THREE WHACKS AT WEALTH TRANSFER TAX REFORM: RETAINED-INTEREST TRANSFERS, GENERATION-SKIPPING TRUSTS, AND FLP VALUATION DISCOUNTS

JOSEPH M. DODGE*

Abstract: This Article offers three sets of proposals to reform the existing federal wealth transfer tax system, the common theme being the link between the timing of the taxable transfer and valuation. Under the first set of proposals, transfers with retained interests would be taxed at the first to occur of the transferor's death or the date the interest expired. In addition, the term "retained interest" would be broadly construed to encompass the power to revoke and the possibility of receiving income or corpus under another person's power. The second set of proposals relates to the generation-skipping tax. To achieve accurate valuation, the tax would be imposed only on taxable distributions, and the exemptions would either be the unused gift/estate exemptions of deemed transferors or separate per-transferee exemptions. The third set of proposals relates to valuation discounts of interests in family-held entities, mostly family limited partnerships. The lack-of-marketability discount for family *investment*-holding entities should be ignored because the tax-motivated destructions of non-unique value are against public policy, and the removal of the value-depressing restrictions is likely to occur in the future. Minority-interest discounts should not be recognized where minority status exists by reason of marital property rights or arises by gift or bequest. As a transition rule (or as an alternate approach), the disappearance of value-depressing restrictions and the recombining of minority interests into a majority interest should, where valuation discounts were previously obtained, be subject to a recapture excise tax.

INTRODUCTION

Although this author personally favors replacing the federal wealth transfer (gift/estate/generation-skipping) taxes with an accessions tax,[1] Congress

* Professor Emeritus, Florida State University College of Law. I thank the ACTEC Foundation, *Boston College Law Review*, and participants at this Symposium.

[1] *See* Joseph M. Dodge, *Replacing the Estate Tax with a Reimagined Accessions Tax*, 60 HASTINGS L.J. 997 (2009). An accessions tax is a tax at progressive rates on an individual's cumulative gratuitous receipts, whereas the existing gift/estate tax system is a tax on an individual's cumulative lifetime and death-time gratuitous transfers.

has been reluctant to abandon existing tax systems.[2] Accordingly, a more realistic tack is to address reform of current law. The tax aim of a wealth transfer tax is to raise some revenue with reasonable efficiency and minimal economic distortion. The non-tax aim is to curb undue accumulations of unearned, gratuitously received wealth by individuals. Since about 1980, the wealth transfer taxes have not done a very good job in terms of their aims. The post-1980 period has seen an increase in wealth inequalities among classes, especially at the very top,[3] that has coincided with a drastic weakening of the wealth transfer taxes—both by legislation[4] and the failure to address loopholes that are exploited by transactions that make little or no sense apart from tax avoidance.[5] That the wealth transfer tax is barely alive politically,[6] despite being limited to about 0.1% of decedents,[7] is itself a symptom of the undue concentration of wealth and political influence.

Despite the bleak short-term prospects for reform, the political climate could change, and that possibility makes it worthwhile to advance some proposals. This Article concentrates on three problem areas that revolve around the timing of the taxable event. The overriding thesis is that timing rules should be the servant of accurate (i.e., ex post) valuations of the taxable transfers. Part I proposes a hard-to-complete approach for gifts under which income and corpus will (or can) return to the donor.[8] Part II proposes that the current

---

[2] Congress has declined to replace or supplement the existing income tax with a cash-flow consumption tax or a value-added tax despite strong advocacy and political support, especially for the former.

[3] *See, e.g.*, THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Goldhammer trans., 2014); Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 998–1012 (2004) (discussing the growing income gap and concentration of wealth in the United States); Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data* 37 (Nat'l Bureau of Econ. Research, Working Paper No. 20,625, 2014), http://gabriel-zucman.eu/files/SaezZucman2014.pdf [https://perma.cc/UW4V-ETDM] (noting that wealth inequality is rising and is reaching levels last seen in 1929).

[4] The wealth transfer tax provisions of the Economic Recovery Tax Act of 1981 retroactively repealed the carryover basis rule of the income tax, replaced the generation-skipping tax with an ineffective alternative, reduced the top tax rates, and accelerated a trend in which the exemption levels increased much faster than the rate of inflation. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

[5] Congress has done nothing to curb such notorious tax-motivated transactions as grantor-retained annuity trusts ("GRATs"), private annuities for the terminally ill, *Crummey* powers, and family investment-holding entities.

[6] Congress repealed the estate and generation-skipping taxes for otherwise taxable transfers occurring in 2010. For an account of political hostility (or indifference) to the wealth transfer taxes, see generally MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH (2005).

[7] In 2015, decedents are estimated to have 3700 taxable estates, which is about 0.12% of the total decedent population. *See* Laura Saunders, *Estate Tax Exemption for 2015 Is Announced*, WALL STREET J.: TOTAL RETURN (Oct. 30, 2014, 12:51 PM), http://blogs.wsj.com/totalreturn/2014/10/30/estate-tax-exemption-for-2015-announced-by-irs [https://perma.cc/E46A-TEMR].

[8] *See infra* notes 11–74 and accompanying text.

generation-skipping tax be replaced by one imposed only upon taxable distributions; three alternative solutions are proposed for determining rates and exemptions.[9] Part III deals with the imposition, and later lapse or removal, of tax-motivated restrictions on property obtained by using legal entities (such as family limited partnerships, or "FLPs") to hold investment property.[10]

I. TRANSFERS WITH RETAINED INTERESTS AND POWERS[11]

The essential characteristic of an inter vivos wealth transfer with a retained interest or power in the transferred property (a "string" or "hybrid" transfer)[12] is that the transferor has not parted with all incidents of ownership over the property.[13] The issue is whether the transfer should be taxed in whole or in part under the gift tax when initially made, or at a later time when the retained interest or power terminates, which can occur no later than the transferor's death.[14] The correct solution is to tax retained-interest transfers (broadly construed to include powers to revoke and possibilities of receiving back income or corpus) when the interest expires, but otherwise to tax transfers when made.

A. Problems with Existing Law

The 1916 estate tax and later (1924, 1932) gift tax[15] were never fully in sync with respect to string transfers. The estate tax aimed to include "testamentary" hybrid transfers in the gross estate,[16] and the gift tax reached gifts of property *or interests therein* (valued using actuarial tables)[17] that were "complete" (not subject to a retained power to revoke, alter, or amend).[18] In the

---

[9] *See infra* notes 75–119 and accompanying text.

[10] *See infra* notes 120–204 and accompanying text.

[11] This Part is an adaptation and modification of Joseph M. Dodge, *Retained Interest Transfers Under the Estate and Gift Tax*, 133 TAX NOTES 235 (2011).

[12] An interest or power in property is "retained" if the transferor still has the interest or power following the transfer.

[13] *See* Dodge, *supra* note 11, at 235.

[14] *See id.* Because a power is personal and does not survive the power-holder's death, it cannot be transferred by gift or bequest. With respect to interests in property, the timing issue arises only for those that must lapse or terminate at or prior to the transferor's death (such as income interests).

[15] Revenue Act of 1916, Pub. L. No. 64-271, §§ 200–12, 39 Stat. 756, 777–80 (codified as amended in scattered sections of 26 U.S.C.); *see also* Revenue Act of 1932, Pub. L. No. 72-154, §§ 501–32, 47 Stat. 169, 245–59 (codified as amended in scattered sections of 26 U.S.C.); Revenue Act of 1924, ch. 234, §§ 319–24, 43 Stat. 253, 313–16 (repealed 1926).

[16] The 1916 statute included in the gross estate inter vivos transfers by a decedent "intended to take effect in possession or enjoyment at or after [the transferor's] death," as well as certain other lifetime-generated transfers. Revenue Act of 1916 § 202(b).

[17] *See* I.R.C. § 7520 (2012) (actuarial tables generally required in valuation of interests); Treas. Reg. § 25.2511-1(e), (h)(7) (1997) (value of retained interests subtracted from value of transferred property); Treas. Reg. § 25.2512-5(a) (2011) (actuarial valuation).

[18] *See* Treas. Reg. § 25.2511-2 (1999).

meantime, the estate tax string-transfer provision evolved into current Internal Revenue Code ("I.R.C.") §§ 2036–2038.[19] Under these provisions, an inter vivos transfer (or a portion thereof)[20] is included in the gross estate if the transferor retains: (1) possession or enjoyment of the property or an income right therein,[21] (2) a reversion which, just prior to the transferor's death, is worth more than five percent of the value of the property,[22] or (3) a power to alter the beneficial enjoyment of income or to revoke, alter, or amend the transfer.[23] In 1990, Congress added § 2702, which treats certain, but not all, retained interests as having a zero value for gift tax purposes.[24] Thus, certain non-gifts are treated as gifts![25]

The independent doctrines under the gift and estate taxes sometimes result in the double taxation of the same transfer, which in turn necessitates rules aimed to mitigate the same.[26] In general, the relevant statutory provisions have generated a vast quantity of confusing and arcane doctrine[27] not clearly derived from the statutory language[28] and insensitive to tax avoidance.[29]

---

[19] I.R.C. §§ 2036–2038 (2012). Section 2036(b) was added in 1978, but is peripheral to the themes of the proposal made herein. *Id.* § 2036(b).

[20] *See* Treas. Reg. § 20.2036-1(c)(1)(i) (2011). Under § 2037, the amount included is the estate tax value of those interests in the property (if any) that are contingent on surviving the decedent (excluding the value, if any, of the retained reversion). Dodge, *supra* note 11, at 236 n.10; *see* Treas. Reg. § 20.2037-1(e) ex. 3 (1958). Under § 2038, the amount included is only the interest subject to the power to alter, amend, or terminate. Dodge, *supra* note 11, at 236 n.10; *see* Treas. Reg. § 20.2038-1(a) (1962) ("However, only the value of an interest in property subject to a power to which section 2038 applies is included in the decedent's gross estate under section 2038.").

[21] *See* I.R.C. § 2036(a)(1).

[22] *See id.* § 2037(a)(2). In addition, it must also be the case that possession or enjoyment of the property can only be obtained by surviving the decedent. *See id.* § 2037(a)(1); Treas. Reg. § 20.2037-1(b), (e) exs. 1 & 3.

[23] *See* Dodge, *supra* note 11, at 236; *see also* I.R.C. §§ 2036(a)(2), 2038.

[24] *See* I.R.C. §§ 2036(a)(2), 2038.

[25] *See id.* § 2702 (2012). Normally, the value of retained interests is subtracted from the value of the property that is the subject of the gift. *See id.* § 7520; Treas. Reg. § 25.2511-1(e), (h)(7); Treas. Reg. § 25.2512-5(a). By treating the retained interest as having a zero value, the entire property is treated as a gift.

[26] *See* I.R.C. § 2001(b) (2012) (eliminating transfers included in the gross estate from the category of "adjusted taxable gifts," which, along with the taxable estate, constitutes the final gift/estate tax cumulative tax base). If property transferred is included in the gross estate under I.R.C. § 2036(a), the § 2702 deemed gift of the retained-income interest remains in the adjusted taxable gifts total. *See id.* §§ 2036(a), 2702.

[27] For a general discussion of string-transfer doctrine, see JOSEPH M. DODGE ET AL., FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 114–17, 199–201, 369–454, 469–72, 488–500 (2011).

[28] For example, nothing in the text of §§ 2036–2038 suggests that a retained power subject to a "standard" (such as "support" or "comfort") is not covered by these sections. *See* I.R.C. §§ 2036–2038. An additional example is the meaning of the "survivorship" requirement of § 2037(a)(1). *See id.* § 2037(a)(1).

[29] *See* Dodge, *supra* note 11, at 236.

B. Congress Should Focus on Fully Taxing Gratuitous Transfers

Congress should revamp string-transfer doctrine both for the sake of simplification and to more efficiently focus on real tax-avoidance scenarios, as opposed to continuing to pursue the property-law-oriented "testamentary transfer" concept.

1. Retained Current-Enjoyment Transfers

The greatest opportunities for tax avoidance lie with retained current-enjoyment transfers.

a. The Stakes

A remainder-interest gift subject to a retained current-enjoyment interest for life or a period of years increases in value with the passage of time, even if the underlying property does not. The discrepancy between the value of the gift when made and when complete is compounded if the underlying property appreciates or is held in an accumulation trust. To illustrate, suppose *Jane* (age 32) creates a trust with securities worth $1 million, income to herself for life and remainder to *Bill*.[30] The value of the gifted remainder interest is about $200,000 (using 4%-discount-rate actuarial tables).[31] *Jane* receives trust income until her death, at which time the property is still worth $1 million. If the only taxing date is the date of the gift, $200,000 would be subject to gift tax. If the taxing date is the date of *Jane*'s death, $1 million would be subject to (estate) tax. Thus, if the property is not included in *Jane*'s gross estate, *Jane* will have succeeded in removing $800,000 from her gift/estate tax base, while continuing to enjoy the property for life. If the property appreciates to $2.5 million at *Jane*'s death, she will have removed $2.3 million from her tax base.

Taxing the *Jane-Bill* transaction only under the gift tax (and not under the estate tax) would be to adopt an unnecessary ex ante approach, in that the transfer can be taxed when the shift in possession or enjoyment becomes final (i.e., at *Jane*'s death). Additionally, the ex ante approach, which relies on actuarial tables, is bound to be inaccurate, because: (1) actuarial tables are only predictions of future events, and (2) the tables are based on mortality statistics for the entire population without regard to the tax-planning context. Thus, if the tables assume that a person of *Jane*'s age (32) will live to age 85, the discount period is taken to be 53 years. But if *Jane* actually dies at age 62, the actuarial estimate will turn out to have been wrong in a way that favors *Jane*, because an accurate longevity calculation would have produced a higher taxa-

---

[30] *See id.*

[31] The higher the discount rate, the lower the value of the remainder interest; thus, if the discount rate were 8%, the same gift would be worth only about $61,000! *See id.*

ble amount. Estate planners understand numbers, and would recommend a remainder-interest gift only for one expected to underperform her statistical life expectancy.[32]

Additionally, the tables systematically undervalue remainders[33] by ignoring appreciation. The true actuarial value of a remainder interest in a trust is the present value of the amount expected to be in the trust at the date the remainder interest is expected to come into possession, but the tables apply the discount rate against the amount presently transferred. This assumes (contrary to the mandates of trust law, portfolio theory, and interest-rate theory) that none of the economic return will inure to the corpus (the remainder interest),[34] whereas *Jane* (in a tax-planning mode) would favor a maximum allocation of economic return to corpus.[35]

b. The Economics of Retained Current-Enjoyment Transfers

In the *Jane*-*Bill* example, transfers of value occur from *Jane* to *Bill* in three stages.[36] First, a gift of the remainder interest occurs immediately. Next, *gratuitous transfers occur over time from the retained current-enjoyment interest to the remainder interest.*[37] Third, upon the termination of the retained current-enjoyment interest at *Jane*'s death, *Bill* accedes to the full value of the property.[38]

---

[32] Courts assert that use of actuarial tables is "neutral" because transferors are equally likely to outperform, as well as to underperform, their life expectancies. *See* Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929); Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 317 (3d Cir. 1996). This attitude ignores the reality of estate planning.

[33] *See* Dodge, *supra* note 11, at 237. Although the operation of actuarial tables undervalues remainder interests in present-value terms, it should be noted that actuarial valuation results in the reckoning of 100% of the value of the underlying property. In contrast, applying a willing-buyer, willing-seller approach to the valuation of trust interests would entail a reckoning of significantly less than 100% of the value of the underlying property, because the market value of trust interests is significantly discounted on account of the thinness of the market, actuarial and investment risks, and non-liquidity, or may be zero due to restrictions on alienation.

[34] Trust law mandates impartiality between current beneficiaries and remainders, meaning an equitable apportionment of benefits and burdens. Accordingly, trustees should look to the total portfolio return. Interest (discount) rates would factor in anticipated inflation, but the tables assume incorrectly that none of the inflation return would accrue to principal (as might occur with a bond-only portfolio).

[35] A debatable bias in the actuarial tables is that the stipulated discount rate may be too high, in which case remainder interests would be further undervalued. I.R.C. § 7520 requires that the discount rate used in actuarial tables be 120% of the applicable federal rate, which is the (low) rate for safe Treasury bills. *See* I.R.C. § 7520.

[36] *See* Dodge, *supra* note 11, at 239.

[37] *See id.*

[38] *See id.*

The economic-transfer concept has precedent in tax provisions providing for accrual of original-issue discount[39] and imputation of gift and interest transfers in the context of certain below-market loans.[40]

c. The Hard-to-Complete Approach Fully Captures the Amount Transferred

In a retained-current-interest gift, all transfers of economic value occur "away from" the donor, and they occur by reason of the donor's gift of a remainder interest while retaining a current-enjoyment interest. Additionally, the donor is in full control of how the arrangement is structured. The estate and gift tax needs to capture the gratuitous transfer to its full extent.[41] This aim can only—and easily—be accomplished by a so-called "hard-to-complete" rule, which eschews present-value calculations based on guesstimates of future events.[42] That is, *the transfer would be complete (for estate or gift tax purposes) at the earlier to occur of the expiration or transfer of the retained current-enjoyment interest or the transferor's death*.[43] For the sake of administrative convenience, the initial transfer would not be subject to gift tax, nor would annual passage-of-time transfers.

If the hard-to-complete approach were adopted, then § 2035(a), which treats gifts of retained interests within three years of death as being ineffective to defeat § 2036, would serve no purpose and would be repealed.[44]

d. Section 2702 Is the Wrong Response

Congress took the wrong path by enacting § 2702 in 1990, as a response to the tax-avoidance device known as the "grantor retained-income trust" ("GRIT").[45] The GRIT follows the format of the gift of the *Jane-Bill* trust, except that *Jane* retains her income interest for a period expected to lapse before her death, in which eventuality the transferred property avoids estate inclusion.[46] Section 2702 provides that the retained interest is deemed to be worth zero for gift tax purposes, resulting in a deemed gift of the retained interest as well as of non-retained interests,[47] but does not alter the estate tax result.

---

[39] *See id.*; *see also* I.R.C. § 1272 (2012).

[40] I.R.C. § 7872 (2012).

[41] Dodge, *supra* note 11, at 239–40.

[42] *Id.* at 240.

[43] *See id.* at 241.

[44] I.R.C. § 2035(a) (2012); *see id.* § 2036.

[45] *See id.* § 2702.

[46] The transfer of the retained interest within three years of the decedent's death would cause estate inclusion under § 2035(a), but a lapse is not a "transfer." *See id.* § 2035(a). If the retained interest lapses before the grantor's death, then the interest was not retained for the grantor's life, for a period not ascertainable without reference to the grantor's death, or for a period that did not in fact end before the grantor's death, as required by § 2036(a). *See id.* § 2036(a).

[47] *Id.* § 2702(a)(2)(A); *see* Dodge, *supra* note 11, at 241.

Section 2702 contains exceptions for (1) certain retained annuity and unitrust interests, (2) a personal residence trust,[48] and (3) cases where the donees are not family members, meaning an ancestor, descendant, sibling, or spouse of the foregoing or of the grantor.[49] Thus, GRITs are still allowed for non-family members, a GRIT-equivalent (the personal residence trust) is allowed even for family members, and the inside build-up is untaxed. The most popular form of transfer excepted from § 2702 is the short-term grantor-retained annuity trust ("GRAT").[50] GRATs not only avoid § 2702 but also minimize exposure to § 2036(a)(1).[51]

Ideally, property expected to generate a high rate of return will fund the short-term GRAT. For example, suppose *Gramps* creates a GRAT with $1 million generating a ten percent rate of return, retaining a two-year annuity of $520,000 each year for two years, remainder to *Junior*. After year 1, the trust will have $580,000 ((1.1 x $1 million) - $520,000). At the end of year 2, the trust will have $118,000 ((1.1 x $580,000) - $520,000). *Junior* will end up with the $118,000 after two years, but *Gramps* will be charged with a gift of only $19,000, using a four percent discount rate. *Gramps* can recycle the annuity distributions into new GRATs.[52] GRITs, GRATs, and grantor-retained unitrusts ("GRUTs") would not exist in the absence of the gift/estate tax. A retained current-enjoyment transfer only makes economic sense as insuring against the risk of longevity while preserving a fund for the natural objects of one's bounty. A retained interest intended to expire before death serves no dispositive purpose.

The proposed hard-to-complete rule would foreclose these transactions. In the *Jane-Bill* example, *Jane*'s estate would be taxed on the value of the trust on Jane's death. In the *Gramps-Junior* example, *Gramps* would be subject to gift tax on $118,000 when his term interest expires.

e. Grantor-as-Beneficiary Trusts

Property law (and current tax law) does not consider a retained possibility of obtaining income in the trustee's discretion as a retained "interest."[53] Nevertheless, for transfer tax purposes it should be so considered, because the remainder interest (again) increases in value with the passage of time, and the transfer can be accurately valued only when the remainder comes into posses-

[48] *See* I.R.C. § 2702(a)(3)(A)(ii), (b).

[49] *See* I.R.C. §§ 2702(e), 2704(c)(2) (2012).

[50] *See* Dodge, *supra* note 11, at 237.

[51] *See* I.R.C. § 2036(a)(1); *see also* Dodge, *supra* note 11, at 237.

[52] *See* Dodge, *supra* note 11, at 237–38.

[53] *See* Comm'r v. Irving Tr. Co., 147 F.2d 946 (2d Cir. 1945) (involving the predecessor of I.R.C. § 2037). Also, the grantor is not here considered as having a retained interest either under the gift tax, *see* Treas. Reg. § 25.2511-1(e), or under I.R.C. § 2702.

sion. Moreover, income not distributed to the grantor increases the amounts gratuitously transferred from the grantor to present and future beneficiaries.

f. Sale of Remainder Interest

Another tax-motivated technique is one involving the sale of a remainder interest in property. Assume the same facts as the *Jane*-*Bill* example, except that, instead of a trust, *Jane* sells a remainder interest in *Blackacre* (worth $1 million) to *Bill* for an amount equal to the actuarial value of the interest (say, $200,000). Because this is a sale of an interest for full and adequate consideration, no gift occurs, in the absence of § 2702.[54] The courts have held that this type of transaction avoids § 2036(a) by reason of having been a sale for full and adequate consideration in money or money's worth.[55] The appeal of this transaction would be muted if § 2702 applied, in which case the value of the retained interest ($800,000) would be treated as a gift; but § 2702 is avoided if *Bill* is not a family member or some other exception applies.[56] Under the hard-to-complete rule, the initial transfer would be incomplete, and the value of the property at *Jane*'s death would be included in her gross estate with a partial consideration offset of $200,000.[57] At the time of sale, the ultimate outcome is speculative. At *Jane*'s death, it is evident that *Jane*'s net transfer is the then-value of *Blackacre* less $200,000. It cannot be assumed that the $200,000 actually increased *Jane*'s probate estate by an amount equal to the date-of-death value of *Blackacre*. Just because present-value analysis *can* be applied at the time of sale, it does not follow that it *must* dictate the "final" tax result—or even *should* dictate it. The growth of *Bill*'s remainder interest is inevitable; the fate of the $200,000 is subject to intervening cause.

g. Private Annuities

Another tax-motivated transaction under existing law involves the exchange of property with a related party in return for a non-secured promise to make fixed-amount payments until the transferor's death.[58] The payments are set so that (using the applicable actuarial annuity factor) the present value of the payment stream equals the fair market value of the property transferred. This results in a zero net gift[59] and (under current law) is not a retained-interest

[54] *See* I.R.C. § 2702.

[55] *E.g.*, *Estate of D'Ambrosio*, 101 F.3d at 312; *see* I.R.C. § 2036(a).

[56] *See* I.R.C. § 2702; Treas. Reg. § 25.2702-4(d) ex. 2 (1992).

[57] The rule that the consideration should be fixed at $200,000 for estate tax purposes is correct. United States v. Righter, 400 F.2d 344 (8th Cir. 1968). The notion that *Bill* has purchased a 20% interest in *Jane*'s property (resulting in an inclusion of 80% of the value thereof at *Jane*'s death) is counter-factual, and a tracing rule would be unworkable.

[58] Dodge, *supra* note 11, at 238.

[59] *See* Treas. Reg. § 25.2512-8 (1992).

transfer because a money claim is not treated as a retained interest “in” the transferred property.[60] This type of transaction—called either a private annuity or a self-cancelling installment note (“SCIN”)[61]—appears, on its face, to remove only future appreciation from the transferor’s gross estate. Yet, if the transferor dies prematurely, her right to payment will also terminate prematurely, and (with the benefit of hindsight) the consideration received will turn out to have been grossly undervalued.

As an example, if *Delilah* (age sixty) transfers *Blackacre* worth $1 million to *Elizabeth* in return for a promise to pay *Delilah* $92,354 a year for *Delilah*’s life, the value of the promise will equal $1 million (using the six percent tables). But if *Delilah* dies one year later, the value of the consideration that replenished *Delilah*’s estate will have turned out to have been worth only $87,126 (meaning that with hindsight, the gift amount should have been $912,874). Not surprisingly, this device appears to be used exclusively by persons who are expected to underperform their actuarial life expectancy.[62]

The hard-to-complete rule should cover this type of transaction. The retained payment right is derivative of the transfer of property. No transaction of this sort exists in commerce: no seller would take back an unsecured obligation, and no buyer would undertake the obligation to make substantial cash payments to a stranger subject to the actuarial risk of the seller’s longevity.

2. Transfers That Can Be Returned to the Transferor

Current law correctly applies a hard-to-complete rule for revocable transfers.[63] A transfer with a retained power to revoke is not a meaningful transfer of ownership. Treating such a transfer as a non-gift (by reason of being an incomplete transfer) helps transferors by preventing the same property from being taxed twice—first upon transfer, and again if the transfer is revoked and appears in the transferor’s probate estate.

Current law should be modified to treat a transfer as being incomplete even where the revocation power is held jointly with an adverse party.[64] Fur-

[60] *See* Fidelity-Phila. Tr. Co. v. Smith, 356 U.S. 274 (1958).

[61] A SCIN is a fixed-term obligation that terminates at the seller’s death. It avoids gift tax exposure only if the periodic payments are increased sufficiently to offset the actuarial risk of death during the term.

[62] Dodge, *supra* note 11, at 238; *see* Estate of Fabric v. Comm’r, 83 T.C. 932, 941–43 (1984). Section 7520 requires use of the actuarial tables in all cases except where the person is ill with an incurable disease such that that there is at least a 50% chance of death within one year of the transfer. Dodge, *supra* note 11, at 238 n.27; *see* Treas. Reg. § 25.7520-3(b)(3) (2011).

[63] The transfer is an incomplete gift, but distributions to third parties are gifts, and the lapse or release of the revocation power entails a gift if it occurs before the transferor’s death. *See* Treas. Reg. § 25.2511-2(f).

[64] *See id.* § 25.2511-2(e). This rule was applied in *Commissioner v. Prouty*, 115 F.2d 331, 335–36 (1st Cir. 1940), in spite of the court’s acknowledgment that “at the time of the creation of the trust

thermore, a transfer should be deemed incomplete in cases where the corpus can be distributed to the donor under a distribution power held by another person, even if that power is limited by such standards as "support" or "comfort."[65] In both scenarios, the interests and expectations of persons other than the transferor are on hold until the power expires (or is released) or distributions are actually received.

3. Retained-Reversion Transfers

Systematic tax avoidance does not appear to be a problem with retained-reversion transfers, because reversions increase in value with the passage of time. Nevertheless, retained-reversion transfers resemble revocable transfers where the reversion might come into possession prior to the grantor's death, raising the specter of double taxation.[66] In cases where the reversion might lapse or be cut off at, or prior to, the grantor's death, such lapse would entail a wealth transfer from the grantor to those whose interests are augmented by such lapse. Current law in this area (especially § 2037) is excessively complex,[67] and involves the use of actuarial tables for both gift and estate tax purposes.[68]

---

there might be extraneous considerations, whether of a pecuniary or sentimental nature, which would give the donor every confidence that such designated beneficiary would acquiesce in any future desire of the donor to withdraw the gift, in whole or in part." *See also* Camp v. Comm'r, 195 F.2d 999, 1004 (1st Cir. 1952).

[65] *See* Dodge, *supra* note 11, at 240.

[66] If the transferor reacquires the property during life, it (to the extent not consumed) will be subject again to gift/estate tax, with no relief from double taxation. Even if the reversion does not come into possession, double taxation might occur under current law. The reversion (possibly subject to gift tax under § 2702) may be included under § 2033 or the remainder might be included under § 2037, but only in the latter case is the twice-taxed remainder interest taken out of the "adjusted taxable gifts" amount. *See* I.R.C. § 2033 (2012); *id.* §§ 2037, 2702.

[67] *See id.* § 2037. Section 2037 requires that "possession or enjoyment of the property . . . be obtained only by surviving the decedent." *Id.* § 2037(a)(1). The meaning of this "survivorship" requirement can only be gleaned by consulting the regulations and case law. An example is an inter vivos trust transfer by *D*, income to *L* for life, reversion to *D* if *D* survives *L*, but if not remainder to *R*. Here, if *D* predeceases *L*, *R*'s remainder interest is contingent on *D*'s death (before *L*'s death). Section 2037 also requires the reversion to be worth more than 5% at the moment just prior to the grantor's death, *disregarding the fact that the grantor actually died when he did*. *Id.* § 2037. This needs both a calculation of the chances that *D* would outlive *L* (a factor not provided by the actuarial tables) and the reduction of *D*'s reversion to present value. *See infra* note 68 and accompanying text.

[68] Assume a trust transfer by *D*, income to *L* for life, reversion to *D*. Under current law, the entire transfer is subject to gift tax if § 2702 applies; otherwise, actuarial tables will be used to value the gift to *L*. *See* I.R.C. § 2702. And, if *D* predeceases *L*, actuarial tables must be used in valuing *D*'s reversion, included in *D*'s gross estate under § 2033. *See id.* § 2033. Assume, alternatively, that in the same hypothetical the reversion is to *D* if *D* outlives *L*, but if not, remainder to *R*. Again the entire transfer is a gift if § 2702 applies; otherwise, actuarial tables are used. *See id.* § 2702. Nevertheless, here the application requires the expertise of an actuary, because the likelihood that *D* will outlive *L* must be factored in. As noted *supra* note 67, if *D* predeceases *L*, § 2037 comes into play. First, actuarial tables must be used to determine if § 2037's 5% requirement is satisfied. *See supra* note 67 and accompany-

Generally, a retained-reversion transfer should be viewed as being incomplete; distributions to beneficiaries during the grantor's lifetime would be completed gifts from the grantor. If the grantor reacquires ownership, so be it. If not, the full value of the property should be included in the grantor's gross estate, as it consists of a future completed transfer to persons either designated under the governing instrument or ascertainable under a reversion to the grantor's "estate." This approach achieves simplicity and accuracy, avoiding both double taxation and transfers valued inaccurately under the actuarial tables. However, an easy-to-complete rule is appropriate for the rare case in which the retained reversion cannot come into possession before the grantor's death and cannot lapse at or before such death.[69]

4. Transfers with Retained Powers to Alter, Amend, or Terminate

Under current law, the estate tax retained-power rules are mostly toothless due to case law,[70] but they can be a trap for the unwary, because a power to alter may exist if the grantor is a co-trustee sharing powers not sufficiently limited by ascertainable standards. At the same time, the retention of such powers under the gift tax allows the grantor to control the timing of gifts and maximize the use of the gift tax annual exclusion.[71]

On the merits, these retained-power transfers should be deemed to be complete when made. Under a gift/estate tax, what matters is parting completely with the possibility of receiving all or a portion of the property back. In fact, the subjective value to the transferor of being able to affect beneficial enjoyment does not possess quantifiable economic value, and it follows that the retention of a dispositive power does not cause value to pass from the transferor to the collective objects of her bounty with the passage of time.[72] The transferor's death only affects how the beneficiaries, as a group, will divide up the property.

ing text. Second, if § 2037 applies, the includible amount is the estate tax value of the trust reduced by the actuarial value of *L*'s outstanding income interest, which may be overvalued if *L* underperforms her life expectancy. *See* I.R.C. § 2037.

[69] An example would be a trust expected to last beyond the grantor's death, followed by several contingent remainders, but a reversion (implied by law) if all such remainders fail. Because this type of reversion is inadvertent, the transfer is likely to be treated as a gift of the full value of the property.

[70] *See, e.g.*, United States v. Byrum, 408 U.S. 125 (1972); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); *see also* Dodge, *supra* note 11, at 241.

[71] Gifts subject to a retained power to alter or amend are incomplete, but distributions to beneficiaries other than the grantor are completed gifts from the donor in the year of distribution that are present-interest gifts under § 2503(b). *See* Treas. Reg. § 25.2511-2(b)–(c), (f); *see also* I.R.C. § 2503(b) (2012).

[72] Dodge, *supra* note 11, at 241.

5. Employee Survivor Benefits and Survivor Annuities

Section 2039 (modeled after § 2036(a)(1)) currently governs the inclusion of employee survivor benefits and commercial annuities in the gross estate.[73] It should be amended to eliminate the retained-interest requirement. The survivor benefit and the retirement (or current annuity) benefits are not mutually dependent interests in property, as is the case with a retained-income trust. Nevertheless, the survivor benefit is always a gratuitous transfer from the employee or annuity purchaser, whose labor or cash premiums generate the benefit. It is best to tax the transfer when its value can be accurately determined, that is, on the transferor's death.[74]

II. GENERATION-SKIPPING TRANSFERS

A generation-skipping transfer ("GST") tax imposes an excise tax on gratuitous transfers from a transferor to a person (referred to as a "skip person") who is two or more generations below that of the transferor.[75] The current GST tax, however, is counterproductive by actually encouraging the creation of dynastic trusts, relative to a series of outright bequests. One approach is to aim for tax neutrality between successive-interest trust transfers and a series of outright bequests. The technical difficulties raised by such an approach can be finessed by an alternative (limited accessions tax) approach of taxing skip persons directly on distributions over a certain exempt amount. A third approach is to discourage dynastic trusts by imposing a trust tax on amounts distributed to skip persons or held in trust as a downward generational shift occurs.

A. Nature and History of the GST Tax

The first federal GST tax, enacted in 1976,[76] was imposed on any taxable termination (the expiration of an interest held by intermediate-generation beneficiaries) or taxable distribution (a distribution to a skip person prior to a taxa-

---

[73] *See* I.R.C. § 2039(a) (2012) (providing "if . . . an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment . . . for his life"); *see also id.* § 2036(a)(1).

[74] This analysis suggests, perhaps, that a mandatory accumulation trust, or a trust that reserves in the grantor the power to accumulate income should be subject to a hard-to-complete rule, on the ground that beneficial enjoyment will be delayed, or might be delayed at the grantor's will, so that the accumulations are essentially additional gifts by the grantor. This is a judgment call. Also, line-drawing issues are raised as to whether any such hard-to-complete rule should extend to accumulation powers held by persons other than the grantor.

[75] *See* I.R.C. § 2613 (2012).

[76] Tax on Certain Generation-Skipping Transfers, Pub. L. No. 94-455, 90 Stat. 1879 (1976) (adding former §§ 2601–2622 to the I.R.C.); *see, e.g.*, Joseph M. Dodge, *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. PA. L. REV. 1265, 1268–71 (1977).

ble termination) from a trust or trust equivalent.[77] To illustrate, suppose *T* created a testamentary trust with income or corpus in the trustee's discretion payable to or among *T*'s issue until the death of *T*'s last surviving child, remainder to *T*'s then-surviving issue. A distribution to a child of *T* was not a GST, as such child is not a skip person, but a distribution to a grandchild prior to the termination of the trust was a taxable distribution. A taxable termination occurred upon the death of *T*'s last surviving child. A GST was treated as a taxable gift or estate transfer of a "deemed transferor,"[78] defined as the descendant of the initial transferor that is the parent of the transferee acceding to the generation-skipping transfer.[79]

In 1986, the 1976 GST tax was repealed retroactively and replaced by the current GST tax,[80] which reaches not only taxable terminations and distributions but also "direct skip" transfers (such as outright gift and estate transfers to skip persons).[81] GSTs are not attributed to deemed transferors, but instead are taxable separately at a rate calculated by multiplying the maximum gift/estate tax rate by the "inclusion ratio."[82] This ratio is equal to 100% minus the exclusion percentage. The exclusion percentage's numerator is the *transferor's* GST exemption that is allocated to the transfer (this is separate and apart from the gift/estate tax unified transfer tax credit but equal in amount to the exemption equivalent of such credit),[83] and its denominator is the value of the net transfer.[84] Thus, if (1) the trust described in the preceding paragraph was funded with a $5 million bequest (producing no gift/estate tax because of the unified transfer tax credit), (2) *T*'s GST tax exemption amount is $5 million, and (3) all of such amount is allocated to the transfer, then the exclusion percentage is 100%, so that all GSTs (even if totaling more than $5 million) would incur a tax rate of zero as a result of the inclusion ratio being zero (100% - 100% = 0%)!

B. Rationale for a GST Tax

The original rationale of a GST tax is presumably to create outcome parity (horizontal equity) for a scenario in which two transferors, *A* and *X*, respectively bequeath, say, $10 million in wealth. In this example, *A* bequeaths the $10 million outright to child *C*, who in due course bequeaths the same $10 mil-

[77] I.R.C. §§ 2611(a), 2613 (1976).
[78] I.R.C. § 2602 (1976).
[79] I.R.C. § 2612 (1976).
[80] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (adding current chapter 13, §§ 2601–2663, to the I.R.C.).
[81] I.R.C. §§ 2611–2612 (2012).
[82] I.R.C. § 2641 (2012).
[83] I.R.C. § 2631 (2012).
[84] I.R.C. § 2642(a) (2012).

lion intact to grandchild *G* (resulting in two impositions of estate tax). By contrast, *X* uses the $10 million to create a generation-skipping trust with income to child *Y* for life and remainder to grandchild *Z* (resulting in one imposition of estate and gift tax). In this scenario, a GST tax imposes a second tax on *X*'s trust on the death of *Y*. Whether this rationale—or any other—is convincing is not thoroughly addressed herein;[85] this Part simply assumes that an effective GST tax is desirable, if it can be made workable.

C. Problems with the Existing GST Tax

The existing GST tax suffers from several defects.[86] The first is the separate GST exemption—apart from the transferor's gift/estate tax exemption *and* apart from the exemptions of the trust beneficiaries. Suppose *T* has $5 million of taxable wealth, all bequeathed to a trust with income to child *C* for life and remainder to grandchild *G*. The trust is fully exempt from *T*'s estate tax and from all GST tax. Assume that the trust does not appreciate but has an annual yield of four percent that is distributed to *C* periodically. If *C* lives for twenty-five years, she will obtain $5 million of trust distributions. Let us assume this incremental wealth is saved by *C* and bequeathed intact to *T*'s grandchild *G*. This results in *G* receiving *C*'s $5 million of saved trust income free of estate and gift tax—plus another $5 million from the trust free of GST (and estate) tax. In contrast, if the same wealth had passed by successive outright transfer, the $10 million obtained by *G* from *C* would have only captured *C*'s $5 million estate tax exemption.

The second defect is that the transferor's separate exemption replicates itself at each generation, because the exemption operates as a reduction (perhaps to a zero rate) that applies to all successive GSTs for the life of the trust. Meanwhile, the gift/estate tax exemptions of trust beneficiaries remain intact.

The third defect is that in reducing the rate (perhaps to zero), the exemption expands as the trust increases in value. Thus, the GST-exempt trust created by *T* described above, initially worth $5 million, is exempt from tax for all

---

[85] *See generally* 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 (2003) (critiquing the equity rationales for the GST tax). Horizontal equity rationales can be tricky, because setting up the comparison can assume the desired conclusion. The equity rationale advanced in the late 1960s and early 1970s assumed that middle-class folks, who could not afford long-term trusts, were subject to successive gift/estate tax, but currently that is no longer the case. Also, the equity argument implies tax avoidance, but, in the context of a wealth transfer tax, no tax avoidance exists if no intermediate-generation transfer occurs. (The holder of a trust income interest, not having a corpus interest, does not transfer either the income or the corpus at death.) Another rationale might be that the absence of a GST tax distorts dispositive patterns. But do we know what those patterns would otherwise be for the very wealthy? The current GST tax certainly distorts dispositive patterns, and it is hard to imagine that any other GST would not.

[86] *See* Tax Reform Act of 1986, 100 Stat. at 2717–32.

time. This occurs even if the trust is worth $10 million, $50 million, or $250 million at successive taxable termination events.

These defects operate perversely to encourage the creation of generation-skipping trusts.[87] The estate-planning bar, which opposed enactment of the 1976 GST tax and supported its repeal, has shown no interest in repealing the existing GST tax.

D. Limiting Taxable Events to Taxable Distributions

The first design issue relates to what should be considered to be a GST. This author proposes that only *distributions* to skip persons should be taxable, whether derived from the income[88] or corpus of a generation-skipping trust (or non-trust equivalent).[89] Thus, in a trust with income payable to *T*'s children and grandchildren and remainder to great-grandchildren, the taxable events would be distributions to the grandchildren and great-grandchildren. By contrast, under current law the death of *T*'s last surviving child is the taxable event (a "taxable termination") with respect to the grandchildren, and subsequent distributions to the grandchildren are not taxed.[90]

Eliminating the category of taxable termination would accord with the notion that it is better to tax actual outcomes than possible future outcomes. Under the taxable-distribution approach, the tax will be borne by the enriched distributee, whereas the burden under the taxable-termination approaches is indirect and often indeterminate.[91] Postponing the taxable event is not systematically advantageous for taxpayers. On average, aggregate taxable distributions will equal (in present-value terms) the taxable amount under a taxable-termination approach.

In addition, although this is a tougher call, the category of direct-skip transfer should be eliminated. Unlike a successive-interest trust, no second (or third, etc.) deemed transfer from an intermediate-generation individual can be discerned. Also, the logic of the direct-skip tax would be to impose a third (or more) tax on direct-skips to great-grandchildren (or subsequent generations).

---

[87] *See* Lawrence W. Waggoner, *Congress Promotes Perpetual Trusts: Why?* 9–10 (U. of Mich. L. & Econ. Research Paper No. 13-015, U. of Mich. Pub. L. & Legal Theory Research Paper No. 349, May 2014), http://ssrn.com/abstract=2326524 [https://perma.cc/835Z-A5NT].

[88] In principle, the income tax paid by the beneficiary (if any) should reduce the amount treated as the taxable distribution. This result would mimic bequests of previously taxed income: the income tax paid or owed reduces the taxable estate. In the present context, the income will be currently taxed so that the deduction for the GST tax can be readily calculated.

[89] In identifying distributees, community property law should be disregarded, and distribution-splitting disallowed. When determining a skip person, the intermediate generation that has predeceased the initial trust transfer would be disregarded. *Cf.* I.R.C. § 2651(e) (2012).

[90] *See id.* §§ 2611(b)(2), 2612(b).

[91] Exercise of trustee discretion can effectively control the burden of charging GST taxes to the trust.

This logic is: (1) not followed by current law, (2) likely to arouse fierce political opposition, and (3) likely to distort dispositive patterns. From a welfarist perspective, if one's children are already well off, why should tax policy discourage outright transfers to grandchildren, etc.? The tax-avoidance potential of direct-skip transfers is less than in the case of long-term successive-interest trusts, especially considering the likelihood that the wealthy are naturally reluctant to bestow significant wealth on youngsters with no strings attached. Trust transfers in lieu of direct-skip transfers (i.e., separating "layered" trusts[92] for each generation) would not avoid GST tax, because distributions from a trust to any skip person would be taxable, even if the trust is incapable of providing for intermediate-generation beneficiaries.[93] Finally, it is long-term dynastic trusts, rather than outright transfers, that raise social policy issues apart from tax. A GST tax is an appropriate response to these concerns, which include perpetuities, agency costs, and economic inefficiencies.[94]

The taxable-distribution approach also offers practical advantages. First, elimination of the direct-skip transfer category would accompany the repeal of § 2515 of the gift tax.[95] This would relieve the transferor (or transferor's estate) from paying a GST tax in addition to an estate or gift tax. Second, tax planning would be simplified by eliminating the current advantage conferred on direct-skip transfers.[96] Third, double-taxing persons in the same generation would be impossible, as any distribution could only be taxed once. Fourth, phenomena such as "out-of-generational-order" distributions or intervening interests for non-skip persons would not create a problem. Fifth, and of considerable importance, the taxable-distribution system would foreclose opportunities to tax intergenerational transfers at earlier dates (as under direct-skip-transfer and taxable-termination options) in order to leverage exemptions.

[92] An example of a layered trust scenario is one where *T* creates three trusts: one for the exclusive benefit of the transferor's children, another for the exclusive benefit of the grandchildren, and a third for the exclusive benefit of the great-grandchildren.

[93] Because this is the case under current law, it is hard to see the point of § 2613(a)(2)(A), which treats the creation of such a trust as a direct-skip transfer. *See* I.R.C. § 2613(a)(2)(A) (2012).

[94] Lawrence Waggoner views the perpetuation of dynastic wealth as the main problem. *See* Waggoner, *supra* note 87, at 3–6. An effective GST tax would serve the same ends as the rule against perpetuities, which has been abandoned or weakened in many states. Sub-problems include agency costs and economic inefficiencies attendant upon trusts in general.

[95] *See* I.R.C. § 2515 (2012).

[96] Taxable terminations and taxable distributions are tax-inclusive, *see* I.R.C. § 2603(a)(1)–(2) (2012), whereas direct-skip transfers are tax-exclusive, *see id.* § 2603(a)(3), (b). Also, gift GSTs are more efficient than estate transfers. *See* DODGE ET AL., *supra* note 27, at 350 (laying out the math).

E. Plan A: Taxing Transferees with Reference to Deemed Transferors

Although at first this proposed transferee-oriented GST tax might appear to sit uneasily with the transferor-oriented gift/estate tax,[97] the two can be harmonized by taxing skipped persons on distributions received at the rates and exemptions supplied by "deemed transferors." This general approach was considered a weakness of the 1976 GST tax,[98] but perhaps it is workable under a taxable-distribution GST tax.

1. The Universal Tax Rate

Since 1976, the unified gift/estate transfer tax credit has had the effect of exempting a certain amount of cumulative taxable transfers from bearing any actual tax.[99] The credit (as opposed to an exemption) results in imposition of tax not at the progressive rate schedule's lowest marginal rates but at the higher marginal rate at the point where the schedule tax is exhausted by the credit. The current exemption equivalent ($5 million, indexed for inflation)[100] of the credit extends far into the highest rate bracket,[101] resulting in a flat (forty percent) rate.

The GST tax should adopt a flat-rate/exemption system. A flat rate eliminates the "bracket effect" of the expanding tax base that results from the taxable-distribution system. Additionally, a flat rate obviates any need to attribute GSTs to deemed transferors for purposes of ascertaining marginal rates. The only computational issue is that of exemptions.

2. Exemptions

Under Plan A, the exemption available to any taxable distribution would be the unused gift/estate tax exemption amount(s) of the deemed transferor(s).

a. Identity of Deemed Transferors

The deemed transferor would be the distributee's parent, who is related to the transferor. The deemed transferor not only links the transferor and the distributee, but also indirectly benefits by being relieved of bequest savings.[102]

---

[97] An issue that falls outside the scope of this Article is the role, if any, to be played by general powers of appointment under a transfer tax system with an effective GST tax.

[98] *See* STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1263 (Comm. Print 1987).

[99] *See* I.R.C. §§ 2010, 2505 (2012).

[100] *Id.* § 2010(c)(3).

[101] I.R.C. § 2001(c) (2012) (applying the highest marginal rate of 40% to taxable transfers in excess of $1 million).

[102] Obviously, if neither parent of the transferee is related (within, say, the fourth degree) to the transferor, then some other rule must be adopted (such as exempting the distributee's eldest parent).

The taxable-distribution tax base avoids the 1976 GST tax problems, where transferees (in taxable terminations of discretionary trusts) were not factually determinable,[103] and "phantom" beneficiaries obtained unjustified incremental exemptions.[104]

b. Accounting for the Exemption in the Case of Living Deemed Transferors

In the case of taxable distributions attributed to a *living* deemed transferor, the available exemption amount must be delivered to the distributee. At the same time, the amount used for GST tax purposes must reduce the deemed transferor's remaining unused exemption amount. The existence of three parties complicates matters. The trustee would send an appropriate information return stating the distribution amount to the deemed transferor, the Internal Revenue Service ("IRS"), and the distributee. Then, the deemed transferor would file a gift tax return using up any available exemption amount. The problem at this point is that the GST tax is a tax "on" the distributee, not the deemed transferor. Accordingly, the trustee should withhold tax from the taxable distribution at the flat tax rate, thereby imposing the maximum tax amount on the distributee. If the deemed transferor's gift tax return shows a tax that is less than the withheld amount, the return would constitute the distributee's claim for refund.[105]

Withholding is not practical for in-kind asset distributions. As before, the deemed transferor would file a gift tax return, but now the deemed transferor would also need to send an information return to the IRS and the distributee stating the exemption amount (if any) to be set off against the distribution amount. Additionally, the distributee would file a GST tax return and pay the tax due, if any. If the in-kind distribution is of qualified non-liquid assets, some kind of postponement-of-tax provision could come into play.[106]

c. Accounting for the Exemption in the Case of Deceased Deemed Transferors

Where the deemed transferor is deceased, the first-tier rule would be to treat taxable distributions as additions to the deemed transferor's taxable estate for purposes of computing unused exemption amounts. But this should only

[103] *See* Tax on Certain Generation-Skipping Transfers, § 2613(b)(3), 90 Stat. at 1885 (providing that unascertainable transferees are determined on a per stirpes basis).

[104] *See* Prop. Treas. Reg. §§ 26.2613-2(b)(3), 26.2613-3, 46 Fed. Reg. 120, 126 (Jan. 2, 1981) (disregarding nominal or illusory beneficiaries to determine the existence of a taxable termination and the identity of transferees in the case of a discretionary trust).

[105] Gift-splitting is not appropriate for GST tax purposes, because the deemed transferor never owned the amount transferred, and therefore community property laws could not apply.

[106] *See* I.R.C. § 6166 (2012) (referring to estate tax).

happen if the distributions occur in the same year as, or are triggered by, the deemed transferor's death.[107] The procedure would be the same as described above, except that the deemed transferor's executor would file the GST tax return.

In cases not covered by the first-tier rule, it may be that the executor has been discharged. Nevertheless, the relevant information should be obtainable. If the estate tax return for the deceased deemed transferor is not in the hands of an interested party (such as the trustee of a testamentary trust), there is a procedure that allows the IRS to disclose a prior estate tax return upon a showing by a person with a "material interest in the information" on the return.[108] By analogy to the problem of obtaining historic basis information under the income tax, a rebuttable presumption would be established that no unused exemption amount exists.

In cases where an unused exemption amount is shown to exist, an issue is posed of how to keep track of its utilization going forward. Here, the unused exemption amount could be treated as having been transferred to generation-skipping trusts (existing at the deemed transferor's death) for the deemed transferor's children.[109] Thus, the trustee(s) would replace the executor as the person responsible for filing the GST tax return.

F. Plan B: Per-Distributee Rates and Exemptions

A GST tax keyed to deemed transferors achieves integration with the gift and estate tax, but raises the administrative problems noted above. Under this "Plan B," the taxpayer would again be the recipient of taxable distributions. But instead of obtaining exemptions of deemed transferors, the distributee taxpayer would deploy his or her own lifetime exemption. The rate could be flat or graduated. No need would exist for gathering information from other (perhaps deceased) parties, a withholding tax would not be necessary, and there would be no need to treat in-kind distributions differently than cash distributions.[110]

This accessions-tax approach also makes more sense conceptually than transferor-based approaches, because there really are no intermediate-generation transferors. A distributee-oriented tax accords with various rationales of wealth-

---

[107] Under the 1976 GST tax, such occurrences would have been relatively less common, because taxable terminations would have triggered tax with respect to a generation. *See* I.R.C. § 2601 (1976).

[108] *See* I.R.C. § 6103(e)(1)(E) (2012). Forms 4506 and 4506-T only cover requests by the taxpayer (or personal representative thereof), and the Form 4506-T does not cover estate tax returns.

[109] If more than one such trust exists at the deemed transferor's death, any unused exemption amount of the deceased deemed transferor should be allocated among them in proportion to their then-respective values.

[110] As under the estate tax, certain non-liquid property could be given special treatment. *See supra* note 106.

transfer and GST taxes: (1) to curb undue accumulations of inherited (and therefore unearned) wealth,[111] (2) to encourage the dispersion of wealth, (3) to reduce the appeal of long-term dynastic trusts, and (4) to achieve after-tax outcome equity between direct and successive-interest transfers. The transferor orientation of the gift/estate tax historically and practically derives from tax collection convenience, but the GST tax has virtually no history—or, at any rate, no history of success—and lacks practical convenience relative to a transferee-oriented tax.

An issue to be reexamined is whether outright direct-skip transfers should be subject to the accessions-type GST tax, considering the possible difficulties of enforcement. The author tentatively proposes that direct-skip outright gifts only to grandchildren should be excluded from the GST tax within the limits of the gift tax annual exclusion, and outright bequests only to grandchildren should be excluded up to a limit equal to that of two gift exclusions. Non-excluded generation-skipping receipts (outright, from trusts, or otherwise) of a skip person would be exempt up to such person's lifetime exemption of, for example, twenty percent of the estate and gift tax exemption amount.[112] After the exemption is exhausted, the issue becomes whether a flat or progressive rate schedule should kick in; and another issue is that of the highest rate.

As a further inhibition on the creation of long-term trusts, amounts received from transferors who are great-grandparents (or in higher generations) would be multiplied by (say) 1.5 for purposes of using up the lifetime exemption, and to the extent taxable, the tax would be (say) 1.5 times the schedule tax.

G. Plan C: A Periodic Wealth Tax on Trusts

Another relatively simple GST-type tax would be a flat-rate tax on taxable terminations and taxable distributions, but not on direct-skip transfers. The rationale for this tax is not tied to any notion of horizontal equity. Instead it would be an event-triggered tax on wealth held in a particular form—namely, successive-interest trusts or trust equivalents.

An annual or periodic federal wealth tax is unconstitutional as a non-apportioned "direct" tax, but a tax on taxable terminations and distributions would be a valid "indirect" (excise) tax.[113] Policy reasons favoring a tax on successive-interest trust transfers include: (1) it taxes the acquisition of unearned wealth because it is borne by trust beneficiaries, (2) it inhibits the crea-

[111] Curbing excessive "accumulations" of wealth is a natural function of an income tax.

[112] Because a transferor's (100%) exemption can be used to shelter transfers to a number of transferees, it is appropriate to limit the transferee exemptions to a fraction of what might be available to a deemed transferor.

[113] This constitutional framework was upheld recently in *National Federation of Independent Business v. Sebelius*. *See* 132 S. Ct. 2566, 2598 (2012).

tion of long-term dynastic trusts, which violate policies favoring the rule against perpetuities, (3) trusts are economically inefficient, and (4) trusts allow able persons to avoid personal financial responsibility.

The rationale behind the tax would presumably affect its design. Thus, the child-to-grandchild shift might be wholly exempt (or generously exempted), but subsequent generational shifts might obtain only modest exemptions. To prevent tax avoidance, it would be necessary to aggregate the trusts of a given transferor (perhaps together with such transferor's spouse) to ensure the exemption is that "of" the transferor, and then allocate the exemption among two or more trusts.

H. Transitioning to a New Regime

1. The Statutory Transition Rule

Congress could apply one of these three proposed regimes (integration with the gift/estate tax, limited accessions tax, and event-triggered wealth tax) to only post-enactment trusts; but that approach is too timid, because the existing separate GST-tax exemption undermines the very purposes of the tax.[114] Accordingly, an appropriate transition is to subject both new and existing trusts to the new regime. Additionally, for pre-enactment trusts, the existing exemption would operate through the first post-enactment taxable termination. Because any expectation of perpetual exemption would be thwarted, Congress should allow for the termination or modification of a pre-enactment trust.

2. Constitutionality of the Transition Rule

The issue, then, is whether Congress can constitutionally eliminate the separate GST-tax exemption after the first post-enactment generation of use for unaltered trusts created before the effective date, considering that, without expiration, such pre-enactment trusts would obtain one more bite at the apple, a different set of exemptions (and perhaps rates) for subsequent GSTs, and the right to modify the trust going forward.

In the early days of the estate tax, the problem was framed as one of retroactivity, which was likely fatal.[115] But later cases, which have tolerated ret-

[114] Waggoner argues that the current exemption should expire after a certain period, unless the trust is reformed so that it would terminate within such period; this makes the modified GST tax into a federal rule against perpetuities. Waggoner, *supra* note 87, at 34–38. The author's view is that perpetuities are not the only problem.

[115] The 1927 Supreme Court decision *Nichols v. Coolidge* involved an irrevocable inter vivos trust created before the 1916 estate tax. *See* 274 U.S. 531, 532, 539 (1927). The grantor (who died in 1921) retained an income interest for life. *Id.* at 532. The Court appears to have held that the transfer was not testamentary in nature and made prior to the effective date of the estate tax. *See id.* at 542–43.

roactivity if the transition rule is reasonable,[116] would apply here.[117] More importantly, retroactivity is absent if the taxable transfers occur after the effective date, even if the trust was created before such date.[118] Thus, a GST tax is not retroactive because it taxes current deemed transfers or current receipts.[119]

III. REVERSIBLE RESTRICTIONS THAT DEPRESS VALUE[120]

The longstanding rule is that valuation for federal wealth-transfer tax purposes is determined by what a willing buyer would pay a willing seller at the relevant valuation date.[121] This Part considers the extent to which self-imposed and reversible restrictions, which momentarily depress the value of equity interests in non-trust entities at the gift or estate tax valuation date, should be recognized.[122] Specifically, the non-liquidity discount should be disregarded

[116] The 1986 Supreme Court case of *United States v. Hemme* involved a transitional rule (§ 2010(b)) that prevented a taxpayer from claiming both an exemption for lifetime gifts under the pre-1977 law and the unified transfer tax credit under the post-1976 unified estate and gift tax. 476 U.S. 558, 560–64 (1986) (citing I.R.C. § 2010(b) (1976)). This amounted to a retroactive repeal of the prior-law exemption during the transition period. Nevertheless, the Court upheld the denial of the exemption, noting that the taxpayer was likely to be no worse off under the new regime than the old one. *Id.* at 570–71.

[117] The scenario in *Hemme* resembles the proposed GST-tax transition rule. *See id.* Although future generations may lose the benefit of the current GST-tax exemption, said exemption would be replaced by some other exemption or rate system. Also, the trust would be modifiable to accommodate the new regime.

[118] In the 1929 Supreme Court case of *Chase National Bank v. United States*, the grantor created a revocable trust prior to enactment of a provision that included revocable trusts in the gross estate. 278 U.S. 327, 332–33 (1929). Inclusion was upheld on the grounds that the transfer occurred at the grantor's death, not when the trust was created. *See id.* at 339. Also, in 1949, in *Commissioner v. Church's Estate*, the Court declined to apply *Nichols* on the grounds that a retained-interest transfer, entailing a shifting of possession from the grantor to another at the grantor's death, resulted in a transfer at death. 335 U.S. 632, 646–48 & n.10 (1949) *see also Nichols*, 274 U.S. at 531. *Church's Estate* implicitly holds that Congress itself can decide (within reason) when a taxable transfer is deemed to occur. *See* 335 U.S. at 650.

[119] In 1928, in *Saltonstall v. Saltonstall*, the Court upheld a state inheritance tax on a pre-enactment trust over which the decedent retained a special power of appointment, on the ground that only the decedent's death assured possession by the remainders. 276 U.S. 260, 270–71 (1928). Thus, in the case of a "succession" tax (as opposed to a "transfer" tax), a retroactivity issue does not exist unless what the recipients obtain was irrevocably fixed prior to the enactment date. *See id.* A taxable-distribution GST tax is a succession tax, not a transfer tax.

[120] For an earlier discussion of this topic, see generally Joseph M. Dodge & Calvin H. Johnson, *Passing Estate Tax Values Through the Eye of the Needle*, 132 TAX NOTES 939 (2011).

[121] Dodge & Johnson, *supra* note 120, at 939. The property value for the federal wealth taxes is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (1965) (estate tax); *see* I.R.C. § 25.2512-1 (1992) (gift tax); I.R.C. § 26.2642-2(a)(1), (b)(1) (1996) (GST tax). The estate tax regulation first appeared as Article 13 of Regulation 63, Relating to Estate Tax Under the Revenue Act of 1921 (1922 ed.).

[122] On discounts generally, see George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 195–204 (1977); James Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995). In *Cartwright v. United*

for *investment* assets held in family holding entities, and minority interest discounts should not accrue where minority status exists by reason of marital property rights or fractionalization by gift. Alternatively (or as a transition rule), a recapture tax should be imposed when previously discounted interests become liquid or lose minority status.

A. Background

The principal technique scrutinized herein is when a wealthy individual drops investment property into a legal entity, usually a family limited partnership, or FLP. This move creates a lack-of-marketability discount where state law or the governing documents prevent family equity-holders from: (1) selling their shares for full value, (2) redeeming their shares for the pro rata share of the underlying investment value, or (3) causing a liquidation of the entire entity or a significant portion thereof.[123] At this point, the state law of limited partnerships—usually some version of the Uniform Limited Partnership Act ("ULPA")—comes into play.[124] Although a limited partner has a right to sell, the buyer obtains only the right to receive future distributions, if and when made.[125] Thus, those without control of the entity would be reluctant to buy such an interest. A right of redemption (a "put" right) does not exist for a limited partner or assignee.[126] Finally, the liquidation of the entity requires the consent of all general partners and a majority of limited partnership interests.[127] In sum, an FLP limited partner has no right to obtain his or her share of the underlying assets, and therefore the interest is entitled to a lack-of-marketability discount.

States, 411 U.S. 546 (1973), in a 5–4 decision, the Court endorsed the notion that restrictions on the disposition of property must be given effect for valuation purposes.

[123] Where an equity-interest holder can use redemption or liquidation to obtain the underlying investment value, the interest is valued by reference to the underlying investments. *See* Rev. Rul. 59-60, 1959-1 C.B. 237.

[124] *See* UNIF. LTD. P'SHIP ACT (UNIF. LAW COMM'N 2013). Although corporations and limited liability corporations ("LLC") might also be used to obtaining investment-holding-company discounts, this Article does not examine issues peculiar to such entities, primarily because FLPs dominate the discount-seeking landscape. This is due mainly to the interaction between the state law of limited liability partnerships and I.R.C. § 2704(b). *See supra* note 123 and accompanying text (providing background information on FLPs); *infra* notes 125–127 and accompanying text (discussing the ULPA); *infra* notes 142–156 and accompanying text (discussing § 2704(b), which provides an exception to restrictions on the liquidation of family-controlled entities).

[125] UNIF. LTD. P'SHIP ACT §§ 102(24), 702. A limited partner or assignee has no right to compel distributions.

[126] *Id.* § 601(a). A person can voluntarily withdraw as a limited partner, but under the ULPA default rule, this causes the person to become a mere "transferee" with a right to future distributions but no right of liquidation. *Id.* §§ 601(a)–(b)(1), 602(a)(3).

[127] *Id.* § 801(2). The state law default rule may be stricter. *See* TEX. BUS. ORGS. CODE ANN. § 11.058 (West 2012) (setting a unanimity requirement as the default rule for liquidations of limited partnerships). These rules can also be made more stringent, or lenient, by the partnership agreement.

A second discount arises from the reconstitution of ownership so that no equity-holder has a majority interest. In an FLP context, this lack-of-control discount mainly reflects the inability of a limited partner or assignee to obtain a steady flow of partnership distributions.[128] Current law allows a person holding a controlling interest to obtain minority-interest discounts for gift-tax purposes (but not estate-tax purposes) by making separate transfers of minority interests.[129] Accordingly, the creation of an FLP is typically followed by the creation of minority-interest gifts. The post-gift FLP interest that the donor retains may itself be a minority interest obtaining an estate tax discount.

The combined allowed lack-of-marketability and minority-interest valuation discounts have usually been on the order of thirty to sixty-five percent.[130] Yet, no willing buyers really exist for such interests,[131] so the real value is probably close to zero.[132] Oddly, the estate tax bar appears to be content with this range of discounts,[133] and the IRS has been acquiescent.

Current law is ineffective to thwart these discounts. Under general gift tax principles, relinquishing an incident of equity ownership (such as a redemption or liquidation right) would constitute a gift or bequest if such loss were to reappear as gain to the natural objects of the owner's bounty. But in the case of both discounts mentioned above, no shift of value occurs; instead, value appears to be destroyed, at least for the period that encompasses the transfer tax valuation date. The IRS's attempts to negate these discounts under a step-

---

[128] Otherwise, the FLP interest could be valued by discounting a predictable cash flow to the present. (Despite this, some non-liquidity discount would still be available.)

[129] Rev. Rul. 93-12, 1993-1 C.B. 202. A similar discount is obtained by converting fee simple property into family-held undivided interests. *See* Propstra v. United States, 680 F.2d 1248, 1253 (9th Cir. 1982).

[130] *See* Martha Britton Eller, *Which Estates Are Affected by the Federal Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001*, STAT. INCOME BULL., Summer 2005, at 8, 8, http://www.irs.gov/pub/irs-soi/01esyod.pdf [https://perma.cc/7VAJ-7JQ3] (subsequently updated to reflect data released in October 2007); *see also* Dodge & Johnson, *supra* note 120, at 941.

[131] *See* George F. del Duca, *Rethinking the Valuation of Family Limited Partnerships Holding Passive Assets*, FLA. B.J., Oct. 2001, at 58, 58 (stating that no market exists for FLP interests). A person having sufficient power to liquidate (by reason of existing holdings or a purchase itself) might be willing to buy an FLP interest, but the willing-buyer, willing-seller test disregards the peculiar circumstances of such a hypothetical "insider" buyer.

[132] The discounts that are allowed are obtained by reference to such "comparables" as private placements, restricted stock, and closed-end investment companies. *See, e.g.*, Holman v. Comm'r, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010); Estate of Kelley v. Comm'r, 90 T.C.M. (CCH) 369 (2005). These comparisons are inapt. Interests in closed-end investment companies are publicly traded, restricted stock is publicly-traded stock that cannot be sold by an insider for a specified period, and entities funded by private placements often go public. In contrast, an FLP interest offers no exit options, and no predictable rate of return.

[133] In *Holman v. Commissioner*, the Tax Court cited the possibility of a consensual liquidation as a factor reducing the lack-of-marketability discount. 130 T.C. at 170.

transaction or sham-entity theory,[134] or under § 2036,[135] rarely succeed, although amended regulations might improve the IRS's success rate under § 2036.[136]

A bolder approach would be to issue regulations[137] stating that restricted equity interests would lie outside of the willing-buyer, willing-seller test and be subject to a liquidation-value rule. The basis for this regulation would be that no real market exists for such interests. Precedent exists in the regulations requiring the actuarial valuation of successive trust interests.[138] The market for trust interests is also thin to nonexistent,[139] beneficiaries have no redemption or liquidation rights, and beneficiaries have minimal control over management. Under a willing-buyer, willing-seller test, trust interests would be very heavily discounted. The regulations ignore these restrictions, as well as the fact that a trust beneficiary's interest possesses the disabilities of a minority interest in an entity, by requiring that the aggregated interests in a given trust must have a value equal to that of the trust's underlying assets. These regulations ignore both restrictions on liquidity and non-controlling status.[140]

---

[134] Instead of applying a tax-avoidance-purpose test, the courts apply a test that only considers whether the entity really exists and whether the gift was an interest in the entity rather than the underlying assets. *See* Estate of Strangi v. Comm'r, 115 T.C. 478, 485 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002).

[135] Although the IRS may attempt to reach underlying assets using § 2036(a)(1) where the decedent continued to enjoy them, the attack may be thwarted on the ground that the FLP interests received in exchange for the underlying assets were full and adequate consideration in money or money's worth. *See* Estate of Bongard v. Comm'r, 124 T.C. 95, 118 (2005). *But see* Estate of Thompson, 382 F.3d 367, 379 (3d Cir. 2004).

[136] The Treasury could amend Treasury Regulation § 20.2043-1(a) in a way that overturns the result of *Estate of Bongard v. Commissioner*, but this would only help in cases where § 2036(a) applies. *See* Note, *Importing a Trade or Business Limitation into § 2036: Toward a Regulatory Solution to FLP-Driven Transfer Tax Avoidance*, 126 HARV. L. REV. 1326, 1335, 1339–41 (2013); *see also* I.R.C. § 2036(a) (2012); *Estate of Bongard*, 124 T.C. at 147 (applying § 2036); *Estate of Strangi*, 115 T.C. at 486 (noting § 2036 does not apply).

[137] The Treasury has indicated that anti-FLP regulations are in the works, but nothing specific has been revealed. *See* James R. Cody, *The End of Discounts for FLPs?*, INV. NEWS (Oct. 4, 2015, 12:01 AM), http://www.investmentnews.com/article/20151004/FREE/310049996/the-end-of-discounts-for-flps [https://perma.cc/V45G-HSPN].

[138] Treas. Reg. §§ 20.2031-7, 25.2512-5 (2011) (codified by I.R.C. § 7520). The predecessors of these regulations (instructions to revenue collectors under the 1898 inheritance tax) were upheld in *Simpson v. United States*, 252 U.S. 547 (1920).

[139] A potential buyer in an anonymous market would be subject to unknown actuarial, investment, and agency risks. Any such sales would be privately negotiated, and significant discounts and transaction costs would attach. *See* STERLING FOUND. MGMT. LLC, ADVISOR'S GUIDE TO THE SALE OF CRT INCOME INTERESTS 6–9, https://www.sterlingfoundations.com/pdf/pureftpd.53e7b526.75.0000 [https://perma.cc/SAU6-37RP] (discussing the process for selling trust interests). A large percentage of trust interests are inalienable spendthrift interests.

[140] An obstacle is the *Cartwright* decision, which invalidated a regulation disregarding a restriction on sale. 411 U.S. at 557. In *Cartwright*, however, a market did exist on account of a "put" right. *See id.* at 546. Also, a liquidation-value regulation amounts to an amendment of an existing regulation, and there is no statutory valuation rule to the contrary. Plus, the administrative law regarding deference to regulations has evolved considerably since 1973.

The principal Code provisions specifically dealing with the destruction of incidental rights, § 2703(a)(2) and § 2704(a)–(b), enacted in 1990, are largely ineffective.[141] The most salient of these is § 2704(b), which disregards restrictions on the liquidation[142] of family-controlled entities where an interest in the entity is transferred to a member of the transferor's family.[143] An initial problem is whether § 2704(b) confers congressional approval for the giving effect of liquidation restrictions that are valid under its statutory exceptions.[144] If so, regulations removing restricted family-entity interests from the willing-buyer, willing-seller test might be foreclosed. One counterargument would be that § 2704(b) is based on an assumption about the underlying law of valuation, which can be corrected by reasonable regulation.[145] Another is that a statute partially closing a perceived loophole should not be construed to ossify the loophole.

In any event, § 2704(b) does not apply to liquidation restrictions imposed by law.[146] Thus, the lack-of-marketability discount is safe for FLPs that do not attempt to impose more restrictive liquidation rights than does state law.[147] Moreover, state legislators can be persuaded to impose more stringent restrictions on liquidation than the ULPA,[148] which itself was promulgated in part to serve the estate-planning needs of wealthy investors.[149] Even if a more stringent restriction is disregarded, the transferred interest is still valued as if state law restrictions applied.[150]

---

[141] *See* I.R.C. §§ 2703(a)(2), 2704(a)–(b) (2012).

[142] Treasury Regulation § 25.2704-2(d) treats a right of redemption as a liquidation right, at least if other interests are owned by unrelated persons, but such a right would not exist in a tax-motivated FLP. *See* Treas. Reg. § 25.2704-2(d) ex. 5 (1992).

[143] *See* I.R.C. § 2704(b); Dodge & Johnson, *supra* note 120, at 941.

[144] *See* I.R.C. § 2704(b).

[145] *See id.*; *cf.* O'Gilvie v. United States, 519 U.S. 79, 81 (1956) (holding that a congressional enactment finding post-enactment punitive damages to be includible in income did not foreclose the Court from determining that pre-enactment punitive damages were includible). In other words, a statute modifying what Congress thinks is the underlying law does not itself establish the underlying law.

[146] *See* I.R.C. § 2704(b)(3)(B).

[147] *See* Treas. Reg. § 25.2704-2(d) ex. 1.

[148] *See supra* note 127 and accompanying text (discussing restrictions beyond those required by the ULPA that states, such as Texas, have placed upon liquidation). Because no residency requirements exist under business organization law, estate planners can form FLPs in any desired state.

[149] *See* UNIF. LTD. P'SHIP ACT, 2001 prefatory note (referring to the desire to curb the exit rights of limited partners in connection with estate planning).

[150] Treas. Reg. § 25.2704-2(c)–(d) & ex. 1. In example 1, the donee acquired a 76% interest; it was enough to liquidate the partnership under state law, but not the 80% requirement in the partnership agreement. *Id.* § 25.2704-2(d) ex. 1. Ignoring the 80% requirement was fatal because the donee's 76% interest would have been sufficient to cause liquidation under state law. *See id.* It follows that, if the donee had only a 60% interest, disregard of the 80% restriction would still leave the lack-of-marketability discount intact. *See id.* (This result perhaps expands the statutory exception.)

Another exception to § 2704(b) exists for restrictions that will never lapse by their terms (the norm for FLP liquidation restrictions)[151] and that the transferor and his or her family members cannot *immediately* remove after the transfer as a matter of legal right.[152] Installing a non-family member as a general partner can satisfy this exception, because the ULPA gives any general partner the power to block a liquidation.[153] In a state requiring unanimity, a one percent non-family limited partner would satisfy the exception. It does not matter if the non-family member might be amenable to a liquidation, or if the partner is not technically a family member—for example, a corporation controlled by family members.[154] What counts is that the "member[s] of the [transferor's] family" lack the "right" to liquidate the entity immediately after the transfer.[155] If this exception applies, the state law exception is irrelevant, and stringent agreement restrictions would not be disregarded. In other words, repealing the state-law exception is not the magic bullet for solving the FLP problem.[156]

Moving to the next provision, § 2703(a)(2) states that restrictions on "the right to sell or use" the transferred property should be disregarded.[157] The § 2704(b) exceptions above do not apply here.[158] To prevent overlap with § 2704(b), § 2703(a)(2) would not apply to entity liquidation restrictions, nor to redemption restrictions.[159] The IRS can still challenge restrictions imposed by the partnership agreement that purport to prevent, for example, a sale to a non-family member.[160] Yet a restriction found to be within the scope of § 2703(a)(2) might still be given effect under § 2703(b) if it has a business purpose, does

[151] *See* I.R.C. § 2704(b)(2)(B).

[152] Treasury Regulation § 25.2704-2(b) broadens this exception beyond the statutory language by imposing a requirement that the transferor and/or family members must have the right to liquidate the entity *immediately* after the transfer.

[153] *See supra* note 127 and accompanying text (referencing the ULPA provision that requires the consent of every general partner prior to liquidation).

[154] The term "member of the [transferor's] family" is limited to individuals, and includes the transferor's spouse, ancestors, descendants, and siblings, as well as spouses of the foregoing. I.R.C. § 2704(c)(2).

[155] *See id.*

[156] The Obama Administration's legislative proposals in this area have not attempted to remove the exceptions to I.R.C. § 2704(b). DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (2012), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf [https://perma.cc/P24S-HFKU].

[157] I.R.C. § 2703(a)(2).

[158] *Id.* § 2704.

[159] *Id.* § 2703(a)(2). The IRS attempted to apply § 2703(a)(2) to an FLP, but its attempt was rebuffed on grounds similar to those noted in the text. *See Estate of Strangi*, 115 T.C. at 478. Section 2703 was primarily aimed at buy-sell agreements involving a decedent's stock in a closely held corporation.

[160] *See Holman*, 130 T.C. at 192.

not amount to a disguised bequest, and follows the commercial norm.[161] Even without the exception, § 2703(a)(2) is unimportant, because the price that a willing buyer would offer would be low, due to an assignee's limited rights. Furthermore, the lack-of-marketability and minority-interest discounts would stand.[162] Thus, § 2703 is not a meaningful weapon against FLP discounts.

The last relevant provision, § 2704(a), treats the lapse of a liquidation or redemption[163] right as a gift or estate transfer equal to such loss in value. But the Treasury—without any basis in the statutory text—has created an exception for when the holder of the lapsed right and family members cannot obtain liquidation value under state law or the governing instrument (if more permissive) *immediately* after the lapse.[164] The Treasury should revoke this exception, because it imposes a "transfer-of-value" requirement on a statutory provision that only requires that the lapse result in a *loss* of value.[165] Nevertheless, because the law governing limited partnerships commonly precludes redemption or liquidation rights (except in the case of general partners), § 2704(a) would rarely come into play in the case of FLPs, except in cases where a general partner dies holding a limited partnership interest.[166]

No statutory provision addresses minority-issue discounts. Nonetheless, minority discounts should disappear under any entity look-through rule, except to the extent that the equity-holder's pro rata share of any particular investment is itself a minority or fractional interest.[167]

In sum, FLP discounts survive IRS attack if the elaborate recipe is dutifully followed.

[161] *See id.* at 192–95 (dealing with the business purpose issue); *see also* I.R.C. § 2703(a)(2), (b). Regulations should be issued that define "business" in this context in the same way that it is defined in the income tax (i.e. to exclude the active management of investments). *See* Higgins v. Comm'r, 312 U.S. 212, 217–18 (1941).

[162] *See Holman*, 130 T.C. at 216.

[163] I.R.C. § 2704(a). Lapsing restrictions appear to be an issue mainly for corporations and LLCs. *See* Treas. Reg. § 25.2704-2(d) exs. 2, 3 & 5.

[164] *See* Treas. Reg. § 25.2704-1(c)(2)(i) (1992).

[165] *See* I.R.C. § 2704(a)(2).

[166] *See* Treas. Reg. § 25.2704-1(f) ex. 5; *see also* I.R.C. § 2704(a).

[167] Thus, if the FLP owns real estate and the interest being valued is a 30% interest in the entity, application of a look-through rule would yield a discountable fractional interest in real estate. *See supra* note 129 and accompanying text (noting that someone holding a controlling interest could obtain minority-interest discounts for gift-tax purposes by making separate transfers of minority interests). On the other hand, a fractional holding of publicly traded stock is not discountable.

B. Plan A: Simply Ignore Self-Imposed Restrictions

1. Why the Non-Liquidity Discount Should Be Disregarded

It is argued below that as a matter of policy, the problem demands broad and simple solutions instead of the existing complex, incoherent, and ineffective provisions of current law.

a. Loopholes Should Not Sully an Already Feeble Tax

First, the gift/estate tax exemption is extremely generous. In 2016, it is approximately \$5.5 million per individual and \$11 million for a married couple. These generous exemptions result in the exclusion of about 99.88% of decedents from ever paying gift/estate tax.[168] With such generosity, Congress should not tolerate loopholes for a miniscule cohort of extremely wealthy decedents.

b. The Destruction of Wealth Is Against Public Policy

The destruction of economic value is, as a general matter, contrary to sound public[169] and economic[170] policy. Accordingly, tax rules that encourage the willful destruction of value should be eliminated. Although some advance reasons to allow the creation of, in effect, a family mutual fund, these reasons are typically contrary to sound investment practice.[171]

c. Self-Inflicted Economic Losses Should Not Be Recognized

The losses in value discussed herein are self-inflicted, and therefore should not be incentivized by the wealth-transfer tax system, a principle that is recognized in the income tax.[172]

---

[168] *See supra* note 7 and accompanying text (citing the low estimated percentage of taxable estates within the decedent population in 2015).

[169] *See* Dodge & Johnson, *supra* note 120, at 943. Unreasonable destruction of value is against public policy. *See* CAL. CIV. CODE § 987 (West 2007) (prohibiting owners from destroying art); *see also* Ford v. Ford's Ex'r, 91 Ky. 572 (Ct. App. 1891) (refusing to enforce a will provision directing executor to destroy property); Will of Pace, 400 N.Y.S.2d 488, 493 (Surrogate's Ct. 1977) (same).

[170] Economic theory posits that free markets are the engine of economic efficiency (social wealth maximization).

[171] The Tax Court often accepts reasons that defy sound investment strategy. *See e.g.*, Estate of Black v. Comm'r, 133 T.C. 340 (2009) (involving a decedent employee who wanted to force the keeping of employer stock); Estate of Miller v. Comm'r, 97 T.C.M. (CCH) 1602 (2009) (concerning a decedent who wanted her assets to be traded according to her husband's investment philosophy and to be managed by her son); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005) (involving lock-in motivation).

[172] Section 83 of the I.R.C., enacted in 1969, provides that manipulative restrictions to suppress taxable value of in-kind compensation are ignored, except where the restrictions never lapse. I.R.C. § 83 (2012). Section 83 denies losses for activities that generate tax losses while having no real aim of being profitable apart from tax. *Id.* Taxpayers are denied deductions for transactional casualty losses

d. FLPs Are Tax Motivated

Three facts offer strong circumstantial evidence that FLPs (and similarly constituted entities) are primarily motivated to save transfer taxes. First, the claimed purpose of destroying family wealth, if correct, is irrational. Second, FLPs were not discernable in the commercial landscape until their gift/estate tax benefits were publicized.[173] Third, FLPs are exclusively used by wealthy individuals facing estate tax exposure.[174]

Assertions as to the non-tax benefits of FLPs are unconvincing. It is speculative that FLPs protect donees and legatees from creditors (especially divorce creditors),[175] and regardless, such protection is dubious public policy in itself. The various investment rationales typically go against sound investment management practice.[176] The cited objectives of FLPs can be obtained through other means, such as corporations, LLCs, and spendthrift trusts.

Finally, debating whether any plausible non-tax reason exists for creating FLPs misses the point. Nothing proposed herein would abolish FLPs or render them unsuitable for non-tax purposes.

e. FLP Discounts Are Like Invisible Ink

Valuation discounts are counterproductive if no estate tax exposure exists, because discounts would lower the income tax basis of family-entity interests, thereby increasing future income taxes. For a married person who is extremely wealthy, estate tax is readily avoided by the unlimited marital deduction. Not surprisingly, discounts are often unclaimed where family entity interests are

---

due to willful or gross negligence (or even failure to make a casualty insurance claim). *See* I.R.C. § 165(h)(4)(E) (2012).

[173] Pre-1980 commentary did not mention investment FLPs. Thus, George Cooper's *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, written in 1977, only mentions family partnerships as an income- and wealth-splitting device. *See* Cooper, *supra* note 122, at 181–82. The discussion of lack-of-marketability discounts is confined to shares of stock in corporations. *Id.* Even James Repetti, writing in 1995, does not focus on the FLP except as it relates to the issue of minority discounts. *See* Repetti, *supra* note 122, at 452–57. Tax litigation involving FLPs did not surface until the early 2000s. The highest-profile case was *Estate of Strangi v. Commissioner*, which involved an FLP created in 1994. 115 T.C. at 478. The early development of the FLP appears to have occurred in Texas, perhaps in the 1990s; the FLP was mainly publicized in continuing legal education programs.

[174] *See* Brian Raub & Melissa Belvedere, *New Data on Family Limited Partnerships Reported on Estate Tax Returns*, *in* 2 INTERNAL REVENUE SERV., COMPENDIUM OF FEDERAL ESTATE TAX AND PERSONAL WEALTH STUDIES 374, 377–78 (2010), https://www.irs.gov/pub/irs-soi/11pwcompench2cfam.pdf [https://perma.cc/6XQL-VQ5C] (observing that, based on year-of-death data from 2004, most FLPs were held by wealthy decedents).

[175] Creditors (and other transferees) can only obtain "charging orders," which is merely a right to whatever distributions the debtor or owner would otherwise receive.

[176] *See supra* note 171 and accompanying text (discussing investment arguments used in Tax Court litigation).

included in marital-deduction transfers.[177] The IRS does not object to this, as it would be hard to deny the same discounts when the same assets are included in the surviving spouse's gross estate, where the stakes are higher.[178] Thus, the discounts have the quality of invisible ink: inscrutable on first showing, but fully revealed when advantageous. Or, to state it differently (as from the IRS's perspective): "Heads you win; tails I lose."

f. FLP Discounts Lack Economic Substance

Current law allows a lack-of-marketability discount even where family members can liquidate the entity immediately after the transfer, because of state law provisions that prevent the liquidation of any single limited partnership interest.[179] But even where no single transferee has a "right" to liquidate his or her interest or the entity, it is reasonable to presume that liquidation of the entity will occur when it becomes desirable to do so. No partner in an investment FLP has an economic interest in permanently maintaining an arrangement that suppresses the value of their personal wealth.

Nor should the formalistic distinction between family members and outsiders be given weight in erecting presumptions concerning the likelihood of liquidation. Under current law, non-family members can include: (1) entities controlled by family members, (2) objects of the transferor's bounty, and (3) persons sympathetic to, or receiving compensation from, family members. Moreover, virtually all FLP interests are created by gratuitous transfer. Furthermore, a true outsider would have no appetite for restrictions on liquidity. Perhaps a general partner receiving management compensation might resist a liquidation, but such a person can be paid off. Additionally, entities can be liquidated ultra vires if necessary.[180] No outsider or government agency has the power to prevent either a legal or ultra vires liquidation. Although an equity-holder might block a liquidation by seeking an injunction,[181] it is hard to imagine a scenario where this might happen. In sum, the partners have the motive, opportunity, and means to liquidate the entity and obtain the underlying asset value.

No reason exists to respect state law restrictions on liquidation for tax purposes. The game in state legislatures regarding federal wealth transfer taxa-

---

[177] *See* Raub & Belvedere, *supra* note 174, at 384–85.

[178] The IRS's gain in increased income taxes would occur in the future and would be relatively small, because the capital gains tax rate is low compared to the estate tax rate.

[179] *See* I.R.C. § 2704(b).

[180] In an in-kind liquidation, only a transfer of title is required. In a cash liquidation, not even that is entailed. Banks, brokers, persons dealing with trustees, and government agencies are generally under no duty to inquire into the legality of transactions that they facilitate. *See* U.C.C. § 3-307 (AM. LAW INST. & UNIF. LAW COMM'N 2014) (banks); *id.* §§ 8-105, 8-115 (brokers); UNIF. PRUDENT INV'R ACT § 1012 (UNIF. LAW COMM'N 1995).

[181] An unsecured creditor (unlikely in an investment FLP) might also have standing.

tion is rigged: the very wealthy and powerful professional groups favor law that undermines the federal tax system, and no state constituency exists to oppose such moves.[182] Also, it is only necessary that one state (or a handful thereof) succumb to anti-federal-tax fever, as wealthy transferors can operate under the law of the state with the most taxpayer-friendly law.[183] Finally, as noted earlier, non-tax purposes (keeping it all in the family, centralized management, or avoiding creditors—including divorcing spouses) can still be accomplished, if they are truly important.

It follows, then, that both exceptions to § 2704(b) are unjustified.[184]

2. Possible Legislative Solutions

a. Look-Through to Investment Assets

Assuming that the regulatory solution mentioned earlier is not feasible,[185] the cleanest and most effective approach is to enact legislation (perhaps by amending § 2704(b)) that simply ignores a closely held investment entity for transfer-tax valuation purposes and treats the equity-holders as pro rata owners of the underlying investment assets.[186]

It is settled that Congress has the power to declare that certain otherwise legal but likely tax-motivated arrangements should be categorically disregarded for federal tax purposes without inquiry into motive or substance.[187] Con-

---

[182] The National Commission on Uniform State Laws has not only promulgated the ULPA but also the Uniform Trust Code, which contains several provisions that undermine the federal transfer taxes. *See* UNIF. TR. CODE § 107 (UNIF. LAW COMM'N 2010) (governing law); *id.* §§ 411(a), 416 (modification of trust to achieve settlor's tax objectives); *id.* § 504(e) (reforming trust to avoid general power of appointment); *id.* § 814(b) (same); *see also infra* note 183.

[183] In another area related to estate planning, in recent years state legislatures in states with a low level of commerce and no connection to the transferor or beneficiaries (e.g., Alaska, Delaware, Nevada, South Dakota, and Wyoming) have enacted statutes that effectively repealed the rule against perpetuities that would otherwise constrain dynastic trusts. *See* Waggoner, *supra* note 87, at 10–11.

[184] *See* I.R.C. § 2704(b).

[185] *See supra* notes 137–140 and accompanying text (suggesting new regulations stating that restricted equity interests lie outside of the willing-buyer, willing-seller test and are subject to a liquidation-value rule).

[186] Dodge & Johnson, *supra* note 120, at 946; *see* I.R.C. § 2704(b).

[187] *See* Corliss v. Bowers, 281 U.S. 376 (1930); *see also* Rogers' Estate v. Comm'r, 320 U.S. 410 (1943). In *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929), the Court construed the "transfer . . . intended to take effect . . . [at] death" provision of the 1916 estate tax so as to exclude a transfer revocable by the grantor only with the consent of an adverse party. 278 U.S. at 344–46; *see* Revenue Act of 1916, Pub. L. No. 64-271, § 202(a), 39 Stat. 756, 778 (codified as amended in scattered sections of 26 U.S.C.). In 1926, Congress enacted what is now § 2038(a)(2), providing that such a co-held power would cause inclusion in the gross estate. *See* Revenue Act of 1926, ch. 27, § 302(d), 44 Stat. 9, 71. It was upheld against constitutional attack in *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935), on the grounds that Congress could thwart tax avoidance obtainable under the *Reinecke* rule—that is, a "formally" adverse party might actually be amenable to an attempt by the grantor to exercise the power to revoke, *see Reinecke*, 278 U.S. at 339. A power of an FLP limited partner, together with other general and limited partners, to liquidate an FLP is no different from a co-held power to revoke.

gress can act with a broad brush to enact per se rules. The Constitution does not require extensive inquiries into such facts as whether particular partners have an economic interest in resisting liquidation.[188] Looking through personal-holding investment companies has long occurred in the income tax realm.[189]

Such a look-through rule would also eliminate the minority-interest discount for closely held investment entities, except to the extent that the entity portfolio consisted of minority or fractional interests in non-liquid assets.[190]

b. Operating Business Assets

In the case of entities holding operating businesses,[191] the lack-of-marketability discount would stand to the extent of its business assets, but minority-interest discounts should be scrutinized. The discount is legitimate where strangers are involved, but it is tempting to suppose that family members will act in concert with regard to management and other issues relating to the business. This is an empirical question, but it would be too costly to examine the facts on a case-by-case basis. The author's intuition and experience suggests that husbands and wives are likely to act in concert, but that other relationships are often contentious. Thus, the "acting-in-concert" theory only justifies combining the holdings of spouses on a per se basis.[192]

A more fine-tuned approach would be to disregard all minority discounts that are self-created by gift. Current law disallows minority-interest discounts created by bequest but allows those created by gift.[193] It cannot be the case that the gift tax allows destruction of wealth but the estate tax does not. The Supreme Court has often ruled that estate tax rules should be imported into the gift tax, unless the gift tax statute is to the contrary.[194] This approach, which

---

Except, unlike a trust scenario, the FLP co-holders are not inherently adverse to the exercise of the power—rather, quite the contrary.

[188] *See supra* notes 180–181 and accompanying text (discussing ultra vires liquidation).

[189] *See* I.R.C. §§ 951, 954 (2012) (controlling foreign corporations having personal holding company income); I.R.C. § 1293 (2012) (involving certain passive foreign investment companies); *cf.* I.R.C. §§ 541–547 (2012) (regarding constructive dividend of personal holding companies).

[190] *See* Dodge & Johnson, *supra* note 120, at 946.

[191] According to the data collected by Brian Raub and Melissa Belvedere, business assets constitute, on average, 17% of FLP assets. Raub & Belvedere, *supra* note 174, at 380–81.

[192] Such a rule would overturn the result of *Estate of Bright v. Commissioner,* 658 F.2d 999 (5th Cir. 1981) (en banc). *Estate of Bright* also has had the unfortunate effect of privileging spouses residing in community property states. *See id.* at 1001–02.

[193] *See supra* note 129 and accompanying text (noting that someone holding a controlling interest could obtain minority-interest discounts for gift-tax purposes by making separate transfers of minority interests).

[194] *See, e.g.*, Harris v. Comm'r, 340 U.S. 106 (1950); Merrill v. Fahs, 324 U.S. 308 (1945); Estate of Sanford v. Comm'r, 308 U.S. 39 (1939). Revenue Ruling 93-12 based its gift tax holding on Treasury Regulation § 25.2512-2(e), which purports to apply the "blockage discount" to individual gifts (thereby reducing the discount). Rev. Rul. 93-12, 1993-1 C.B. 202; Treas. Reg. § 25.2512-2(e) (1976). The blockage rule itself deviates from the willing-buyer, willing-seller test in assuming a compulsion

can be imposed by regulation, makes sense both from the angle of transfer-tax theory and the policy against tax-motivated, self-imposed destructions of wealth.

A third possible basis for overturning minority-interest discounts among family members is that they can be undone after the gift/estate tax valuation event by recombining minority interests through gifts, bequests, trusts, business entities, or otherwise. Yet, because such a recombination within the family is neither certain nor likely, a better remedy would be a wait-and-see approach. Such a remedy is the next topic of discussion.

C. Plan B: A Recapture Tax on the Disappearance of Restrictions

Discount-breeding scenarios may be reversed in the future, restoring the underlying property interest to full or enhanced value. The entity might be liquidated or an equity-holder might be able to redeem her interest. Minority and fractional interests may be reunited or consolidated. In such scenarios, the discount phenomenon can be reframed as a timing issue.

1. The Removal of the Restrictions Is Itself a Gratuitous Transfer

The disappearance of a restriction or arrangement that created a substantial discount in its transfer tax valuation should be considered a transfer subject to the transfer tax system. Because such restorations of wealth were made possible by the acts creating the discounts, they are gratuitous transfers in relation to a baseline that is the discounted value of the property.[195]

The notion of such a tax has ample precedent, not only in the income tax,[196] but also the estate tax.[197] Thus, although § 2032A(c) allows a discount on the valuation of farm real estate if it passes to qualified heirs (family members), it imposes a recapture estate tax if the property is no longer subject to qualifying use, or if the qualified heir transfers the interest to an outsider, with-

---

to sell, but no such need exists in the case of a gift. The regulation applying the blockage rule to gifts should be revoked.

[195] *See* United States v. Land, 303 F.2d 170 (5th Cir. 1962); Goodman v. Granger, 243 F.2d 264 (3d Cir. 1957) (holding that a lapse, at the time of transfer, of a restriction on transferred property increases the value for transfer-tax purposes).

[196] Although a non-lapse restriction on compensatory stock will reduce the value of the stock as compensation, § 83(d)(2) provides that a cancellation of the restriction can result in additional taxable compensation. I.R.C. § 83.

[197] *See* I.R.C. § 2041(b) (2012) (treating lapse of general power of appointment as a constructive transfer); *id.* § 2704(a) (providing that lapse of right can be a transfer); *supra* note 163 and accompanying text (discussing § 2704(a)); *cf.* I.R.C. § 2037 (2012) (stating, in effect, that the lapse, at death, of a retained reversion is an estate transfer of the entire remainder interest).

in ten years of the decedent's death.[198] A similar recapture rule operates with respect to an estate tax discount for qualified conservation easements.[199]

2. Scope and Role of the Recapture Tax

A tax on the removal of a restriction should be linked to the earlier allowance of a discount on account of the restriction. Thus, to the extent that Congress declines to eliminate lack-of-marketability and minority-interest discounts as recommended above, it can enact a recapture tax on the removal of recognized restrictions.[200]

Even if Congress acts prospectively to abolish these discounts, it can enact a recapture tax with respect to discounts allowed under prior law. Here the recapture tax would operate as a transitional rule, and the constitutionality of such a transition rule would be secure.[201]

3. Mechanics of the Recapture Tax

The recapture tax would be imposed on the expiration, lapse, removal, etc., of a restriction imposed by a gratuitous transferor (whether immediate or remote) that had resulted in a discount in the value of property (or interest therein) subject to transfer taxes on the relevant valuation date by more than five percent of the value of the property. It would not matter who caused the restriction to disappear or by what mechanism.

The taxable amount would be the lesser of: (1) the earlier discount or (2) the current undiscounted value's excess over the earlier discounted value. The taxable amount would be attributed to the initial transferor. The latter may be long dead (with his or her tax information being hard to retrieve), and valuation discounts would not be sought except to save the gift/estate tax.[202] Thus, an exemption amount of zero should be applicable to the transfer,[203] and the tax rate should be the (maximum) statutory tax rate in effect at the time of the initial transfer.

The tax should be payable by the persons who benefit from the lapse of the restrictions, as they benefitted (perhaps indirectly) from the valuation discounts.

---

[198] I.R.C. § 2032A(c) (2012).

[199] *See* I.R.C. § 2031(c)(5)(C) (2012).

[200] Dodge & Johnson, *supra* note 120, at 945.

[201] *See supra* notes 114–119 and accompanying text (discussing transfer tax transition rules).

[202] Because unneeded estate tax discounts would reduce income tax basis under § 1014, it would be irrational to seek them. *See* I.R.C. § 1014 (2012).

[203] No advantage should be obtainable in this context from any post-transfer increase in the exemption amount.

CONCLUSION

The three federal transfer tax reforms considered here (which hardly exhaust the menu of desirable reforms)[204] relate to: (1) transfers with retained interests, (2) the GST tax, and (3) lack-of-marketability and minority-interest discounts. For string transfers, a hard-to-complete rule would apply for transfers subject to the possibility (or certainty) of receiving back the corpus or economic return; transfers with retained powers to alter beneficial enjoyment would be subject to an easy-to-complete rule. The GST tax could be modified along any of three lines, two of which would reach only taxable distributions. Any of these design options would simplify the tax and align it with a plausible goal of the tax. Finally, self-created lack-of-marketability discounts would be disregarded for closely held investment holding companies; spousal holdings would be aggregated for the purpose of testing for minority-interest discounts; and a recapture tax would be imposed where previously allowed discounts disappear.

All three reform categories possess a common theme of the linkage of timing and the accurate valuation of transfers, eschewing the unnecessary use of actuarial tables. Also, all three shy away from reliance on property-law concepts and formalism, which have straight-jacketed the development of the federal wealth-transfer tax system.

[204] Other reforms should include: (1) disqualifying trust transfers from the gift tax annual exclusion, (2) adopting a hard-to-complete rule for split-interest charitable transfers, (3) requiring inclusion of life insurance in an insured's estate, and (4) repealing the marital deduction qualification for qualified terminable interest property transfers.