TOWARD A REALITY-BASED ESTATE TAX

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Abstract: Currently, the estate tax does not accurately value the property and transactions that it is meant to cover. Additionally, the marital and charitable deductions do not reflect actual associated transfers, instead skewing their benefits away from their purported beneficiaries. This Article proposes reforming the estate tax by eliminating these sources of unreality and distortion, and to make the current estate tax a reality-based tax. Through six specific proposals, the Article identifies solutions to the problems associated with testamentary transfers, puts forth alternative methods of valuation to prevent gaming of transfer taxes, and offers significant modifications to two deduction provisions.

INTRODUCTION

This Article proposes reforming the estate tax by eliminating devices and distortions that have crept into the estate tax and frustrated its goal. The present focus in reforming the estate tax is to make the current estate tax a reality-based tax. This means that the estate tax should encompass testamentary property transfers at their real values, and the marital and charitable deductions should reflect actual marital and charitable transfers.

The biggest sources of unreality and distortion include omitting certain common testamentary transfers, allowing valuation games to defeat the impact of transfer taxes, and skewing the major benefits of certain deductions away from their purported beneficiaries. Therefore, Part I of this Article focuses on the problems associated with testamentary transfers, specifically involving life insurance, will substitutes, and retained powers.[1] Part II proposes alternative methods of valuation to prevent gaming of transfer taxes.[2] Part III proposes that certain deduction provisions be either repealed or changed.[3]

I. TESTAMENTARY TRANSFERS

Because of the many benefits associated with gift-giving, such as the annual exclusion, as well as the tax-exclusive nature of the gift tax, and the

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[1] *See infra* notes 4–65 and accompanying text.

[2] *See infra* notes 66–94 and accompanying text.

[3] *See infra* notes 95–114 and accompanying text.

benefit of value freezing,[4] Congress has historically tried to prevent inherently testamentary transfers from receiving those tax advantages.[5] Those measures have failed to ensure that some of those inherently testamentary transfers are included in the decedent's estate at their date of death values, either because of case law or inadequate safeguards in the statutes. Thus, section A of this Part proposes changes to the taxation of life insurance proceeds.[6] Section B proposes an amendment to § 2036.[7] Section C addresses the consequences of eliminating certain powers from inclusion in a decedent's estate.[8]

A. Life Insurance on Decedent's Life Indirectly Funded by Decedent

In trying to grapple with the issue of inherently testamentary property, Congress and the courts have developed estate tax laws that have become counterproductive. A prime example of this consequence is that the proceeds of life insurance on decedent's life, paid for with decedent's funds, are rarely taxed in decedent's estate. With a common estate-planning device most of those life insurance proceeds are in fact exempt. This is because of the interplay of a couple of estate tax statutes[9] and because of changes made to the insurance inclusion statute.[10]

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[4] *See* Wendy C. Gerzog, *A Simpler Verifiable Gift Tax*, 6 COLUM. J. TAX. L. 182, 201–06 (2015) (describing benefits associated with making gifts).

[5] *See, e.g.*, I.R.C. § 2035 (a)–(b) (2012) (adjusting value of estate for certain gifts made within three years of decedent's death); *id.* § 2701 (2012) (creating special valuation rules for transferring interests in corporations or partnerships).

[6] *See infra* notes 9–36 and accompanying text.

[7] *See infra* notes 37–60 and accompanying text.

[8] *See infra* notes 61–65 and accompanying text.

[9] *See generally* Estate of Leder v. Comm'r, 89 T.C. 235 (1987) (interpreting the amended I.R.C. §§ 2035, 2042), *aff'd*, 893 F.2d 237 (10th Cir. 1989), *action on dec.*, 1991-012 (July 3, 1991); Estate of Headrick v. Comm'r, 918 F.2d 1263 (6th Cir. 1990) (same). Thus, the sole incidents of ownership test paved the way for the viability of irrevocable life insurance trusts (ILIT); that is, the current literal language of § 2042 provides a loophole for the decedent's paid life insurance to escape estate taxation. *See Estate of Headrick*, 918 F.2d at 1267–68 (analyzing the literal language of § 2042 to exclude certain life insurance proceeds from decedent's taxable estate). There is not much criticism of ILITs; that may be because of not only the insurance lobby but also the fact that ILITs provide liquidity for an estate, which in turn means a quick source of funds for estate tax payments.

[10] Between 1942 and 1954, § 2042 required estate tax inclusion of life insurance on the decedent's life either because the decedent possessed any incidents of ownership in the policy or the decedent paid the insurance premiums. *See* JOSEPH M. DODGE ET AL., FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 240 (2011) [hereinafter FEDERAL TAXES ON GRATUITOUS TRANSFERS]. In 1954, however, the premium payment test was abandoned in order to allow the decedent to avoid estate tax inclusion if the decedent had transferred all incidents of ownership more than three years before death. *See id.* at 240–41. Moreover, the payment of premiums *within* three years of death no longer affects inclusion of the proceeds under § 2035(a) because the "beamed transfer" of premium payments was eliminated as a basis for inclusion under that I.R.C.

Currently, inclusion in decedent's estate is the subject of gaming through the creation of an irrevocable life insurance trust ("ILIT").[11] Literally, under the estate tax statute, because the decedent never owned any of the incidents of ownership in the policy, because the trust—although empowered to—does not have to purchase life insurance on the decedent's life, and because the insurance proceeds do not pass to the estate, the life insurance proceeds in an ILIT are not taxed in the decedent's estate.[12] Further, through the use of another fiction referred to as *Crummey* powers,[13] the decedent's lifetime transfers to the ILIT, which are made in order to pay the life insurance premiums, are further minimized for gift tax purposes.[14] Thus today, informed taxpayers create an ILIT, designate the beneficiaries of the trust—basically, the beneficiaries of the insurance proceeds—and are the source of premium payments. By means of an ILIT, the taxpayer effectively and legally evades estate taxes.

The current approach to life insurance is the result of years of legislative change. The 1939 Internal Revenue Code ("I.R.C.") contained a premium payment test that required that any portion of the proceeds from life insurance policies on the decedent's life purchased directly or indirectly in premiums paid by the decedent were includible in decedent's estate.[15] Ex-

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section in 1981. *See Estate of Leder*, 89 T.C. at 239–44 & n.12 (recognizing that § 2035(b) "precludes any consideration of the 3-year rule").

[11] *See* William S. Huff, *The Irrevocable Life Insurance Trust*, 38 ARK. L. REV. 139, 139–41 (1984) ("Its primary purpose is to eliminate the insurance death proceeds from the grantor's gross estate for federal estate tax purposes."); Donald O. Jansen, *Giving Birth to, Caring for, and Feeding the Irrevocable Life Insurance Trust,* 41 REAL PROP. PROB. & TR. J. 571, 573–76 (2006) ("Properly drafted, the life insurance trust can be a vehicle for removing the insurance proceeds from the estates of the insured and insured's spouse for federal estate tax purposes.").

[12] *See supra* notes 9–10 and accompanying text (describing the tax characteristics of ILITs).

[13] Crummey v. Comm'r, 397 F.2d 82, 86–96 (9th Cir. 1968) (granting a tax exclusion for certain trust property distributed under a demand right); *see* Mikel v. Comm'r, 109 T.C.M. (CCH) 1355, 12–13, 20–21 (2015) (granting petitioners' tax exclusion for gift to a "*Crummey* trust" because the trust beneficiaries' had an unconditional right to withdraw property which could not be legally resisted by the trustees); *see also* Estate of Cristofani v. Comm'r, 97 T.C. 74, 79–83 (1991) (adopting the test in *Crummey*). *Crummey* powers allow the holder to withdraw a limited amount of money; generally "the lesser of (a) the amount (if any) transferred to the trust by the grantor during that year or (b) an amount equal to the maximum annual exclusion." FEDERAL TAX ON GRATUITOUS TRANSFERS, *supra* note 10, at 131. In order to create the most benefit, the settlor creates "hanging" powers, which can gradually absorb the full annual exclusion amount without causing a lapse. *Id.* at 330–31.

[14] *See generally* Bradley E.S. Fogel, *The Emperor Does Not Need Clothes—The Expanding Use of "Naked"* Crummey *Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L. REV. 555 (1998) (explaining the history and practical effect of *Crummey* powers).

[15] I.R.C. § 811(g) (1939). At that time § 811(g) also required, as does the current statute, that any proceeds from life insurance on decedent's life that were receivable by the estate or any life insurance on decedent's life on which decedent held the incidents of ownership at this death are includible in the decedent's estate. *See id.*; *see also* I.R.C. § 2042 (2012). Regarding the 1939 provision, in order to determine the amount includible when the decedent paid a portion of the

plaining the reaction to this provision, the Joint Committee on Internal Revenue Taxation stated that many taxpayers considered this provision to be unfair where owners transfer all of the incidents of ownership in the policy during their lifetimes.[16] Specifically, taxpayers argued for change because of the hardship imposed in the context of business partnerships. Hardships arose in partnership agreements that required the purchase of life insurance to allow the surviving partners to purchase a deceased partner's interest.[17] As a result, in 1954 the new § 2042 eliminated the payment of premiums rule[18] despite the recognition at that time that such a change would cost about $25 million in fiscal year 1955.[19]

In 1955 a group of prominent American Law Institute ("ALI") scholars met and discussed the issue of life insurance.[20] The group "adopted the intermediate rule that the difference between the cash surrender value and the face amount of the policy would be included in the gross estate to the extent that the insured had paid the premiums."[21] One scholar described the 1939 statute as replicating the treatment of a retained life interest or power, causing fair market value date of death inclusion of the insurance proceeds.[22] Another commentator emphasized that insurance not only is a transfer at

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premiums before decedent transferred the policy as a gift to another, the provision explained that the amount includible reflects the same ratio as decedent's contributions bear to all paid premiums. *Id.* § 811(g)(2).

[16] JOINT COMM. ON INTERNAL REVENUE TAXATION, 83D CONG., PRELIMINARY DIGEST OF SUGGESTIONS FOR INTERNAL REVENUE REVISION SUBMITTED TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 109 (Comm. Print 1953) [hereinafter PRELIMINARY DIGEST], https://ia600304.us.archive.org/15/items/preliminarydiges353unit/preliminarydiges353unit.pdf [https://perma.cc/N56R-X4YB]. The Joint Committee states:

> [The taxpayers] state that where a decedent has paid premiums on a life-insurance policy on his life but subsequently divests himself completely of any incidents of ownership of such policy by either assignment or gift, there exists no logical reason to include the insurance proceeds in his estate to the extent of the premiums he paid prior to the transfer. They indicate that the present rule imposes unnecessary obstacles in the use of life insurance in partnership agreements for the purpose of permitting surviving partners to buy out the deceased partner's interest. It has therefore been proposed that the payment of premiums test should be eliminated.

Id. Other remarks favored an exclusion of varying amounts ranging up to $100,000. *Id.*

[17] *See id.* (describing the complaint made by taxpayers).

[18] *See* H.R. REP. NO. 1337-83, at A316–17 (1954) (Conf. Rep.) (explaining revisions to § 811(g) made by § 2042); S. REP. NO. 1622-83, at 124 (1954) (Conf. Rep.) (same).

[19] H.R. REP. NO. 1337-83, at 91; S. REP. NO. 1622-83, at 124.

[20] *See* AM. LAW INST., PROCEEDINGS OF THE THIRTY-SECOND ANNUAL MEETING OF THE AMERICAN LAW INSTITUTE 101–120 (1955) (discussing Estate and Gift Tax Statute, Tentative Draft No. 10), *reprinted in* STANLEY S. SURREY ET AL., FEDERAL WEALTH-TRANSFER TAXATION: CASES AND MATERIALS 593, 593–605 (3d ed. 1987).

[21] *Id.* at 594.

[22] *Id.* at 595.

death, but also has added value created by death, establishing life insurance as the most testamentary asset of any taxpayer.[23]

Life insurance on decedent's life is also viewed as an example of a type of valuation freeze: the value of a policy during the decedent's lifetime is not equal to the proceeds payable at death. Thus, a gift of a life insurance policy is valued at the interpolated reserve value and not at the present discounted value of the proceeds.[24] Moreover, the investment growth during the decedent's life is not taxed for income tax purposes[25] and proceeds paid to beneficiaries at decedent's death are not includible in the income of either the beneficiary or the estate.[26]

In 1981 Congress was concerned with valuation freezing of life insurance on the decedent's life when it amended I.R.C. § 2035.[27] Under the unification of the gift and estate taxes and their unified rates and exemptions in 1976,[28] Congress realized that including "deathbed" gifts in the decedent's estate was no longer necessary in most cases.[29] Where, however, the valuation increase in certain lifetime transfers was disproportionately large, Con-

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[23] *Id.* at 599. Specifically referring to the "gambling" factor, the excerpt states:

> [T]he insurance risk element for which the decedent was paying—that is the value that springs into being after death. I can't imagine anything that is more fundamentally testamentary than that value, and I feel that if the decedent is the one who paid for that value, that amount should be in his estate.

Id.

[24] *See* Treas. Reg. § 25.2512-6(a) (2015) (stating rule for the valuation of certain life insurance contracts). A gift of a life insurance policy is valued at the cost of similar policies—the replacement cost—or at the interpolated terminal reserve value. *Id.*

[25] FEDERAL TAX ON GRATUITOUS TRANSFERS, *supra* note 10, at 234.

[26] I.R.C. § 101 (2012).

[27] *See* Economic Recovery Act of 1981, Pub. L. No. 97-34, § 424, 95 Stat. 172, 317 (amending § 2035 to exclude from decedent's estate certain gifts made within three years of decedent's death).

[28] *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846–1850 (creating a unified rate schedule for estate and gift taxes).

[29] JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 262 (1981), *available at* https://www.jct.gov/publications.html?func=startdown&id=2397 [https://perma.cc/F5J3-P2C8] ("The Congress concluded that inclusion of such appreciation generally is unnecessary, except for gifts of certain property included in the gross estate pursuant to certain of the so-called transfer sections (secs. 2036, 2037, 2038, 2041, and 2042)."). "Deathbed" gifts are either gifts in contemplation of death or within three years of decedent's death. *See id.* at 261–62 (describing tax consequences of gifts made "in contemplation of death"). The 1976 Act amended I.R.C. § 2035 to include all gifts made within three years of the decedent's death. Tax Reform Act of 1976 § 2001. Prior to that legislation, motivation determined inclusion. *See id.* (amending § 2035 for gifts made "in contemplation of death"). *See generally* Gina B. Kennedy, Note, *Section 2035: Taxation of Gifts Made Within Three Years of Death*, 19 B.C. L. REV. 577 (1978) (explaining the revisions made to § 2035 by the Tax Reform Act of 1976).

gress retained exceptions under the revised statute.[30] Prominent among those exceptions is the rule for life insurance.[31]

The current proposal to tax life insurance in decedent's estate is to amend § 2035 and § 2042. At a minimum, § 2035 should be amended to include in decedent's estate the full date of death proceeds of life insurance on the decedent's life to the extent to which the decedent has paid, directly or indirectly, insurance premiums within three years of his death. That should include any transfers by decedent to a trust within three years of death that in fact can be traced to the payment of life insurance premiums on decedent's life. That change to § 2035 would equate inherently testamentary life insurance on decedent's life in an ILIT with a transfer of life insurance within three years of decedent's death and with the other testamentary transfers that highly appreciate at death, which currently are the focus of that I.R.C. section.[32]

Optimally, however, § 2042 should be amended to include all life insurance on decedent's life to the extent to which decedent at any time, directly or indirectly (e.g., through any trust), paid the premiums during his lifetime and wherein at any time during his lifetime decedent directly or indirectly irrevocably selected the beneficiary of the policy.[33] Section 2035 and § 2042 should also specify that any payments by decedent's employer, paralleling § 2039,[34] are to be considered payments by the decedent.

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[30] JOINT COMM. ON TAXATION, *supra* note 29, at 262 ("For example, if one year prior to death, a decedent transferred any incident of ownership in a life insurance policy to a third party, the entire amount of the proceeds will be included in the decedent's gross estate pursuant to sections 2035 and 2042.").

[31] *See* Kennedy, *supra* note 29, at 594 (discussing the exception for life insurance). Not only is a gift of the insurance policy included under the three year rule of § 2035, but also the transfer of even one final retained incidence of ownership in that policy will cause inclusion under the 1981 version of that statute. Economic Recovery Act of 1981 § 424.

[32] *See* I.R.C. § 2035. The statute and regulations include life insurance proceeds in decedent's estate where the decedent transfers life insurance on decedent's own life or releases any of the policy's incidents of ownership within three years of death. *See id.* § 2035(a)(2); Treas. Reg. § 20.2042-1(c)(2) (2015). The regulation defines incidents of ownership as:

> [T]he right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy . . . .

Treas. Reg. § 20.2042-1(c)(2). Likewise, I.R.C. § 2035(a)(2) subjects to estate tax a transfer or release of an interest or power within three years of death that would have caused inclusion in decedent's estate under I.R.C. §§ 2036–2038 if otherwise held at death.

[33] The statute could be revised more expansively to include life insurance proceeds wherein the beneficiary of decedent's life insurance policy is "a family member" of the decedent, as defined in § 2701(e)(1). *See* I.R.C. § 2701(e)(1) (2012). Section 2701(e)(1) defines a "member of the transferor's family" as including the transferor's—here, it would be the decedent's—spouse, descendants, the spouse's descendants, and the spouses of any descendant. *Id.*

[34] *See* I.R.C. § 2039(b) (2012); Treas. Reg. § 20.2039-1(c) (2015).

In an ILIT, the trust holds a life insurance policy on decedent's life, proceeds are paid to beneficiaries of the trust irrevocably named by the decedent, and the proceeds are paid to the ILIT at the decedent's death. As a result, the ILIT is clearly a testamentary device and the value of the proceeds should be included in the decedent's estate. In the case of an ILIT, the trustee should be responsible for payment of the tax attributable to that estate tax inclusion. Finally, the specific reason for eliminating the premium payment test in 1954 was the hardship that could befall the surviving partners in a partnership where insurance is used to supply cash to buy a deceased partner's interest.[35] Assuming that the partnership is carrying on a trade or business, the amended statutes should include an exception limited to that particular situation.[36]

Proposal 1: Except in the instance of a business partnership wherein the surviving partners use the insurance proceeds to purchase a deceased partner's interest in the partnership, § 2042 includes life insurance proceeds paid on decedent's life to the extent to which decedent at any time, directly or indirectly, paid the premiums on or irrevocably designated the beneficiary or beneficiaries of the policy.

B. Will Substitutes and Section 2036

Section 2036 provides that the following types of transfers are essentially testamentary: a lifetime transfer with a grantor-retained life income interest; a lifetime transfer with a grantor-retained current enjoyment over non-income producing property; or a lifetime transfer with a grantor-retained power over lifetime income or enjoyment.[37] Those strategies are all considered "will substitutes" and as such describe inherently testamentary disposi-

[35] *See* PRELIMINARY DIGEST, *supra* note 16, at 109 (noting taxpayer opposition to the test because of the difficulty imposed on surviving spouses).

[36] *See* I.R.C. § 2039(b) (determining amount of annuity includible in gross estate); Treas. Reg. § 20.2039-1(c) (creating ratio for amounts to be included in the gross estate under § 2039); Treas. Reg. § 20.2042-1(c)(6) (creating rules for attribution of incidents of ownership of a life insurance policy on decedent's life reserved to a corporation).

[37] *See* I.R.C. § 2036 (2012) (concerning transfers with a retained life estate); United States v. Estate of Grace, 395 U.S. 316, 320 (1969) ("The general purpose of the statute was to include in a decedent's gross estate transfers that are essentially testamentary—i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."); Comm'r v. Estate of Church, 335 U.S. 632, 646 (1949) (quoting Goldstone v. United States, 325 U.S. 687, 690–91 (1945)) ("Testamentary dispositions of an inter vivos nature cannot escape the force of this section by hiding behind legal niceties contained in devices and forms created by conveyancers."). Section 2036, and consequently the relevant case law, corresponds with § 811(c)(1)(B) of the 1939 I.R.C. *See* H.R. REP. NO. 1337-83, at A314.

tions.[38] Thus, the statute requires that the full date of death value of the underlying property is to be included in the decedent's estate. The statute's history is replete with a discussion of the legislative intent to use this provision to attack the abuse of converting what are essentially death-time transfers into gifts.[39] Likewise, Congress wanted to deny taxpayers the ability to freeze the value of those transfers as well as other preferences accorded gifts.[40]

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[38] *See* Helvering v. Hallock, 309 U.S. 106, 114 (1940) (interpreting congressional intent to treat certain transfers as will substitutes); *see also Estate of Grace*, 395 U.S. at 643 (explaining the Court's reasoning in *Hallock*).

[39] Congress enacted the predecessor statute to § 2036 in reaction to three Supreme Court cases allowing a decedent to avoid estate taxes where he retained for his life a right to enjoy the transferred property. *See Estate of Church*, 335 U.S. at 639–40 (citing Burnet v. N. Tr. Co., 283 U.S. 782 (1931) (per curiam); McCormick v. Burnet, 283 U.S. 784 (1931) (per curiam); Morsman v. Burnet, 283 U.S. 783 (1931) (per curiam)). Acting Secretary of the Treasury Ogden Mills stated that without quick congressional action to reverse the three Supreme Court opinions tax revenue collected would decrease "in excess of one-third of the revenue derived from the Federal estate tax, with anticipated refunds in excess of $25,000,000." *Estate of Church*, 335 U.S. at 639–40 (quoting 74 CONG. REC. 7198, 7199 (1931)). Reacting to *United States v. Byrum*, Congress enacted I.R.C. § 2036(b). *Compare* Tax Reform Act of 1976 § 2009(a) (treating retention of voting rights in retained stock at retention of enjoyment of such stock), *with* United States v. Byrum, 408 U.S. 125, 148 (1972) (holding that retention of voting right in stock was not enjoyment of such stock). Subsequent to *Byrum*, Congress determined that:

> [T]he voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes . . . [and] that this treatment is necessary to prevent the avoidance of the estate and gift taxes.

H. REP. NO. 94-1380, at 64 (1976); JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 589 (Comm. Print 1976), *available at* https://ia600308.us.archive.org/29/items/generalexplanati00jcs3376/generalexplanati00jcs3376.pdf [https://perma.cc/UC7B-26XM]. Likewise, in response to the increased use of valuation freezes in estate planning, Congress enacted I.R.C. § 2036(c). *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 101-203, § 10402(a), 100 Stat. 1330-1, 1330-431 (amending I.R.C. § 2036). The statute was amended to be applicable to decedents dying after 1987, but only with respect to transfers subsequent to December 17, 1987. *Id.* As to the problem of estate freezes, the Joint Committee on Taxation stated:

> Estate freezes raise three basic transfer tax concerns. First, because frozen interests are inherently difficult to value, they can be used as a means of undervaluing gifts. Second, such interests entail the creation of rights that, if not exercised in an arm's-length manner, may subsequently be used to transfer wealth free of transfer tax. Third, '"frozen"' interests may be used to retain substantial ownership of the entire property while nominally transferring an interest in the property to another person.

JOINT. COMM. ON TAXATION, 101ST CONG., FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES 17 (Comm. Print 1990); *see* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601, 104 Stat. 1388-1, 1388-490 (repealing the 1987 enactment of I.R.C. § 2036(c)).

[40] *See supra* note 39 (explaining tax concerns surrounding tax freezes). The gift tax is a tax-exclusive tax, unlike the estate tax, which is a tax-inclusive tax. Gerzog, *supra* note 4, at 202–03. The difference between the two tax systems is that the estate tax computes the tax inclusive of the amount that will be paid to the government, whereas the gift tax computes the tax based only on the net amount that the beneficiary receives. *Id.*

In 1990, however, reflecting a desire to have the gift tax rules, instead of the estate tax provisions, deal with those valuation distortions, Congress replaced § 2036(c) with the special valuation rules in §§ 2701–2704.[41] Since the enactment of the special valuation rules, a majority of courts have determined that what constitutes "adequate and full consideration" under § 2036 in the sale of a remainder interest in property, wherein the decedent has retained a life interest, is the economic value of the remainder interest as calculated under the actuarial tables.[42] Although apparently sound reasoning, this economic equivalent position ignores the inherently testamentary nature of those transfers and the fundamental policy rationale underpinning § 2036.

In 1995, in *Estate of D'Ambrosio v. Commissioner*, the decedent and her son owned a closely held company, Valparo, which at that time had only issued one class of stock: common stock.[43] The company was recapitalized in 1983, after which it held both common and preferred classes of stock, with the common stock assigned future appreciation.[44] Between that time in 1983 and September 1, 1987, decedent transferred all of her common stock and retained only 470 shares of her noncumulative convertible preferred shares.[45] On September 1, 1987, when she was eighty years old, the decedent and Valparo agreed that the company would buy her remainder interest in those shares in return for an annuity of $296,039 per year.[46] On May 25, 1990, fewer than three years after the agreed transaction, decedent died having received $592,078 in annuity payments.[47] At the time of the sale, as well as at the time of her death, the fair market value of the 470 shares of Val-

[41] Omnibus Budget Reconciliation Act of 1990 §§ 11601–11602(a); *see* JOINT COMM. ON TAXATION, 101ST CONG., COMPARISON OF REVENUE PROVISIONS OF H.R. 5835 (REVENUE RECONCILIATION ACT OF 1990), at 46 (Comm. Print 1990), *available at* https://www.jct.gov/publications.html?func=download&id=3225&chk=3225&no_html=1 [https://perma.cc/WHF9-K8JQ] ("The Senate amendment repeals section 2036(c) retroactively and provides in its place rules generally intended to assure more accurate gift tax valuation of the initial transfer.").

[42] *See, e.g.*, Estate of Magnin v. Comm'r, 184 F.3d 1074, 1097 (9th Cir. 1999) (determining that "adequate and full consideration" is measured by the actuarial value of the remainder interest); Wheeler v. United States, 116 F.3d 749, 767 (5th Cir. 1997) (same); Estate of D'Ambrosio v. Comm'r, 105 T.C. 252 (1995), *rev'd*, 101 F.3d 309, 311–12 (3d Cir. 1996) (same). Those courts rejected the interpretation of *Gradow v. United States*. *Compare* Gradow v. United States, 11 Cl. Ct. 808, 813–14 (1987) (requiring a full fair market value of the underlying property to allow escape from the reach of § 2036, as estate tax inclusion under that I.R.C. section requires the full date-of-death value of the underlying property), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990), *with Estate of Magnin*, 184 F.3d at 1077–78 (rejecting the holding of *Gradow*), *and Wheeler*, 116 F.3d at 756 (declining to apply the rationale of *Gradow*), *and Estate of D'Ambrosio*, 101 F.3d at 314 (rejecting the holding of *Gradow*).

[43] *Estate of D'Ambrosio*, 105 T.C. at 253.

[44] *Id.*

[45] *Id.* at 253–54.

[46] *Id.*

[47] *Id.*

paro was $2,350,000. Under the actuarial tables, the annuity's value was $1,324,014.[48]

The facts in the case were fully stipulated and the only issue before the court was whether Valparo had paid "full and adequate consideration in money or money's worth" to except the transfer from the full date of death value inclusion under § 2036(a)(1), less the value of any consideration decedent had received.[49] The U.S. Court of Appeals for the Third Circuit reversed the Tax Court, which had held in favor of the government, and held that the exception in the statute applied: Valparo had paid the full actuarially determined value of the remainder interest in decedent's preferred stock.[50] Although the value paid was the actuarial value of the remainder, that value would not indicate the inherently testamentary nature of transfer.[51] If § 2036 had applied the full date of death value of the full underlying fee simple property would have been included in her estate because of the testamentary nature of the transfer, despite the fact that the decedent held no interest in the property at her death. On a purely economic analysis, § 2036 makes no sense; on its policy basis of preventing tax evasion, however, it makes perfect sense. Someone who transfers a future interest in property to her child but retains the current enjoyment creates the split interest only to obscure the fact that she actually enjoys her property until her death when her child takes possession.

In *D'Ambrosio*, we first see a parent transferring future value to her family in a corporate reorganization, which after 1990 would likely have resulted in a gift of the full value of the company under § 2701. She transfers all future appreciation by transferring the common stock to her family during her lifetime. At the same time, as she ages, she would like to avoid the testamentary function of § 2036 and she understands that she only needs an annuity interest for her expenses before her death. Perhaps she also understands that at eighty years old her health is worse than the average eighty-year-old.[52] Consequently the decedent uses another estate-planning strategy to devalue her remaining shares, one that allows her a fixed income and indirectly allows her to sell her remaining shares to her son for what her lawyer may suggest will be at a fraction of its value. By selling a partial interest (a remainder) in the property to Valparo, the strategy aims to pre-

[48] *Id.* The government conceded that the value included in the decedent's estate should be the value of the stock ($2,350,000) less the value of the annuity ($1,324,014), and not merely the actual amounts paid to the decedent ($592,078). *Id.* at 254.

[49] *Estate of D'Ambrosio*, 101 F.3d at 311–12.

[50] *Id.* at 311–14.

[51] *See id.* at 311–16 (discussing valuation and the nature of the transfer).

[52] She benefits from adverse selection because she has special knowledge of the state of her health, tipping the actuarial tables in her economic favor.

vent the natural application of full date-of-death estate tax inclusion under the abuse prevention provision—§ 2036.

By having her and her son's company buy an annuity for her in exchange for the value of the remainder interest in the company's stock, and instead of having $2,350,000 included in her estate, their company in theory paid about half that amount ($1,324,014), as calculated by the actuarial tables, for the annuity.[53] In actuality the company spent $592,078—all for about one quarter of that § 2036 date-of-death figure.[54]

In *D'Ambrosio*, the Third Circuit ignored the role of adverse selection and the inaccuracy of the actuarial tables when it offered the following example to support its economic equivalence interpretation of the bona fide sale exception in the statute:

> Assume that a decedent sells his son a remainder interest in . . . Blackacre, which is worth $1 million in fee simple, for its actuarial fair market value of $100,000 (an amount which implicitly includes the market value of Blackacre's expected appreciation). Decedent then invests the proceeds of the sale. *If the rates of return for both assets are equal and decedent lives exactly as long as the actuarial tables predict, the consideration that decedent received for his remainder will equal the value of Blackacre on the date of his death* . . . . We therefore have great difficulty understanding how this transaction could be abusive.[55]

The court's example neglects to acknowledge that: (1) The actuarial tables are more often inaccurate than a true reflection of actual values in any particular circumstance, in part because they assume a constant interest rate over the term equal to the initial month's interest rate and in part because they ignore capital appreciation;[56] (2) because the taxpayer has inti-

[53] *Estate of D'Ambrosio*, 101 F.3d at 311.

[54] *Id.*

[55] *Id.* at 316–17 (emphasis added).

[56] *See* Estate of Cook v. Comm'r, 349 F.3d 850, 854 (5th Cir. 2003) ("In enacting § 7520(a)(1) and requiring valuation by the tables, Congress displayed a preference for convenience and certainty over accuracy in the individual case."). By statute, with very few exceptions, split interest values must be determined under the actuarial tables. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5031(a), 102 Stat. 3342, 3668–69 (codified at I.R.C. § 7520 (2012)) (mandating use of valuation tables). Even before the enactment of § 7520, case law directed that split temporal interests be valued by the tables. Ithaca Tr. Co. v. Comm'r, 279 U.S. 151, 155 (1929). Section 7520(c)(2) requires that interest rates be published monthly, implicitly acknowledging that interest rates will probably vary over any actual term of years. I.R.C.A. § 7520(c)(2) (West 2014). Likewise, compounding the tables' inaccuracies, the principal's growth during a stated term is ignored for valuation by means of the tables. *See* Wendy C. Gerzog, *Annuity Tables Versus Factually Based Estate Tax Valuation: Ithaca Trust Revisited*, 38 REAL PROP. PROB. & TR. J. 745, 752 & n.46 (2004) (discussing the shortcomings of the valuation tables).

mate knowledge of personal variables, such as poor health, the taxpayer only utilizes split interest planning strategies[57] like the one in *D'Ambrosio* when the probabilities favor the use of the actuarial tables—i.e., when the application of the tables is not neutral;[58] and (3) transactions among unrelated third parties do not usually involve voluntarily splitting fee simple interests into different temporal interests.[59]

Section 2036, reflecting the policy reasons for its enactment and application, requires inclusion in decedent's estate of the fair market value of the underlying property at the decedent's death.[60] At a minimum, any sale for less than the full value of the underlying property within three years of decedent's death should be included in the decedent's estate, and § 2035 should be amended accordingly.

Optimally, however, in order to avoid any ambiguity and to stem abuse, § 2036 should be amended to define what interest is to be valued to determine the exemption in that statute. In keeping with the purpose of this anti-abuse I.R.C. section and conceding the role of adverse selection, that interest should be the full value of the underlying property interest and not any split interest created, directly or indirectly, by a taxpayer when she retains any split interest until her death.

Proposal 2: When a transferor splits a property interest and retains an income interest under § 2036, except where the transferee pays full and adequate consideration in money or money's worth equal to the value of the

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[57] These strategies divide a fee simple interest in property into different temporal interests. Although a fee simple interest is valued under a "facts and circumstances" approach, split interests must be valued by means of the actuarial tables. *See* I.R.C. § 2031 (2012) (defining gross estate); *id.* § 7520 (mandating use of valuation tables); Treas. Reg. §§ 20.2031-1(b), 25.2512-1 (2015) (creating rules for valuation of property included in the gross estate). If decedent has a terminal illness where there is a greater than 50% probability that she would die within one year, the actuarial tables cannot be used to value the split interests. Treas. Reg. § 20.7520-3(b)(3) (2015). Where, however, the taxpayer does not have a terminal illness, but has either overall poor health or a more slowly advancing illness or condition (such as some cancers or heart disease), he or she may split a fee interest in property and rely on the actuarial tables to determine valuation. *Id.*

[58] 136 CONG. REC. 30,485, 30,538 (1990).

> Based on average rates of return and life expectancy, those tables are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of Treasury tables undervalues the transferred interests in the aggregate, more often than not.

Id.

[59] By contrast, "[t]emporal interests are commonly created by gifts and bequests, often in trust, in family estate planning." JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 728 (4th ed. 2012). Note that in *D'Ambrosio*, only family members and a company owned by family members are parties to the transactions. *Estate of D'Ambrosio*, 105 T.C. at 253–54.

[60] I.R.C. § 2036.

underlying fee interest in the property, the date-of-death value of the underlying property is included in the decedent's estate.

C. Powers

Some reform recommendations have included proposals to eliminate retained powers from inclusion in decedent's estate.[61] Such a change, however, would encourage transfer tax freezes, thereby eliminating disproportionate and substantial post-transfer appreciation from estate taxation. Consequently, ignoring retained powers would sap § 2036(a)(2) and § 2038 of their anti-abuse protection. For the wealthiest of decedents—those who possess sufficient assets to meet their needs and desires—who want to transfer some assets to family members while at the same time retaining control of their transferred assets, retained power is actually often more important than the retention of those assets themselves.[62]

In a recent article[63] this author proposed the elimination of the five or five power rule under § 2514(e) for gift taxes because it is an unnecessary and complex de minimis provision and, when intertwined with *Crummey*[64] powers, is a fantastical story in its own right. Should that gift tax reform be enacted, eventually there would be no need for the companion estate tax provision under § 2041(b)(2).[65]

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[61] *See* 2 DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 374–80 (1984) (discussing proposed changes to the estate tax and its treatment of retained powers).

[62] *See* Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, *in* RETHINKING ESTATE AND GIFT TAXATION 113, 121–22 (William G. Gale et al. eds., 2001) (emphasizing the strong preference of potential donors for the retention of economic power); Wojciech Kopczuk, *Economics of Estate Taxation: Review of Theory and Evidence*, 63 TAX L. REV. 139, 154 (2009) ("Schmalbeck argues that most tax avoidance strategies require relinquishing control over assets, but that is something most taxpayers are reluctant to do.").

[63] Gerzog, *supra* note 4, at 199–200.

[64] *See supra* notes 11–14 and accompanying text (discussing *Crummey* powers and ILITs).

[65] I.R.C. § 2041(b)(2) (2012). Section 2041(b)(2) provides that a lapse will not be considered a release such as to cause the property to be included in decedent's gross estate to the extent that the value of the property subject to the general power of appointment did not exceed the greater of $5000 or 5% of the aggregate value of the property subject to the power. *Id.* That is, in each year that the decedent, during his lifetime, allowed his power over the statutorily de minimis amount of property to lapse, if he also retained an interest or power over the property in the same way as if he had owned the property outright and then transferred and retained an interest or power under § 2035 through § 2038, decedent would have a proportionate inclusion of the value of that property in his estate. *See* Treas. Reg. §§ 20.2041-3(d)(3)–(5) (2015) (detailing rules related to lapse of a power of appointment).

II. REALITY-BASED VALUATION

Too easily, taxpayers can game the valuation system to avoid paying the appropriate value of transfer taxes. In order to correct this situation, this Part proposes ways to move towards a more reality-based system of valuation. Section A explores the inadequacy of using actuarial tables to value future interests, and argues that the value should be determined and taxed at distribution to the beneficiary at the highest transfer tax rate.[66] Section B proposes that except in the case of an operating business, *no* discounts should be allowed to transfers of entity interests to family members with respect to any liquid assets transferred to that family entity.[67]

A. The Limited Use of Actuarial Tables to Value Future Interests

With respect to a taxpayer's division of a fee interest into its temporal parts, the transfer taxes need to match the timing of taxation with the timing of possession and receipt of partial interests in that fee. That principle and new focus would drastically reduce the current reliance on the actuarial tables for the valuation of donor-decedent-created split interests. Although § 7520 requires partial interests in property, such as remainders, to be valued by the actuarial tables—which have the benefits of simplicity and historical acceptance[68]—*donor-decedent-created* partial interests are the subject of disproportionate valuation manipulation and tax avoidance. Because a transferor decides if and when to employ an estate-planning strategy that relies on actuarial valuation (i.e., adverse selection), transferors naturally only opt to do so when the probabilities are skewed in their favor. Thus, a donor division of a fee interest into its temporal property interests makes the tables factually a non-neutral valuation tool.[69] In order to correct this abuse,

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[66] *See infra* notes 68–78 and accompanying text.

[67] *See infra* notes 79–94 and accompanying text.

[68] *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5031(a), 102 Stat. 3342, 3668 (requiring use of the well-established valuation tables). Prior to the enactment of that statute, the regulations required the use of the tables to value split interests. *See* Treas. Reg. § 20.2031-7(c) (2015) (indicating the applicable regulation and tables for valuing interests in a decedent's estate from before January 1, 1952 to the present date); Treas. Reg. § 25.2512-5(c) (2011) (actuarial tables also necessary to value partial interests for gift tax purposes). In the context of the valuation of lottery winnings in a decedent's estate, some courts have departed from the required use of the tables under I.R.C. § 7520 based on the rationale that the tables do not produce a realistic valuation. *See generally* Gerzog, *supra* note 56 (providing background on the issue of lottery winnings and actuary tables); Wendy C. Gerzog, *The Lottery Cases and Ithaca Trust*, 101 TAX NOTES 289 (2003) (same); Wendy C. Gerzog, *Valuation Discounting and the Lottery Cases*, 137 TAX NOTES 917 (2012) (same).

[69] *See Alternatives to the Current Federal Estate Tax System: Hearing Before the S. Comm. on Finance*, 110th Cong. 1081 (2008) (statement of Joseph M. Dodge, Professor, Florida State University College of Law) ("Actuarial tables are not only inaccurate in individual cases, but can be 'gamed' by such devices as GRATs and private annuities.").

a donor- or decedent-created remainder should be valued and taxed at the life tenant's death. The value of that "future interest" can be accurately determined when the beneficiary actually enjoys the property interest.

At the 2015 Boston College Law School symposium, "The Centennial of the Estate and Gift Tax: Perspectives and Recommendations," Martin Hall, President of the American College of Trust and Estate Counsel Foundation, asked whether the tables could be modified to be more accurate in forecasting value.[70] The author had thought about this issue and considered a few "solutions" in an earlier article on charitable split interests.[71] Those solutions included requiring charitable lead annuity trust ("CLAT") investments to be of a more predictable type, such as U.S. Treasury debt instruments, or enacting a recapture provision for adjustments in value when a CLAT remainderman receives the property. [72] After the Symposium, this author considered specific options to correct the actuarial tables, such as increasing the § 7520(a)(2) multiplier from 120%, using the long-term instead of the mid-term rate, or using some sort of historical weighted average interest rate to more accurately reflect the interest rates that are likely to arise in the future.[73] Certainly, in the current anomalously long period of low interest rates, these suggestions would improve future prediction of value; however, they still are guesses at that value and not immune to gaming. Nonetheless, value is most easily and accurately knowable by waiting until property is possessed by the recipient.

The current proposal is, therefore, that with respect to a donor who directly or indirectly divides a fee interest into different temporal interests, the value of any future interest must be determined and taxed when received by the beneficiary.[74] If the interest is in trust, whenever the future interest is possessed the trustee should be responsible for filing and paying the estate tax at the highest transfer tax rate before the property's distribution to the

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[70] Martin Hall, President, The Am. Coll. of Tr. & Estate Counsel Found., Opening Remarks at Boston College Law School and the American College of Trust and Estate Counsel Foundation Symposium: The Centennial of the Estate and Gift Tax: Perspectives and Recommendations (Oct. 2, 2015).

[71] *See generally* Wendy C. Gerzog, *The Times They Are Not a-Changin': Reforming the Charitable Split Interest Rules (Again)*, 85 CHI.-KENT L. REV. 849 (2010) (reviewing the history of the law pertaining to charitable split interests and proposing solutions to improve simplicity and curtail abuse).

[72] *Id.* at 880–82.

[73] The author discussed this issue with Alex G. Shaller, Fellow, Society of Actuaries, and Harry S. Cohen, Ph.D., Operations Research, M.I.T., and attributes these suggested solutions to them.

[74] This proposal is similar to the one proposed by Professors Mitchell Gans and Jay Soled. *See* Mitchell M. Gans and Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759, 789–90 (2007) (proposing to treat GRATs and qualified personal residence trusts, or QPRTs, as incomplete gifts until the grantor's interest terminates or, at the taxpayer's option, to tax the full value of the property paid to the trust instead of only the remainder value).

beneficiary. Thus, the transfer taxation of a distribution of a future interest should parallel and replicate the taxation of a taxable termination in a generation-skipping transfer trust.[75] By timing the valuation to the date of possession, the real value of the property is known; by requiring the trustee to pay the transfer tax prior to distribution of the property, compliance rates should be high. By taxing the property at the highest transfer tax rate, there will be certainty, ease of calculation, and a further abuse deterrent.

For example, when a grantor creates a grantor-retained annuity trust ("GRAT") for a term of years, the determination of the value of any potential remainder gift would be determined at the end of the grantor's annuity term. For zeroed-out short-term GRATs, if there is any payout after the retained term to a beneficiary (e.g., because of the actual success of the investment or because the actual income produced during the term exceeded expectations), a transfer tax would then be imposed and paid by the trustee before distribution to any third party.

The media have described how billionaires will have skirted hundreds of millions of dollars in estimated transfer taxes by means of GRATs.[76] Therefore, not surprisingly, since the U.S. Tax Court's decision in *Walton v. Commissioner* in 2000, [77] there have been many suggestions to curtail the use of short-term zeroed-out GRATs.[78] The Obama Administration's proposals to

[75] *See* I.R.C. § 2611 (2012) (defining generation-skipping transfers); I.R.C. § 2612 (2012) (defining taxable terminations); I.R.C. § 2613 (2012) (defining skip persons).

[76] *See, e.g.*, Deborah L. Jacobs, *Zuckerberg, Moskovitz Give Big Bucks to Unborn Kids*, FORBES (Mar. 7, 2012), http://www.forbes.com/sites/deborahljacobs/2012/03/07/facebook-billionaires-shifted-more-than-200-million-gift-tax-free/#44f515e95614 [https://perma.cc/472K-XFH3] (explaining how Mark Zuckerberg, Dustin Moskovitz, and Sheryl Sandberg can use GRATs to make a combined $204,353,993 of tax-free transfers); Laura Saunders, *How Facebook's Elite Skirt Estate Tax*, WALL STREET J. (May 11, 2012), http://www.wsj.com/articles/SB10001424052702304543904577395971333422002 [https://perma.cc/Y5RE-9BPS] (discussing how using these devices and freezing values allow billionaires to avoid estimates of "about $100 million for Mr. Zuckerberg and more than $415 million for Mr. Moskovitz").

[77] *See generally* Walton v. Comm'r, 115 T.C. 589 (2000) (determining the valuation under § 2702 of gifts resulting from petitioner's creation of two GRATs), *acq.*, 2003-2 C.B. 964.

[78] *See, e.g.*, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 197–99 (2015) (proposing GRATs have a minimum term of ten years and requiring the remainder interest to have a minimum value at the time of creation); Paul L. Caron & James R. Repetti, *Revitalizing the Estate Tax: 5 Easy Pieces*, 142 TAX NOTES 1231, 1240 (2014) (proposing a lifetime limit on GRATs). In particular, the Treasury proposal stated:

> The proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years to impose some downside risk in the use of a GRAT. The proposal also would include a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). In addition, the proposal would prohibit any decrease in the annuity during the

increase the § 2036 exposure by requiring a longer term for GRATs are an improvement to the current transfer tax treatment. The present proposal, however, would eliminate most of the present transfer tax benefits of employing a GRAT and would better reflect a reality-based approach to its use.

Proposal 3: When a transferor directly or indirectly divides a fee interest into temporal interests, the value of any future interest shall be determined and taxed at distribution to the beneficiary at the highest transfer tax rate.

B. Non-Business Family Entity Discounts

Older generation family members create entities to which they transfer liquid assets like cash or marketable securities.[79] In return they receive heavily discounted entity interests that are passed to younger generations.[80] In order to eliminate unwarranted and unreal lack-of-marketability[81] and minority[82] discounts accorded non-business entities, such as family limited partnerships and family limited liability companies, transfer taxes on transfers of interests in those non-business entities should be assessed on the undiscounted asset values represented by those transferred interests. The transfer would need to be a "transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)" in order to be exempt from this valuation rule.[83]

> GRAT term, and would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust.

DEP'T OF THE TREASURY, *supra*, at 198.

[79] *See* Martha Britton Eller, *Which Estates Are Affected by the Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001*, STAT. INCOME BULL., Summer 2005, at 1, 11–12, http://www.irs.gov/pub/irs-soi/01esyod.pdf [https://perma.cc/F8YB-NT74] (describing how older family members contribute assets to a family limited partnership which are in turn passed to younger generations).

[80] *See id.* at 11 (noting the substantial discounts created by gifting interests in a family limited partnership). The transferred assets are discounted to values between 30% and 60% of their fair market value.

[81] Because the entity or state law imposes restrictions on the transferability of such entity interests, gifts of those interests are normally entitled to lack-of-marketability discounts. Here, however, the underlying assets are freely marketable and are transferred to the entity for estate tax reduction, and not for business, purposes. Eliminating those transfer tax valuation benefits would result in the end of such transfers.

[82] The values of those gifts are also normally entitled to a minority (lack of control) discount because holders of those interests cannot freely control the entity's assets. But, in a non-business estate-planning context, there is no reason for these transfer tax valuation benefits either. *See* Estate of Strangi v. Comm'r, 115 T.C. 478, 495 (2000) (Parr, J., dissenting) ("If a hypothetical third party had offered to purchase the assets held by the partnership for the full fair market value of those assets, there is little doubt that decedent could have had the assets distributed to himself to complete the sale.").

[83] Estate of Bongard v. Comm'r, 124 T.C. 95, 145–47 (2005); Treas. Reg. § 25.2512-8 (2015). In *Estate of Bongard v. Commissioner*, Judge Halpern in a dissenting opinion stated that the proper focus of the bona fide sale exception is an economic calculus and not a motive inquiry.

In an earlier article, this author proposed prototype amendments to the regulations under I.R.C. § 2031.[84] That article proposed modifying the fair market value definition where the parties are not acting as customary parties to a sale, i.e., where a seller intentionally devalues property for transfer tax valuation purposes.[85] According to that proposal, "A buyer is one who is seeking to pay the lowest price for property and a seller is one who is seeking to sell property at its highest price."[86] Except where the transfer falls under the "ordinary course of business exception" in the gift tax regulations, when a transferor has intentionally devalued his property, the normally applied fair market value definition in the estate tax regulations would not be used to value the devalued asset; instead, the asset's value "must be determined without regard to the volitional acts of valuation depression."[87] A presumption of intent to devalue property would apply where the transferor converted liquid assets into illiquid ones and would be evidenced by associated gift-giving as well as the transferor's ill health or age at or near the date of the volitional devaluation.[88]

The IRS recently announced proposed regulations under § 2704(b) to close this tax avoidance strategy.[89] Section 2704(b)(4) specifically provides for additional restrictions imposed by the regulations.[90] Section 2704(b)(3)(B), however, specifically excepts from the definition of an "ap-

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Estate of Bongard, 124 T.C. at 145–47 (Halpern, J., concurring in part, dissenting in part). Also in *Estate of Bongard*, Judge Laro asserted that the court should continue to apply the business purpose test laid out in Gregory v. Helvering. *Id.* at 139 (Laro, J., concurring) (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)). In 2004, in *Estate of Thompson v. Commissioner*, the Court of Appeals for the Third Circuit cited to the business purpose test in *Gregory*. *Estate of Thompson v. Comm'r*, 382 F.3d 367, 383 (3d Cir. 2004) (citing *Gregory*, 293 U.S. at 469)).

[84] Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775, 803–04 (2008) (proposing a new regulation, § 20.2031-1(c)).

[85] *Id.*

[86] *Id.* at 803.

[87] *Id.* at 803–04.

[88] *Id.*

[89] *See* Paul Sullivan, *Navigating Tougher I.R.S. Rules for Family Partnerships*, N.Y. TIMES (Aug. 7, 2015), http://www.nytimes.com/2015/08/08/your-money/navigating-tougher-irs-rules-for-family-partnerships.html?_r=1 (reporting on IRS plans to tighten rules related to tax avoidance by means of family partnerships); Letter from Ronald D. Aucutt, Past President, The Am. Coll. of Tr. & Estate Counsel Found., Capital Letter No. 38: Anticipated Valuation Discount Regulations (July 20, 2015), http://www.actec.org/resources/capital-letter-no-38/ [https://perma.cc/BQF8-N6GZ] (discussing the history of I.R.C. § 2704(b) and forthcoming proposed regulations).

[90] I.R.C. § 2704(b)(4) (2012). This section provides:

> The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

Id.

plicable restriction" "any restriction imposed, or required to be imposed, by any Federal or State law."[91] That language has been the problem with enforcing this statute as the law was originally intended.[92] Hopefully the proposed regulations will find a successful way to avoid that issue. Alternatively, the present suggestion is that this valuation issue is better addressed in new regulations under § 2031, which contains the fair market value definition and is not subject to any restriction like the one in § 2704(b)(3)(B).[93] Moreover, after much speculation about the § 2704(b) proposed regulations, the government has lowered expectations about their reach[94] and, in fact, has not released them as of early 2016.

Proposal 4: Except in the case an operating business, *no* discounts shall be allowed to transfers of entity interests to family members with respect to any liquid assets transferred to that family entity.

III. REALITY-BASED DEDUCTIONS

Two of the most popular deductions under the I.R.C. can be warped to the point that they no longer operate in accordance with their underlying policies. The marital and charitable deductions have, over time, either been diluted by Congress or exploited by tax planners to create tax advantages that do not comport with reality. Thus, section A proposes changes to the application of the marital deduction, including the repeal of certain provisions.[95] Section B offers alterations to the determination of the charitable deduction in order to refocus the deduction on the gift to the actual charity.[96]

A. Marital Deduction

Married taxpayers may take a marital deduction to defer estate and gift taxes on property that passes between them.[97] Virtually all married couples

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[91] *Id.* § 2704(b)(3)(B).

[92] *See* Kerr v. Comm'r, 113 T.C. 449, 473 (1999) (holding in favor of the taxpayer because the partnership agreements' liquidation restriction "was no more restrictive than the limitations that generally would apply to the partnerships under Texas law"), *aff'd*, 202 F.3d 490 (5th Cir. 2002).

[93] *See supra* notes 84–88 and accompanying text (detailing the author's proposal for new regulations under § 2031).

[94] *See* William R. Davis, *Valuation Discount Rules to Rely on Statute, Not Obama Proposal*, TAX NOTES (Nov. 6, 2015), http://www.taxnotes.com/tax-notes-today/estate-gift-and-inheritance-taxes/valuation-discount-rules-rely-statute-not-obama-proposal/2015/11/06/17526161 [https://perma.cc/8E23-YYUX] (noting tempered expectations for the proposed regulations).

[95] *See infra* note 97–109 and accompanying text.

[96] *See infra* note 110–114 and accompanying text.

[97] I.R.C. § 2056 (2012). Congress enacted the marital deduction in 1948 in order to give married couples in common law states tax benefits comparable to the tax benefits available in community property law jurisdictions. Revenue Act of 1948, Pub. L. No. 80-471, § 361, 62 Stat. 110, 117–21; H.R. REP. NO. 1274-80, at 21–26 (1948); S. REP. NO. 1013-80, at 22–29 (1948). For the

and almost half of all decedents use and benefit from the marital deduction, which costs the government billions of dollars in current revenue.[98] Since its enactment in 1981,[99] the qualified terminable interest property ("QTIP") marital deduction trust has become the most popular form of the marital deduction.[100] The QTIP provisions are an exception to the marital deduction terminable interest rule.[101] Unlike the terminable interest exception for a qualifying income interest coupled with a general power of appointment, the QTIP exception allows the predeceasing spouse to receive the benefits of a marital deduction without ceding control or ownership of the transferred property to the surviving spouse. The fiction of the QTIP as a marital transfer is intrinsically abusive.[102] It also results in a significant current revenue loss.[103]

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next twenty-eight years, Congress made only minor revisions to the marital deduction provisions, e.g., it amended § 812(e) so that life estates as well as income interests in a trust would qualify for the marital deduction where they were combined with a general power of appointment in the surviving spouse. *See* JOINT COMM. ON INTERNAL REVENUE TAXATION, 83D CONG., SUMMARY OF THE NEW PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 (H.R. 8300), at 115 (Comm. Print 1955) (explaining a 1954 amendment expanding marital deductions). In 1976, however, in order to allow married persons to transfer small or moderate estates to each other tax free, Congress increased the estate tax marital deduction to the greater of $250,000 or one half of the decedent's adjusted gross estate. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(a)(1)(A), 90 Stat. 1520, 1854; H.R. REP. NO. 1380-94, at 17 (1976). At the same time and for substantially the same reason, Congress expanded the gift tax marital deduction to shield the first $100,000 of interspousal gifts as well as 50% of such gifts above $200,000. Tax Reform Act of 1976 § 2002(b), (d)(2) (amending I.R.C. § 2523(a) (1954)). Between 1976 and 1981, Congress again made only minor revisions in the marital deduction provisions.

[98] INTERNAL REVENUE SERV., STATISTICS OF INCOME: ESTATE TAX STATISTICS, https://www.irs.gov/pub/irs-soi/10esesttaxsnap.pdf [https://perma.cc/KJC6-V562]. Using data from estate tax returns filed in 2009, statistics indicate that "97 percent of the estates of married decedents, and 48 percent of estates overall, reported deductions for marital bequests, for a total of $42 billion." *Id.* Additionally, "[o]nly 9 percent of estates with a marital bequest owed estate tax." *Id.*

[99] Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 403(d)(1), 95 Stat. 172, 302–03. QTIP is the acronym for "qualified terminable interest property," which is defined as property: (1) which passes from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which an election under this paragraph applies. I.R.C. §§ 2056(b)(7)(B)(i), 2523(f)(2) (2012); Treas. Reg. §§ 20.2056(b)-7(b), 25.2523(f)-1(b) (2015).

[100] *See* Ira Mark Bloom, *The Treatment of Trust and Other Partial Interests of the Surviving Spouse Under the Redesigned Elective-Share System: Some Concerns and Suggestions*, 55 ALB. L. REV. 941, 955 (1992) (offering an example applicable to "both the multiple-marriage society phenomenon and the popularity of QTIP dispositions"); Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 466 (2001) ("In estates of the well-off, the most popular form of marital bequest is the QTIP trust . . . .").

[101] *See* Dodge, *supra* note 100, at 464–65.

[102] *See generally* Wendy C. Gerzog, *The Marital Deduction QTIP Provisions: Illogical and Degrading to Women*, 5 UCLA WOMEN'S L.J. 301 (1995) (describing the flaws with QTIPs).

[103] *See supra* note 92 and accompanying text (noting that the government has had difficulty enforcing I.R.C. § 2704(b)).

In order to make the marital deduction reflective of a purely marital and not third-party transfer, the QTIP provisions and the reverse-QTIP election generation-skipping tax ("GST") provision[104] should be repealed. The main features of this proposal are outlined elsewhere,[105] but essentially the power of appointment ("PAT") trust form would be amended to be a strengthened equivalent of outright ownership so that only outright transfers or a strengthened power of appointment trust transfer would qualify for the tax deferral benefits of the marital deduction.[106] That is, only where the donee or recipient spouse actually has control over, and an ownership interest in, the transferred property is the donor spouse entitled to a transfer tax marital deduction.[107] In addition, the proposal provides for amending the PAT and the GST provisions in order to preserve the computational flexibility currently afforded the QTIP provisions, which assist the taxpayer in receiving the full use of exemptions, including both federal and state estate tax benefits where applicable.[108]

The rationale for this change is that the marital deduction should only be available where both spouses have equivalent ownership of "their" property. That was the underpinning for the unlimited marital deduction.[109] The QTIP provisions, however, encourage spouses to transfer less than a full property interest to their mates by providing the donors with a marital deduction based on the value of the underlying property, although they actually give their spouses only a lifetime income interest in that property. The marital deduction was intended to cover actual transfers of a fee property interest between spouses and was not intended for transfers of limited in-

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[104] I.R.C. § 2652(a)(3) (2012).

[105] *See generally* Wendy C. Gerzog, *The New Super-Charged PAT (Power of Appointment Trust)*, 48 HOUS. L. REV. 507 (2011) (critiquing the QTIP and proposing to weaken the QTIP in favor of a PAT form of marital deduction).

[106] *See id.* at 539–42 (describing the benefits of creating a "super-charged" PAT).

[107] *See id.* (explaining the structure of a "super-charged" PAT).

[108] *Id.*

[109] In 1981, besides enacting the QTIP provision exception to the terminable interest rule, Congress enacted the unlimited marital deduction. I.R.C. § 2056(a). ERTA also repealed I.R.C. § 2056(c) (1954), which contained the dollar and percentage limitations placed on the deduction. Economic Recovery Tax Act of 1981 § 403(a)(1)(A). The unlimited marital deduction reflected a decision to treat a husband and wife as one unit for the purposes of transfer taxation. S. REP. NO. 97-144, at 127 (1981). That decision paralleled the choice of the married couple as the proper unit for income taxation and solidified the concept that a husband and wife's property is really "theirs." *See id*. The ALI recommended the unlimited marital deduction as a way that married couples, in transferring property to others, could take full advantage of both spouses' lower transfer tax brackets. *See* AM. LAW INST., FEDERAL ESTATE AND GIFT TAXATION: RECOMMENDATIONS ADOPTED BY THE AMERICAN LAW INSTITUTE AND REPORTERS' STUDIES 32–33 (1968) (proposing a 100% marital deduction); *see also* Joseph Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction,* 51 U. CHI. L. REV. 1, 31 (1984) ("Viewed broadly, the unlimited marital deduction has the effect of treating spouses as a single taxpayer with a lifetime equal to the survivor's.").

come interests to a spouse (hence, the nondeductible terminable interest rule). In order to preserve that original intention and not marginalize the recipient spouse, the QTIP statute should be repealed.

Proposal 5: Repeal the QTIP statute and replace it with a PAT, modified to allow for both a reverse PAT and a state-only PAT election.

B. Charitable Deduction

There are numerous policy reasons for giving preferential tax treatment to charitable donations.[110] Unfortunately, those tax benefits can be realized by individuals who do not share the purpose of charitable deductions. The charitable deduction should be allowed only where the deduction primarily benefits a charity and not where a split-interest transfer to a charity is designed to benefit mainly the non-charitable beneficiary. Yet, this skewed focus is touted by charities and estate planners to encourage the use of a CLAT. In a CLAT, the value of the gratuitous transfer to the charity is secondary. Instead, a CLAT is promoted with such labels as "Charitable Lead Trusts for the Noncharitably Inclined."[111]

Under current law, instead of making a direct gift of a remainder interest to a family member, more value can pass to a beneficiary free of transfer tax by incorporating a charitable donation into the transfer. A CLAT is the preferred strategy to use for this result because "the annuity remains fixed and more property can go [untaxed] to the family beneficiaries."[112] Donors are enticed by the charity's advertisements of the CLAT as a "'powerful tool,' as a device that results 'in little or no taxes,' and more."[113] The CLAT

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[110] *See* Miranda Perry Fleischer, *Libertarianism and the Charitable Tax Subsidies*, 56 B.C. L. REV. 1345, 1351–54 (2015) (providing a brief summary of several policy rationales for subsidizing charitable donations through the tax code).

[111] KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS ¶ 35.09 (abridged student ed. 2003). As one scholar stated,

> If the donor is not actually charitably inclined, but is simply interested in transferring property to his descendants in the least costly way, a comparison can be made between the amount the family beneficiaries would have as remainder beneficiaries of the CLT and the amount they would have as recipients of an outright gift of the initial value of the remainder interest in the CLT. Under this comparative analysis, the CLT gets more money to the beneficiaries if the property actually earns more than the 7520 rate, and vice versa.

Id.

[112] *Id.* ¶ 35.08.

[113] *Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning: Hearing Before the S. Comm. on Finance*, 110th Cong. 38 (2008) (statement of Diana Aviv, President & CEO, Independent Sector). Describing the powerful tax incentive CLATs create, one practitioner explained:

> Take, for example, a donor who wants to set up a 10-year CLAT and zero out the gift to the remainder beneficiaries . . . . Assuming a section 7520 rate of 3.4% (May

achieves this benefit because the non-charitable interest is valued and taxed under current law when the CLAT is created, and that valuation is based on the actuarial tables that routinely undervalue the remainder interest and ignore the actual growth and income of the investment in the trust.[114]

Therefore, in order to refocus the charitable deduction on the gift to the charity, either the CLAT provisions should be repealed or the non-charitable interest should be valued and taxed at the time it is actually received by the beneficiary. In that way, the CLAT transferor would pay his or her fair share of transfer taxes for that part of the CLAT transfer that solely benefits the non-charitable beneficiary.

Proposal 6: When the property is distributed to the non-charitable donee in a CLAT, the trustee shall pay a transfer tax, at the highest transfer tax rate, from trust assets at distribution.

CONCLUSION

Reforming the estate tax requires transforming the estate tax into a more reality-based tax. In so doing, the estate tax will eliminate most of the abuses that have become rampant in the current estate tax regime. The estate tax should apply to inherently testamentary transfers and should reject unreal valuation discounts and actuarial valuation gaming. On the deduction side, a reformed estate tax should make the marital deduction more intra-spousal and should make the charitable deduction mainly a benefit for the charity.

> 2010), this donor could set up a 10-year CLAT with a steady annuity of $598,179 per year. In other words, a contribution of $5 million to the CLAT would provide a $5 million income tax deduction and a zero taxable gift. Assuming an after-tax growth rate of 6%, $1,069,762 would be left in the trust at the end of the trust term to be distributed to beneficiaries.

Scott E. Testa, *Charitable Planning: CRTs, CLTs and the Increasing Payment CLAT*, J. ACCT. (July 1, 2010), http://www.journalofaccountancy.com/issues/2010/jul/20102678.html [https://perma.cc/L8WV-YWHF].

[114] *See* Wendy C. Gerzog, *From the Greedy to the Needy*, 87 OR. L. REV. 1133, 1164–67 (2009) (explaining the tax benefits of a CLT and CLATs); Gerzog, *supra* note 71, at 877 (same).