusts are still, as they were after the 1976 Act, the estate planning method of choice to avoid wasting the first-spouse-to-die’s unused exclusion amount.\(^{52}\)

Despite the relatively broad flexibility of credit shelter trusts, most people, in the case of a first marriage with no issues of marital strife, would prefer to leave assets outright to their spouses.\(^{53}\) In each case in which this is true, the Code is in effect inducing the taxpayer—the decedent—to establish a credit shelter trust solely for tax reasons.\(^{54}\) What is it about the

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\(^{47}\) See Estate of Vissering v. Comm'r, 990 F.2d 578, 580-81 (10th Cir. 1993).

\(^{48}\) These amounts are scheduled to differ from each other in the future. For example, in the year 2004, the Estate Tax Exclusion Amount will be $1.5 million while the Gift Tax Exclusion Amount will remain fixed at $1 million.

\(^{49}\) The current law is EGTRRA in the year 2003 as well as after expiration of the provisions of EGTRRA after the year 2010, assuming no further tax legislation.

\(^{50}\) The $1 million combined amount is unaffected by annual exclusion gifts. These gifts are present interest gifts not in excess of a current inflation-adjusted amount of $11,000 per year per donee. See I.R.C. § 2503(b) (2000).

\(^{51}\) For an excellent article suggesting that the unified credit—the predecessor to the applicable exclusion amount—should be transformed into an exemption transferable to the surviving spouse, see Soled, supra note 42, at 83.

\(^{52}\) See CAMPFIELD, ET AL., supra note 41, at ¶ 27,415.

\(^{53}\) See Soled, supra note 42, at 83.

\(^{54}\) Commentators have suggested that this inducement hampers economic growth because placing assets in trust affects the potential ways that those assets, as well as other assets received by a surviving spouse, are invested. See, e.g., Edward J. Gac & Sharon K. Brougham, A Proposal for Restructuring the Taxation of Wealth Transfers: Tax Reform Redux?, 5 AKRON TAX J. 75, 82 (1988).
use of credit shelter trusts that would cause people to prefer leaving assets outright to their spouses?

There are many issues with credit shelter trusts.\(^5\) The first issue concerns funding the trust. In the absence of assets that may easily be divided, such as cash and marketable securities, fractionalizing assets is often necessary. For example, it may be necessary for the credit shelter trust to own a certain percentage of the real estate as a tenant in common.\(^5\) Second, even if the surviving spouse is the sole trustee, the surviving spouse has obligations as a fiduciary to the remainder beneficiaries of the trust.\(^5\) If a falling out with those remainder beneficiaries were to occur, the surviving spouse would need to be very careful or he or she could be subject to liability.\(^5\) Third, if other trustees are involved, the surviving spouse may have difficulty convincing the other trustees to make distributions.\(^5\) Fourth, the trust may need to pay trustee fees.\(^6\) Fifth, a credit shelter trust is a separate taxpayer for income tax purposes,\(^6\) which means that separate accountings and income tax returns are necessary each year. Finally, a trust often creates a need for attorneys and related expenses.\(^6\)

Because of the complexity and unnecessary expenses related to credit shelter trusts, it is apparent why President Bush and a significant number of the members of Congress have pushed for a complete repeal of the estate tax.\(^6\) Unfortunately, at least for large estates with highly appreciated assets, the situation under repeal with respect to the simplification of basic estate planning does not appear to be any better than before repeal.

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\(^5\) This is certainly not intended to be an all-inclusive list. This list merely represents certain fundamental issues that have arisen in the context of the author's estate planning practice.

\(^6\) Cf. Colo. Rev. Stat. § 15-12-906 (1997) (noting that residuary property may be converted to cash for distribution, but this may not be a desired result when the residuary property is real estate).


\(^8\) See id.

\(^9\) Cf. Ind. Code § 30-4-3-4 (2002) (requiring unanimity for exercising powers if there are two trustees and a majority if there are three or more trustees).


\(^6\) See Mohr & Rojas, supra note 28 and accompanying text.
C. Step-Up Trusts After Repeal

After repeal, the primary tax issue for large estates will be how to make use of the first-spouse-to-die’s full $1.3 million basis step-up for assets transferred to someone other than the surviving spouse. A transfer of all assets of the estate to the surviving spouse outright (or to a marital trust that qualifies as a transfer to the surviving spouse for income tax basis step-up purposes) will result in a waste of up to a $1.3 million basis step-up, much like the wasting of the unified credit that could occur after the 1976 Act. If the surviving spouse subsequently sells those assets, the surviving spouse unnecessarily will pay a capital gains tax of up to $260,000.\(^\text{64}\) To avoid this waste, estate planning after and in anticipation of repeal will likely incorporate the concept of a step-up trust that will qualify for the $1.3 million basis step-up while giving the surviving spouse a certain degree of access to the trust assets.\(^\text{65}\)

All the undesirable issues of credit shelter trusts mentioned above will continue to exist with step-up trusts. In the areas in which surviving spouses would have been unsatisfied with a credit shelter trust, they will experience the same dissatisfaction with a step-up trust. In addition, funding the step-up trust will be much more difficult than funding a credit shelter trust because, rather than basing the amount passing into the trust on the fair market value of assets at the time of funding, the amount passing into the trust will be based on the amount of unrealized gain in certain assets at the time of funding.\(^\text{66}\)

IV. ANALYSIS OF REPEAL UNDER EGTRRA

A. In General

Under EGTRRA, the post-repeal $1.3 million step-up in basis, as with the present applicable exclusion amount, may not be transferred between spouses. Thus, as with the applicable exclusion amount before repeal, the first-spouse-to-die’s $1.3 million step-up in basis is wasted if the first spouse leaves everything outright to the surviving spouse. Whether this

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\(^\text{64}\) This assumes the current long-term capital gains rate of 20% (i.e., 20% of $1.3 million).

\(^\text{65}\) See Hastings & Covey, supra note 5, at 48-53.

\(^\text{66}\) However, if a fractional funding clause is used, then the amount presumably will be based on the amount of unrealized gain on the date of death.
system is good tax policy should be analyzed based on tax policy standards of equity, administrative efficiency, and neutrality.67

B. Equity

1. Horizontal Equity

The concept of horizontal equity requires that similarly situated taxpayers bear similar tax burdens.68 With respect to estates after repeal of the estate tax, the relevant taxpayer for purposes of this analysis is not the decedent. Instead, the relevant taxpayer is the beneficiary or beneficiaries of the decedent’s estate because the decedent or, more accurately, the estate of the decedent will not be paying any federal estate tax after repeal. The beneficiary or beneficiaries of the decedent’s estate, on the other hand, may pay capital gains taxes upon a subsequent disposition of inherited assets, assuming sufficient appreciation in the estate. In this context, the sole child (and sole heir) of a married couple that dies nearly simultaneously is a convenient illustration.

For purposes of this analysis, compare the child of a couple with $10 million in highly appreciated assets (“Child A”) with the child of another couple with $10 million in highly appreciated assets (“Child B”). Assume, for simplicity, that each $10 million in assets has an income tax basis of zero and that Child A’s parents both die at the same time as Child B’s parents (i.e., all four deaths occur simultaneously). For tax purposes, Child A and Child B are similarly situated taxpayers. Therefore, horizontal equity dictates that Child A and Child B should achieve equivalent income tax consequences upon selling inherited assets. Unfortunately, this is not necessarily the case.

Assume that the only asset of Child A’s parents at the time of their deaths was a single piece of real estate that the parents owned as tenants-in-common. Assume further that they had not hired an estate planning attorney and, knowing that the estate tax was repealed, prepared their own simple wills using a basic will form. Their wills leave everything to the surviving spouse outright. Now assume that Child B’s parents, on the other

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68 See Donaldson, supra note 67, at 545. See also Richard Schmalbeck, Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity, 1984 DUKE L. J. 509, 546.
hand, owned a highly appreciated portfolio of readily marketable securities (50% owned by each parent). Child B’s parents consulted an estate planning attorney who drafted their wills to include a step-up trust to take full advantage of the first-spouse-to-die’s $1.3 million step-up in basis. Under these facts, a subsequent disposition of assets by Child A and Child B at the same time will result in Child A paying $260,000 in capital gains taxes that Child B will not pay.

As indicated with the above example, Child A’s and Child B’s tax situations are dependent, in significant part, on whether their parents employed estate planning attorneys. This example does not consider complicating factors such as ownership as joint tenants with right of survivorship or unequal distribution of assets. In these cases, the advice of an estate planning attorney would have been even more critical. In such situations, the attorney probably would have advised the parents to change the title of their assets to tenancy-in-common and to shift assets between each other to equalize the size of their respective estates. Thus, in this example, the similarly situated taxpayers, Child A and Child B, are only accorded similar tax treatment if their parents retain professional advice.

In addition to the need for professional advice for estate planning, the nature of the assets in the above example could affect significantly the ability of the personal representative of the parents’ estates to fund a step-up trust during estate administration. For example, funding a step-up trust (had the parents’ wills established one) would have been more difficult for Child A’s parents’ personal representative than it would have been for Child B’s parents’ personal representative. This is because Child A’s parents’ personal representative would be required to fractionalize the ownership of the real estate, causing the estate to incur unnecessary legal expenses. The personal representative of Child B’s parents’ estates, on the other hand, would not worry about fractionalizing assets because readily marketable securities with an income tax basis of zero are relatively simple assets to divide for purposes of funding a trust.

The potential disparity between the tax treatment of similarly situated taxpayers is made even more apparent if one remembers that the amount passing into the step-up trust will be determined not by the value of assets alone as with credit shelter trusts but, instead, by the difference between the assets’ value and the decedent’s basis in those assets. Thus, the above example is an over-simplification of what truly will be a complex situation.

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69 This amount is equal to 20% of $1.3 million. See supra note 64.
70 See supra Part III.C.
The decedent's income tax basis will affect a family's ability to take advantage of a step-up trust. For example, departing from the above illustration, consider a decedent who owns, among other significant assets, (a) one asset with a value of $1.3 million and a zero basis, (b) two assets each with a $1.3 million value and a $650,000 basis, and (c) thirteen assets each with a $1 million value and a $900,000 basis. Potentially, the step-up trust in this case could be funded with $1.3 million, $2.6 million or $13 million depending on the assets chosen. Thus, the decedent's income tax basis in various assets can affect the ability to fund a step-up trust to take advantage of a significant tax benefit. This difficulty is likely to cause similarly situated taxpayers to pay significantly different amounts of tax.

To summarize, income tax consequences to similarly situated taxpayers (i.e., the beneficiaries of decedents' estates) are affected by (a) the ability of the decedent to hire attorneys, (b) the nature of the assets owned, and (c) the income tax basis of the decedent in the assortment of assets owned. This disparate treatment does little to achieve horizontal equity. In fact, it likely will foster the perception that certain types of individuals are being discriminated against. For example, farmers will be identified as being discriminated against because they often own highly illiquid assets. They also may not have as ready access to qualified estate planning professionals as would a person living in a large city.

2. Vertical Equity

The concept of vertical equity provides that taxpayers who are not similarly situated should bear tax burdens relative to their respective abilities to pay. The vertical equity implications of estate tax repeal under EGTRRA are less severe than the horizontal equity implications because the people who will be affected by the tax consequences of their actions are likely to have enough money to consult estate planning professionals. That being said, there are still some undesirable vertical equity implications here as well.

As an example, consider a married couple with $5.6 million in appreciated assets, such as a farm, with a basis of zero. This couple should, after repeal, be sure to utilize a step-up trust to take advantage of the first-

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71 For a similar example dealing with the issue of funding a marital trust (rather than a step-up trust) after estate tax repeal under EGTRRA, see Hastings & Covey, supra note 5, at 44-45.
72 This assumes a choice between (a), (b), or (c).
73 See Donaldson, supra note 67, at 545; see also Schmalbeck, supra note 68, at 546.
spouse-to-die's $1.3 million basis step-up. This couple, especially assuming that they have few liquid assets, would be less likely to be able to afford legal fees to set up a step-up trust and to arrange proper asset ownership than would a couple with ten times as much ($56 million in appreciated assets). Thus, there will be a greater chance that taxpayers with relatively less money will bear a greater proportion of the tax on the taxable gain on inherited assets.

C. Administrative Efficiency

Generally, administrative efficiency concerns are judged in the following two principal ways: (1) indirect costs, which are costs to taxpayers for attempting to comply with the law, and (2) direct costs, which are the costs to the government for administering the tax law. Estate tax repeal under EGTRRA is likely to result in large, unnecessary indirect costs and direct costs.

1. Indirect Costs

As indicated in the Child A and Child B example above, estate tax repeal as it exists under EGTRRA will make basic estate planning and estate administration for wealthy individuals even more complex than estate planning is under the current credit shelter trust system, especially regarding indirect costs. Wealthy individuals such as the parents in the above example will need to pay close attention to income tax basis issues in addition to the asset titling and trust creation issues that they presumably now deal with in conjunction with credit shelter trust planning. The complexity and length of wills will likely only increase as a result of repeal under EGTRRA. In addition, wealthy taxpayers will need to keep detailed records of their income tax basis in all assets, including assets that they have no intention of ever selling. Maintenance of these basis records is not quite as simple as it may sound. For example, real estate may have been improved, partially sold, or depreciated after it was purchased. Stock may

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75 This does not consider the fact that the provisions of EGTRRA sunset on December 31, 2010, making planning with any degree of certainty virtually impossible unless individuals seeking estate planning can predict accurately the year of their deaths. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, § 901 (2001).
have been acquired for different amounts on different dates. There may have been mergers, and stock may have generated dividends.

In addition to the increased indirect costs of estate planning, estate administration also will have increased indirect costs. Because of EGTRRA, personal representatives will be required to determine both the fair market value of each asset and the decedent's basis in each asset. Tracking the basis of assets received from a decedent is generally more difficult than tracking the basis of assets received by lifetime gift. Also, the mere formation of a step-up trust will result in the creation of a new taxpayer for income tax purposes. This new taxpayer must file annual income tax returns and the trust may also need the services of lawyers and accountants, again with the incumbent expenses.

There are also less tangible indirect costs to taxpayers. Holding property as tenants-in-common rather than as joint tenants with rights of survivorship, for example, may be necessary to ensure that assets are available to fund the step-up trust. Thus, taxpayers may be pulled into the probate process when they otherwise could have avoided it by owning assets jointly.

2. Direct Costs

The direct costs associated with step-up trusts are less obvious but nonetheless present. From the government's perspective, its auditors will run into the same basis tracking issues that the beneficiaries will encounter. The auditor will spend time reviewing wills and tax returns showing the property that is receiving the limited step-up in basis. In addition, the continuing administration of step-up trusts will present on-going administrative difficulties for the government. As mentioned above, the step-up trust is a separate taxpayer from the surviving spouse. This certainly makes the government's position more complicated, as it will have additional income tax returns to review each year.

D. Neutrality

The concept of tax neutrality suggests that the Code, to the extent possible, should not cause people to alter behavior solely for tax reasons.

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76 See Jeffrey M. Colon, Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy, 34 SAN DIEGO L. REV. 1, 42-43 (1997) (suggesting that death is an "involuntary conversion," and a purpose of the current step-up in basis at death of I.R.C. § 1014 may be "to relieve heirs from having to recreate the tax history of inherited property").
unless there is a public policy reason for doing so.\textsuperscript{77} As far as the author is aware, Congress does not have a stated public policy of trying to induce people to create trusts. Therefore, step-up trusts unquestionably violate the principle of tax neutrality.

As mentioned above, in the absence of marital strife, most taxpayers would prefer to leave assets outright to a surviving spouse. This would mean that most wills of wealthy married couples with no children from a prior marriage would be fairly simple. Possibly after some relatively small specific bequests, the wills would leave everything outright to the surviving spouse.\textsuperscript{78} After the second-spouse-to-die's death, assets would be left to children or other family members either outright or in trust. In this typical situation, wills would be relatively short and simple.

Instead of short and simple wills, wealthy married couples with no children from a prior marriage likely will have attorneys draft wills that create step-up trusts to ensure that their families do not unnecessarily pay taxes. These wills will be relatively long and complex and will incur significant legal fees. After the first-spouse-to-die's death, the personal representative (likely the surviving spouse) will need to deal with the division of assets to fund the step-up trust, as well as on-going trust maintenance and administration expenses.

A surviving spouse certainly would prefer to avoid all the costs and inconveniences associated with a step-up trust. These trusts, however, will be created for the sole purpose of minimizing capital gains taxes after the estate tax repeal. Thus, repeal under EGTRRA, as the law is currently drafted, fails the tax neutrality test.

\section*{V. PROPOSAL FOR SIMPLIFICATION}

\subsection*{A. Overview of Proposal}

The proposed change to EGTRRA is relatively simple. Congress should amend I.R.C. § 1022\textsuperscript{79} to provide that any unused portion of a person's basis increase under I.R.C. § 1022(b)(2)(B) automatically passes to the surviving spouse upon the first spouse's death. This new rule could be written as I.R.C. § 1022(i). This proposed change will have no effect on

\textsuperscript{77} See Donaldson, \textit{supra} note 67, at 550-51.

\textsuperscript{78} In certain situations, of course, everything would be left in trust for the surviving spouse for purely nontax reasons.

\textsuperscript{79} This is the codification of the basis step-up rule under EGTRRA that under current law becomes effective for decedents dying after December 31, 2009 and before January 1, 2011.
the $3 million basis increase under I.R.C. § 1022(c)(2)(B) for assets passing to a surviving spouse (the "spousal step-up"). Thus, a basis step-up of up to $1.3 million (the "non-spousal step-up") would pass from each married decedent to surviving spouse, effectively increasing the surviving spouse’s non-spousal step-up to up to $2.6 million at that person’s death. Section 1022(b)(2)(B) would also need to be amended to state that each person’s non-spousal step-up at death is limited to $1.3 million plus the value of any basis step-up received from a "qualified" spouse pursuant to I.R.C. § 1022(i).  

B. Application of Proposal

Under EGTRRA as it now exists, the personal representative of a decedent’s estate with a certain amount of appreciated assets presumably will need to file a tax return (the "step-up return") within nine months after the decedent’s death. This step-up return will be used to report the assets for which the basis step-up will apply. The proposal will not have any effect on this reporting requirement.

The proposed change to EGTRRA would require one simple change to the anticipated step-up return. The return preparer of each person who is married at the time of death would, after computing the amount of the $1.3 million non-spousal step-up that has been used, be able to determine how much of it remains unused at that time. The return preparer could identify the surviving spouse on the step-up return and state that this unused amount is passing to that person.

This reporting requirement at the first-spouse-to-die’s death should not be mandatory (i.e., transfers from qualified spouses should be automatic). The idea is that the reporting at the first-spouse-to-die’s death will be evidence that could be used at the second-spouse-to-die’s death to establish the amount of step-up available. Thus, for estates in which all

80 See author’s comment regarding the identity of a qualifying spouse, infra note 87.
81 See I.R.C. § 1022(b)(2)(B) (2002) (providing as it currently exists that the limit on the non-spousal step-up is $1.3 million).
82 See id. § 1022(h) (directing the Secretary to prescribe regulations to carry out the purpose of I.R.C. § 1022). Although these regulations have not yet been issued, they likely will require the use of some sort of tax return to obtain the benefit of the stepped-up income tax basis. The nine-month period was chosen here merely because that is the current time period in which one must file a Federal Estate Tax Return (Form 706).
83 See author’s comment regarding the identity of a qualifying spouse, infra note 87.
84 This is important. A mandatory reporting requirement at the first death would tend to counteract some of the simplicity sought by this proposal.
assets are passing to the surviving spouse outright, including intestate estates (if that is the case under state law), there would be no need to file a step-up return at the first-spouse-to-die's death, although this may be necessary to take advantage of the $3 million spousal step-up. With respect to the $1.3 million nonspousal step-up, the filing of the return at the first-spouse-to-die's death would serve merely to simplify proof of available step-up at the second-spouse-to-die's death.

At the death of the second-spouse-to-die, the personal representative of that spouse's estate would need to file a step-up return to take advantage of the available step-up. If a step-up return were filed with the first-spouse-to-die's estate, the personal representative merely would need merely to attach a copy of that return as presumptive evidence that the second-spouse-to-die inherited the amount of nonspousal step-up reported on the return as being transferred to the second-spouse-to-die.

If no step-up return were filed at the first-spouse-to-die's death, the second-spouse-to-die's personal representative would bear the burden of proving that the second-spouse-to-die inherited the first-spouse-to-die's nonspousal step-up. This proof would be fairly easy. The personal representative would merely need to identify the first-spouse-to-die, including that person's social security number, that spouse's date of death, and the date of marriage of the spouses. If no step-up return were filed at the first-spouse-to-die's death, the second-spouse-to-die presumptively would have an available step-up of $2.6 million.

There admittedly are two problem areas with this proposal. First, commentators certainly will assert that the proposal discriminates against people who live together in a committed relationship without being married, both heterosexual and homosexual. There is no correct solution to this problem. Our tax system has long favored legally married couples and also has sought to treat these couples as a single economic unit. Right or wrong, the support for the special preference for married couples in this country is indisputably overwhelming. This proposal, in giving preference to married people, is in accordance with that view.


Second, dealing with the situation of multiple marriages is difficult. Should a person be able to marry and survive an unlimited number of spouses to obtain each deceased spouse's additional step-up? There are three possible approaches. One approach would be to limit the total amount of nonspousal step-up that a person could possibly have to some amount, for example, $2.6 million. However, this approach would still allow people to benefit from multiple marriages (i.e., a person could absorb $650,000 from two separate spouses). A second approach would be to allow a transfer from only one predeceased spouse. A sub-issue would be how to choose the spouse—the first, the last, or some spouse in between. A final approach would be to allow an unlimited nonspousal step-up (i.e., if a person married and survived ten different people sequentially, that person could potentially inherit a total of $13 million in additional basis step-up). The necessary assumption in the third approach would be that people are not marrying merely to absorb each spouse’s nonspousal step-up. There is no correct solution to the multiple marriages problem. In the interest of administrative simplicity and perceived fairness of the system, this Article proposes allowing a transfer from only one predeceased spouse—the decedent’s first spouse to die in or after the year 2010.87

C. Analysis of Proposal

1. Equity

   a. Horizontal Equity

   As mentioned above, horizontal equity requires similarly situated taxpayers to bear similar tax burdens.88 For illustration purposes, consider what would happen in the Child A-Child B example above if the proposal of this Article were the law and if the parents of Child A and Child B were all to die in the year 2010.90

   Recall that Child A’s parents owned a $10 million piece of real estate with a basis of zero as tenants-in-common and that they had prepared simple wills leaving everything outright to the surviving spouse. Recall too that Child B’s parents each owned 50% of a portfolio of readily marketable

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87 This first spouse would be defined in the Code as the only qualified spouse.
88 See Donaldson, supra note 67, at 545; Schmalbeck, supra note 68, at 546.
89 See supra IV.B.1.
90 For purposes of this analysis, assume further that both sets of parents are in their first and only marriage and that their preference would be to leave everything outright to the surviving spouse and, if that spouse is not alive, outright to their child.
securities, with a basis of zero, and they had had an attorney prepare complex wills, which took advantage of the first-spouse-to-die’s nonspousal step-up.

Assuming, for convenience of explanation, that each father dies moments before each mother, then Child A’s and Child B’s tax situations would be identical. In Child A’s case, Child A’s father’s estate would automatically get a step-up of $3 million for assets passing to Child A’s mother.\(^9\) Furthermore, a $1.3 million basis step-up amount would pass from Child A’s father to Child A’s mother for her use at death under the proposed new section of the Code.\(^9\) On Child A’s mother’s death (moments after Child A’s father’s death), she would have the father’s $1.3 million step-up available to her in addition to her own $1.3 million step-up.\(^9\) Thus, Child A would receive all $10 million in assets with a combined income tax basis of $5.6 million.\(^9\) If Child A then were to sell the real estate immediately, Child A would need to pay a capital gains tax of $880,000.\(^9\)

In the case of Child B, Child B’s father’s estate would get a step-up of $3 million for the assets passing to the mother and an additional $1.3 million for assets passing into a step-up trust. At Child B’s mother’s subsequent death, her estate would be entitled to an additional step-up of $1.3 million. The total step-up available to the combined estates of B’s mother and father would be $5.6 million, the same amount available to the combined estates of Child A’s mother and father. An immediate sale by Child B of all of Child B’s parents’ assets, would result in Child B’s needing to pay a capital gains tax of $880,000. Thus, Child A and B in this example would pay identical amounts in taxes.

In addition to the above benefit, there are some other less obvious horizontal equity benefits to a change in the law. First, the manner of titling assets as between spouses would not cause a waste of the first spouse’s step-up. In the Child A-Child B hypothetical, for example, it would make no difference if Child A’s parents owned the real estate as joint

\(^{92}\) See supra Part V.A. (describing the proposed change to § 1022(1)).
\(^{93}\) See supra Part V.A. (describing the proposed amendment to § 1022(b)(2)(B)).
\(^{94}\) This number is the sum of $3 million plus $1.3 million plus $1.3 million.
\(^{95}\) This figure is equal to 20% of $4.4 million ($10 million minus $5.6 million). This calculation assumes that the piece of real estate is not deemed to be Child A’s primary residence for the purposes of the $250,000 exclusion of gain from the sale of a primary residence under I.R.C. § 121(b) (2002).
tenants with rights of survivorship. Second, intestacy would not change the result if the state's intestacy law provides that all assets pass to the surviving spouse. Finally, funding a step-up trust would not require the fractionalization of assets. Each of these benefits puts taxpayers on more equal footing from a horizontal equity standpoint regardless of whether they hire attorneys.

b. Vertical Equity

As mentioned above, vertical equity requires taxpayers who are not similarly situated to bear tax burdens relative to their abilities to pay. With the proposed change to the law, the fact that some people may have more money to hire attorneys does not mean that their heirs necessarily will bear a smaller proportion of the tax on the taxable gain on inherited assets. As explained above, the tax results, with or without an attorney, will be comparable. Thus, vertical equity is achieved under the proposal.

2. Administrative Efficiency

a. Indirect Costs

The proposal in this Article will certainly help to reduce indirect costs (costs to the taxpayer). While wealthy individuals still will need to be careful to keep records of their income tax basis in their assets both (1) for the convenience of their heirs, and (2) to maximize the benefits of the $5.6 million total step-up for married couples, basis issues will be greatly simplified under the proposal.

As a result of Congress's adoption of the proposal, wealthy married couples would not need to spend as much time attempting to title their assets appropriately in order to obtain the maximum basis step-up. Thus, the indirect costs of estate planning should be reduced. Assuming that a couple has sufficient assets for this to be an issue, they merely would need to ensure that the first-spouse-to-die owns assets with at least $3 million in

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96 It would still be important, however, to make sure that the first spouse to die owns enough appreciated assets to take full advantage of the $3 million spousal step-up.

97 As explained below, some tax issues related to timing of realization of gain may merit more complex planning. See infra Part V.C.4.

98 This change only makes a difference from a purely tax perspective. As mentioned above, estate planning advice from attorneys may be necessary for many nontax reasons.

99 See Donaldson, supra note 67, at 545; Schmalbeck, supra note 68, at 546.

100 This statement assumes marital harmony and a desire to leave all assets, either outright or in trust, to the surviving spouse.
unrealized appreciation at death. As in the Child A-Child B example above, joint ownership of property can suffice for this purpose. Therefore, these wealthy individuals may be less motivated for solely tax reasons to title their assets other than as joint tenants with rights of survivorship.

Indirect costs of estate administration should also be reduced. Most significantly, assuming that a couple wants to leave everything outright to each other, executors would not need to waste the time and money to fund a step-up trust. They would not need to report the nonspousal step-up assets on a tax return at the first-spouse-to-die's death, and the surviving spouse would continue living as if she and her husband still owned the assets. The family would not need to waste money administering a trust that exists only for tax reasons. The surviving spouse could do with her money as she wished without worrying about fiduciary obligations. If she wished to have help administering her assets, she could hire and fire people to do this at will.

b. Direct Costs

The proposal will also reduce direct costs to the government. Whenever a married person leaves all his assets to a spouse, the government would not need to review provisions of a tax return that attempt to maximize the $1.3 million nonspousal step-up. With less need to set up trusts, fewer taxpayers will need monitoring from the government's perspective. This certainly reduces direct costs to the government.

3. Neutrality

This proposal attempts to help EGTRRA be more tax neutral. As mentioned above, tax neutrality suggests that the Code should not cause people to alter behavior solely for tax reasons unless there is a specific policy reason for doing so. Because Congress does not appear to have a

101 See supra Part IV.B.1.
102 For purposes of this example, assume that the wife survived the husband.
103 In the author's experience, this example is commonly the kind of control and freedom a happily married couple would like the surviving spouse to have.
104 However, returns presumably will be necessary to take advantage of the first-spouse-to-die's $3 million spousal step-up. Also, the surviving spouse may want to file a return reporting the $1.3 million step-up for evidentiary purposes at that spouse's later death.
105 See Donaldson, supra note 67, at 550-51.
public policy reason for inducing people to create trusts, its tax policy
should not do so, if possible.

This proposal represents a simple way for Congress to minimize the
unnecessary, purely tax-motivated inducement to create trusts. This
proposal would not prevent people from creating trusts for nontax reasons.
The proposed change, however, would minimize, though not eliminate, the
tax-motivated creation of step-up trusts.

4. Additional Issues

a. Timing

The proposal will not completely eliminate a tax-motivated desire to
create step-up trusts because of the timing of the realization of gains.
Unfortunately, there is no simple way to eliminate this problem.

As the reader no doubt will have noticed, all examples used in this
Article assume near-simultaneous deaths of spouses. This assumption
helps to simplify what can be a very complex issue. Specifically, some
couples may still want to use step-up trusts to allow the surviving spouse,
or actually the trustee of the step-up trust, to sell assets with up to $1.3
million in unrealized gains during the surviving spouse’s lifetime, rather
than after the surviving spouse’s death. The author has been unable to
devise a simple, tax-neutral way to address this issue.

This Article’s proposal will not let the surviving spouse benefit from
the tax-free realization of $1.3 million of gain from the first-spouse-to-die’s
estate until the second-spouse-to-die’s death. If this benefit is desired,
estate planning attorneys certainly will be able to devise a step-up trust that
will immediately allow for the untaxed realization of $1.3 million in gain.

Very wealthy older couples are unlikely to create step-up trusts solely
for this purpose, especially given the administrative burdens and expenses
associated with step-up trusts. In a marriage between people with great age
differences, a surviving spouse may have a desire to sell certain appreciated
assets during the surviving spouse’s lifetime. Such desire undoubtedly will
result in the creation of some step-up trusts for this purpose.

b. Revenue

The adoption of this proposal certainly will affect tax revenue;
however, because estate and gift tax revenue represents such a small

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106 However, the surviving spouse will be able to benefit from the $3 million spousal
step-up during life.
portion of federal tax receipts, this effect should be relatively small. This negative effect results solely from the fact that under EGTRRA, as it now exists, some people are likely to fail to plan to maximize the benefits of the first-spouse-to-die's $1.3 million nonspousal step-up (i.e., some people will not, by choice or by failure to work with an attorney, create step-up trusts). However, attempting to maximize government revenue by hoping that people will not create complex estate plans to minimize taxes seems inappropriate.

VI. CONCLUSION

The proposal for simplification raised in this Article is not a perfect solution. However, it does address an issue likely to surface as a result of EGTRRA with a simple, taxpayer-friendly change to the Code. When the proposed change is analyzed based on tax policy standards of equity, administrative efficiency, and neutrality, the proposal is far superior to the system we currently have under EGTRRA.