TOWARD AN INTEGRATED TAX TREATMENT OF GIFTS AND INHERITANCES

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INTRODUCTION

The Economic Growth and Tax Reconciliation Act of 2001 (the "2001 Tax Act" or the "Act")[1] crafted the most dramatic changes in the tax treatment of gifts and inheritances since the adoption of the estate tax in 1916.[2] The 2001 Tax Act, signed by President George W. Bush on June 7, 2001, is sweeping in its impact and provides for perhaps the most interesting sunset[3] in tax legislative history.[4] Beginning in 2002, and continuing through 2009, the 2001 Tax Act gradually reduces estate and generation-skipping taxes[5] through rate reduction and by increasing the amount of the unified credit

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1 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter 2001 Tax Act].

2 *Id.* Section 2001 of the Internal Revenue Code imposes a tax on "the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." I.R.C. § 2001 (2003). An estate tax "falls on the net assets of a deceased individual, as opposed to an inheritance tax, which falls on the heir, or a gift tax, which applies only to living donors." Edward J. McCaffery, *Grave Robbers: The Moral Case Against the Death Tax*, 85 TAX NOTES 1429, 1430 (1999).

3 "Sunset law" is defined as "[a] statute under which a governmental agency or program automatically terminates at the end of a fixed period unless it is formally renewed." BLACK'S LAW DICTIONARY 1450 (7th ed. 1999).

4 2001 Tax Act, *supra* note 1, § 901.

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> A [generation-skipping tax] is imposed on all transfers, made either directly or through a trust or similar arrangement to remote generations (generally, bypassing children in favor of grandchildren) as though the assets had been transferred to each succeeding generation (that is, from parents to children and from children to grandchildren). Essentially, the [generation-skipping tax] imposes a flat tax at the maximum estate tax rate . . . on cumulative transfers deemed to be inter-generational, subject to an inflation-adjusted exemption.

Charles P. Rettig, *The Life and Death of Estate Taxes*, 24 L.A. LAW. 32, 34 (Nov. 2001).

exemption.[6] To the delight of estate tax opponents, the 2001 Tax Act provides for a complete elimination of the estate tax in 2010.[7] To the consternation of these same estate tax opponents, however, the estate tax returns to its pre-2001 Tax Act form in 2011.[8] The sunset was necessary in order to keep the overall cost of the 2001 Tax Act within President Bush's target of $1.35 trillion in overall tax reduction.[9]

The 2001 Tax Act's treatment of the gift tax is more limited. The Act dictates a one-time increase in the gift tax exemption to $1 million in 2002 and reduces the gift tax rates, along with the estate tax and generation-skipping tax rates, through 2009.[10] Congress retained the gift tax in 2010 to avert a massive shift in wealth to younger generations before the return of the estate tax in 2011.[11] Since the 2001 Tax Act calls for the repeal of the estate tax for only one year, Congress feared that if it repealed the gift tax in the same year, individuals would take advantage of this tax-free year and gift

[6] 2001 Tax Act, *supra* note 1, § 511 (authorizing the reduction in tax rates); *id.* § 521 (authorizing the increase in exclusion amounts). The Internal Revenue Code dictates that "a credit of the applicable credit amount shall be allowed to the estate of every decedent against the tax imposed by § 2001." I.R.C. § 2010 (2003).

[7] 2001 Tax Act, *supra* note 1, §§ 511, 521.

[8] *Id.* § 901. In other words, without further legislation, the 2001 Tax Act does not apply after December 31, 2010. Jack MacGregor Campbell, *The 2001 Tax Cuts 'Sunset'—But Didn't Have To. Here's Why*, 95 TAX NOTES 623, 623 (2002). Some commentators believe the sunset provision was enacted to guarantee compliance with the Congressional Budget Act and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (1974) (codified as amended in 2 U.S.C. §§ 602-692 (2000)). Campbell, *supra*, at 624.

[9] Glenn Kessler & Juliet Eilperin, *Congress Passes $1.35 Trillion Tax Cut; Lawmakers Hand Bush A Big Legislative Victory*, WASH. POST, May 21, 2001, at A01 ("[T]o keep the overall cost within the 11-year, $1.35 trillion framework required by the congressional budget outline, many . . . parts of the plan are delayed . . . ."). The 2001 Tax Act sunsets in 2011, an "accounting maneuver that kept the cost below $1.35 trillion and allowed a deal to be struck." *Id.* Yet, the "tax law passed with the euphoria of large budget surpluses. With the economic slowdown, these budget surpluses have vanished. The change in economic forecasts make the freezing or modification of the new tax very likely." *Estate Tax 'Repeal' Not Really Reform*, PITTSBURGH POST-GAZETTE, Oct. 2, 2001, at E-3. When the 2001 Tax Act passed, "markets were sky high, the budget was inching back into surplus because of a healthy economy, and Republicans wanted to reward wealthy contributors." James O. Goldsborough, *Permanent Estate-Tax Repeal Bad Fiscal Policy*, SAN DIEGO UNION-TRIB., June 13, 2002, at B13; *see* D. Mark Wilson & William W. Beach, *The Economic Impact of President Bush's Tax Relief Plan* (discussing the economic effects of the 2001 Tax Act), *at* http://www.heritage.org/Research/Taxes/CDA01-01.cfm (Apr. 27, 2001) (on file with author).

[10] 2001 Tax Act, *supra* note 1, §§ 511, 521.

[11] See *infra* notes 180-87 and accompanying text for a discussion of potential tax avoidance associated with gift tax repeal.

substantial assets,[12] resulting in significantly reduced estates subject to taxation upon the return of the estate tax to its pre-2001 Tax Act level.[13]

Another important 2010 tax event is that the Act adopts a carryover basis for bequests and inheritances, replacing the current system that uses the fair market value at date of death to determine the basis of inherited property.[14] This change to a carryover basis for inheritances removes the bias that existed in favor of bequests at death, rather than gifts during life.[15]

The President has called on Congress to make permanent the repeal of the estate tax.[16] In calling for permanent repeal, however, the President has remained silent on whether a repeal of the gift tax should be pursued.[17] Nor do any of the current proposals mention the income tax exclusion of gifts and inheritances under § 102 of the Internal Revenue Code ("§ 102")[18]—a provision untouched by the 2001 Tax Act.[19] Section 102 specifically excludes gifts and inheritances from the recipient's gross income; thus, such recipients do not include the value of gifts and inheritances in their income base.[20] This disconnect between the income tax treatment and the

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[12] *Id.*

[13] *Id.*

[14] *Compare* I.R.C. § 1014 (2003), *with* 2001 Tax Act, *supra* note 1, §§ 541, 542 (replacing a fair market value basis with a carryover basis). For example, Jane Doe purchases 100 shares of stock in XYZ for $100 in 1980. In 2010, Jane Doe dies leaving the stock to her son, John. In 2010, the value of the 100 shares of stock is $5,000. In a carryover basis regime, the basis in the stock would be transferred from Jane to John; thus, John's basis in the stock would be $100. Yet, under a fair market value basis system, the fair market value basis would be $5,000. If John later sells the stock for $6,000, he would either be taxed on $5,900 in a carryover basis system or $1,000 in a fair market value basis system.

[15] Krisanne M. Schlachter, *Repeal of the Federal Estate and Gift Tax: Will It Happen and How Will It Affect Our Progressive Tax System*, 19 VA. TAX REV. 781, 783 (2000).

[16] President Bush hopes to permanently repeal the estate tax. Joel Friedman, *Estate Tax Repeal Would Be Costly, Yet Benefit Only a Few*, 95 TAX NOTES 1984, 1984 (2002). Furthermore, the House introduced a bill entitled the "Permanent Death Tax Repeal Act of 2003" to the House on January 7, 2003. H.R. 139, 108th Cong. § 2 (2003). The same bill was introduced to the Senate on January 15, 2003. S. 169, 108th Cong. § 2 (2003). The House passed another bill, "The Death Tax Permanency Act of 2003," to permanently repeal the estate tax. H.R. 57, 108th Cong. § 2 (2003). "Because he [President Bush] enjoys narrow but probably adequate majorities in both houses of Congress, it would seem at this point that repeal is more likely than not." Richard Schmalbeck, *The Death of the 'Death Tax'?*, 48 CLEV. ST. L. REV. 749, 749 (2000).

[17] *See* Friedman, *supra* note 16, at 1984.

[18] I.R.C. § 102(a) (2003).

[19] 2001 Tax Act, *supra* note 1.

[20] *Id.*

transfer tax treatment of gifts and inheritances is surprising since a longstanding justification for the exclusion of gifts and inheritances from gross income is the existence of the transfer tax.[21] Future legislation making the estate tax repeal permanent is a certainty. Consideration of permanent repeal will necessitate a reexamination of the income tax treatment of gifts and inheritances in order to ensure a comprehensive tax structure for wealth transfers.

The focus of this Comment is the overall tax treatment of gifts and inheritances in an estate tax-free world, should the repeal of the estate tax in 2010 become permanent. Specifically, it asks whether the exclusion of gifts and inheritances from the recipient's gross income under § 102 should continue in an environment free of wealth transfer taxes. Secondly, this Comment addresses whether Congress should repeal the gift tax given the policy justifications supporting the repeal of the estate tax. Ultimately, this Comment concludes that should the estate tax repeal be made permanent, Congress should repeal both the gift tax and the exclusion of gifts and inheritances from the recipient's gross income. Thus, the recipient (rather than the transferor) would be responsible for the payment of a tax on all gifts and inheritances received.[22]

Part I of this Comment discusses the history of the tax treatment of gifts and inheritances. Part II reviews the historical arguments for and against estate and gift taxes. Part III explains the 2001 Tax Act and the changes it dictates. Part IV contends that should Congress decide to make the repeal of the estate tax permanent, consistent tax policy requires a repeal of the gift tax as well. More importantly, a permanent repeal of the estate and gift taxes should be coupled with the repeal of the income tax exclusion of gifts and inheritances under § 102. This Comment determines that no rationale exists for a gift tax other than safeguarding a future tax base should a permanently repealed estate tax prove to be less than permanent. Moreover, it maintains that the permanent repeal of the estate tax, along with gift tax repeal, requires a reexamination of the justifications for excluding gifts and inheritances from gross income. This Comment concludes that sound tax policy necessitates § 102 repeal. Further, it reveals that the principles underlying the gift tax and income tax exclusion of gifts and inheritances collapse without

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[21] Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955, 961 (2001).

[22] Actually, the tax would be paid on all gifts and inheritances received above a certain exemption amount. See *infra* notes 273-76 and accompanying text for a suggested exemption amount.

the added justification of an estate tax.

I. HISTORY AND CURRENT TAX TREATMENT OF GIFTS AND INHERITANCES UNDER THE INTERNAL REVENUE CODE

Although the modern estate tax came into existence in 1916, efforts to impose some tax on the transfer of wealth dates back almost to the founding of our nation.[23] In 1797, for example, Congress imposed a stamp tax or duty on legacies and intestate shares of personalty.[24] For the most part, however, Congress did not consider levies on such wealth transfers until the fiscal demands of the Civil War drastically increased the need for funds.[25]

This increased need for revenue led to the first American income tax[26] in 1861.[27] This original income tax, however, excluded gifts.[28] One year later, Congress nullified this tax[29] in favor of another income tax and separate inheritance tax.[30] In 1864, as revenue needs

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[23] William A. Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 MINN. L. REV. 215, 229-31, 235-36 (1963) (discussing early income taxes); *see* MAX WEST, THE INHERITANCE TAX 87 (1908) (discussing the history and policy underlying inheritance taxes); Louis Eisenstein, *The Rise and Decline of the Estate Tax*, *in* FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 819 (Joint Comm. Print 1955) (tracing the estate and gift taxes by the government's need for revenue).

[24] Act of July 6, 1797, ch. 11, 1 Stat. 527 (effective 1798-1802) [hereinafter Stamp Act]. "Personalty" is defined as "[p]ersonal property as distinguished from real property." BLACK'S LAW DICTIONARY 1164 (7th ed. 1999). See Eisenstein, *supra* note 23, at 820, for a discussion of the Stamp Act. The Stamp Act was a form of a death tax because federal stamps were required on wills offered for probate, inventories and letters of administration, and receipts and discharges from legacies and intestate distributions of property. Barry W. Johnson & Martha Britton Eller, *Federal Taxation of Inheritance and Wealth Transfers* 3, 4, *at* http://www.irs.gov/taxstats/article/0,,id=106176,00.html (Mar. 2001) (on file with author). After the naval war with France ended and the need for revenue decreased, Congress repealed the Stamp Act. *Id.*

[25] RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 9 (1954). During America's early history, congressional debates focused on the proper tax system, i.e., income or inheritance tax, and the proper rates, rather than center on the scope of the tax. Klein, *supra* note 23, at 231. During this time period, Klein suggests that gift taxation was not a pressing issue. *Id.*; *see* C. Lowell Harriss, *Legislative History of Federal Gift Taxation*, 18 TAXES 531, 538 (1940) (stating that "there were no debates with scholarly discussion of the pros and cons of alternative methods of taxing or not taxing gifts," but noting that the essential issues were presented to Congress).

[26] An "income tax" is "a tax on an individual's or entity's net income." BLACK'S LAW DICTIONARY 1470 (7th ed. 1999).

[27] Act of Aug. 5, 1861, ch. 45, 12 Stat. 292, 309 (effective 1861); PAUL, *supra* note 25, at 9; *see* Harriss, *supra* note 25, at 531 (discussing the first income tax).

[28] *Id.*

[29] Klein, *supra* note 23, at 231 (noting that the first income tax in 1861 "was so badly drafted" that the government "did nothing to enforce it").

[30] Act of July 1, 1862, ch. 119, 12 Stat. 432, 473, 485 (effective 1862-1863); Klein,

again mounted, inheritance tax rates increased and Congress adopted a succession tax on gifts conveying real property, thereby establishing the first gift tax.[31]

Following the Civil War, Congress abolished both the income tax and inheritance tax.[32] Even though there was little debate regarding the repeal of the inheritance tax in the House of Representatives, "there seemed to be no widespread objection to these taxes."[33] Although Congress repealed the inheritance tax, Congress generally viewed the inheritance tax as "just and equitable."[34] Yet, Congress posited that it was inequitable to tax direct heirs when the government's need for revenue was minimal.[35] Congress also abolished the inheritance tax because of administrative feasibility concerns regarding collection.[36] The driving force leading to the repeal of both the income tax and inheritance tax, however, was largely the government's decreased need for revenue.[37]

The need for revenue, and a desire to provide a more equitable tax burden, brought income and estate taxes to Congress's attention once again in 1894.[38] In that year, Congress, responding to political pressure from Populists, reformers and intellectuals, passed an

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supra note 23, at 231 (stating that gifts that took effect after the Civil War were included in the inheritance tax). An "inheritance tax" is "a tax imposed on a person who inherits property from another (unlike an estate tax, which is imposed on the decedent's estate)." BLACK'S LAW DICTIONARY 1470 (7th ed. 1999). See SIDNEY RATNER, AMERICAN TAXATION 73-77 (1942), for an overview of tax policy after the Civil War. See generally WILLIAM J. SCHULTZ, THE TAXATION OF INHERITANCE 98-167 (1926), for a discussion of taxes on inheritances.

[31] Act of June 30, 1864, ch. 173, 13 Stat. 285, 288 (effective 1864) [hereinafter 1864 Act]; RATNER, *supra* note 30, at 88 (discussing the 1864 Act). "The 1864 Act, although altered by subsequent legislation, introduced several features, which later formed the foundation of the modern transfer tax system." Johnson & Eller, *supra* note 24, at 6. For example, "[s]ome of these features included the exemption of small estates, the taxation of certain lifetime transfers that were testamentary in nature, and the special treatment of bequests to the surviving spouses." *Id.*

[32] RATNER, *supra* note 30, at 121-27, 129 (discussing the debate following the Civil War regarding the preservation of taxes).

[33] *Id.* at 128.

[34] *Id.* at 129 (internal citations omitted) ("Nevertheless, these justifications for the inheritance taxes failed to prevent their elimination from the federal revenue system at a time when capitalism in America was receiving a new impetus, and when some corrective or restriction on the undue concentration of wealth was needed.").

[35] *Id.* at 128.

[36] *Id.* at 128-29 (citing CONG. GLOBE, 41st Cong., 2d Sess. 3495, 4073, 4708 (1870)).

[37] Eisenstein, *supra* note 23, at 821.

[38] Klein, *supra* note 23, at 232 (stating that the Populists, reformers, and intellectuals favored a tax on the rich).

income tax and an inheritance tax.[39] This time, Congress passed legislation that included gifts and inheritances of personal property in gross income.[40] Some commentators suggest that Congress viewed the tax on gifts as an inheritance tax, rather than an income tax, but included gifts in income for convenience.[41] This income tax, however, was short lived: in 1895, the Supreme Court declared in *Pollock v. Farmer's Loan & Trust Co.*[42] that the tax was unconstitutional.[43]

Unable to impose an income tax, but badly in need of revenue to fund the Spanish American War effort, Congress imposed a tax on recipients of transfers of personal property in 1898.[44] The 1898 "Death Tax" was in effect a "modified estate duty," rather than an inheritance tax.[45] Instead of increasing with the size of the recipient's share, as would be typical of an inheritance tax, the tax rates accelerated "as the size of the estate increased."[46] Although the 1898 tax did not contain a general tax on gift transfers, it did contain a provision imposing a tax on gifts that took effect after the death of the donor.[47] Congress repealed the tax in 1902 upon the conclusion of the war.[48]

In 1913, with the passage of the Sixteenth Amendment, Congress had unfettered discretion to build almost any tax system it

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[39] *Id.*

[40] Act of Aug. 27, 1894, ch. 349, 28 Stat. 509, 553 (effective 1894-1895) [hereinafter 1894 Act]. See WEST, *supra* note 23, at 94, for a discussion of the 1894 Act.

[41] Klein, *supra* note 23, at 231-33. The 1894 tax rates were not progressive, but rather consisted of a 2-percent flat tax above $4,000, with no separate estate tax. *Id.* This system essentially resulted in a tax on income, along with a separate tax on gifts and inheritances. *Id.*

[42] 158 U.S. 601 (1895) (holding the income tax unconstitutional under Article I, Section 9, of the United States Constitution).

[43] *Id.*

[44] Act of June 13, 1898, ch. 448, 30 Stat. 448, 464-66 (effective 1898-1902) [hereinafter 1898 Death Tax]. See Klein, *supra* note 23, at 234, for a discussion of the 1898 Death Tax. See also PAUL, *supra* note 25, at 32-39, for a detailed analysis of the Populist movement.

[45] Klein, *supra* note 23, at 234.

[46] *Id.* For a thorough analysis of the 1898 Death Tax, see RATNER, *supra* note 30, at 234, WEST, *supra* note 23, at 94-95, and PAUL, *supra* note 25, at 65-68.

[47] Klein, *supra* note 23, at 234 (noting that the treatment of gifts in the 1898 Death Tax "followed the precedent of the Civil War legislation").

[48] Act of April 12, 1902, ch. 500, 32 Stat. 96 (1902) (repealing 1898 Death Tax); Klein, *supra* note 23, at 235 (discussing the repeal of the 1898 Death Tax). Before Congress repealed the tax, the Supreme Court upheld the tax in *Knowlton v. Moore*, 178 U.S. 41 (1900).

saw fit to create.[49] It began with the income tax.[50] Importantly, this income tax excluded gifts, bequests, devises, and descents from gross income.[51] Gifts and inheritances were not subject to a transfer tax at this time.[52] Interestingly, Senator Norris proposed an amendment to adopt an estate tax in order to break up concentrations of wealth.[53] Although the amendment had little opposition in Senate debates, the Senate defeated it along with an amendment for an inheritance tax.[54] One commentator suggests that Congress was not necessarily opposed to an estate tax, but rather members of Congress who would have supported an estate tax "did not want to divert their own and their colleagues' attention from the main issue—'income' taxation."[55]

War would once again resurrect the estate tax.[56] In 1916, Congress found itself looking for other revenue sources to fund the increased expenditures caused by World War I.[57] Congressman Cordell Hull, a longtime supporter of breaking up concentrations of wealth, proposed a tax bill that included an estate tax.[58] During congressional hearings on the hill, the House Ways and Means Committee criticized the then-current tax system and stated that persons "deriving the most benefit and protection from the government" should account for a larger percentage of the government's revenue.[59] The Committee also added that the estate

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[49] U.S. CONST. amend. XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."); *see* RATNER, *supra* note 30, at 298-320 (discussing the proposal and ratification of the sixteenth amendment). Congress passed the sixteenth amendment in order to ensure its power to tax income "from whatever source derived." *Id.* at 303.

[50] Klein, *supra* note 23, at 235 (discussing the enactment of the modern income tax).

[51] Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 166-67 (1913) (codified as amended in scattered sections of 26 U.S.C.); *see* Klein, *supra* note 23, at 235 (noting the gift and inheritance exclusion from gross income). Today, the exclusion for gifts and inheritances from gross income is found in § 102 of the Internal Revenue Code. I.R.C. § 102(a). The original income tax bill was silent as to gifts but a "Senate amendment, accepted without extended debate, provided specifically that the gains on, or profit from, but not the value of, property acquired by gifts were to be taxed." Harriss, *supra* note 25, at 532.

[52] Klein, *supra* note 23, at 235.

[53] *Id.* (citing 50 CONG. REC. 4422, 4426, 4459-61, 4468-69, 4470 (1913)). See *id.* for a discussion of the defeated amendment.

[54] *Id.*

[55] *Id.* at 235-36.

[56] *See* PAUL, *supra* note 25, at 106.

[57] *Id.*

[58] *Id.*

[59] *Id.* (quoting hearing transcript without citation).

tax would create a "well-balanced system of inheritance taxation as between the Federal government and the various states,' and could be 'readily administered with less conflict than a tax based upon the shares passing to heirs and distributes or devisees and legatees. . . ."[60] Indeed, the Committee reasoned that the federal government would tax "the transfer of the net estate while the states continued to tax the shares."[61]

During the congressional debates, public reaction to the estate tax bill was intense.[62] While some attacked the progessivity of the bill,[63] calling it socialistic policy, progressives called for higher surtaxes.[64] Despite the criticisms, Congress passed the bill on September 8, 1916, and the modern estate tax was born.[65]

Many social and political factors combined to enable Congress to enact this estate tax.[66] First, the tax was familiar, convenient, and practical.[67] Many Americans were accustomed to the concept of a wealth transfer tax due to its existence in England and early American history.[68] Additionally, American public sentiment leaned heavily towards imposing higher taxes on the wealthy in order to

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[60] *Id.* (quoting hearing transcript without citation).

[61] *Id.* at 106-07 (quoting hearing transcript without citation).

[62] PAUL, *supra* note 25, at 107-08.

[63] The New York Times declared the bill an attack on the Northeast and the rich. *Id.* at 107 (citing the New York Times).

[64] *Id.* A "surtax" is "[a]n additional tax imposed on something being taxed or on the primary tax itself." BLACK'S LAW DICTIONARY 1472 (7th ed. 1999). See RATNER, *supra* note 30, at 346-52, for a thorough description of the congressional debates surrounding the estate tax.

[65] Revenue Act of 1916, ch. 463, 39 Stat. 756, 777 (1916) (codified as amended in scattered sections of 26 U.S.C.). The tax contained a high exemption in order to tax only the rich, leaving the states to tax the small estates. PAUL, *supra* note 25, at 107. The Supreme Court upheld the modern estate tax in *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921), reasoning that the estate tax was a transfer tax on property, not on the ownership of property and, thus was an indirect tax avoiding the apportionment clause under the Constitution. *See* McCaffery, *supra* note 2, at 1430 (noting the constitutional foundation of the estate tax). The estate tax imposed a tax on the transfer of the net estate of the decedent, not on the property. RATNER, *supra* note 30, at 356. Thus, the 1916 tax was not an inheritance tax. *Id.* Ratner notes: "From the standpoint of the heir against that of the community, an inheritance tax on, and graded to, the shares of the individual beneficiary was preferable to the estate duty, but the difficulties of administration and loss in revenue entailed impelled Congress at that time to choose the latter." *Id.* at 357. The estate tax of 1916 did include gifts that were made within the two years prior to death. *Id.*

[66] "The guiding principles behind the federal estate tax were productivity of revenue in the face of a fiscal emergency, ease and simplicity of collection, and placement of the preparedness tax burden on the wealthy rather than the poor." RATNER, *supra* note 30, at 357.

[67] Klein, *supra* note 23, at 236.

[68] *Id.* at 230.

break up family fortunes.[69] Populist support for an estate tax was borne of resentment against big business, the high cost of living, and greater public awareness of increases in concentrations of wealth.[70] The writings of "muckrakers"[71] also "stirred dissension and class-consciousness."[72] After its inception, the estate tax underwent minor revisions throughout the years,[73] but seemed here to stay, at least until the 2001 Tax Act.[74]

Surprisingly, during the debate surrounding the 1916 Act, no one focused on transfers of wealth made by gifts.[75] The record is devoid of discussion of inter vivos intergenerational transfers.[76] That discussion occurred eight years later, in order to protect the estate tax.[77] Not long after the 1916 Act, taxpayers realized that gifting schemes could avoid the estate tax.[78] This had the added benefit of shifting income from the transferred assets to lower-bracket

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[69] *Id.*

[70] PAUL, *supra* note 25, at 108. Two reports (the Manly report and Commons report) issued by the Commission of Industrial Relations demonstrated the large class differences in the United States in the early twentieth century. RATNER, *supra* note 30, at 355 (citing the Manly report and Commons report).

[71] PAUL, *supra* note 25, at 108.

[72] *Id.*

[73] M.C. Mirow & Bruce A. McGovern, *An Obituary of the Federal Estate Tax*, 43 ARIZ. L. REV. 625, 628-29 (2001).

[74] *See* 2001 Tax Act, *supra* note 1. Rates were increased or decreased alternatively, usually coinciding with wartime, and the scope of property taxed broadened throughout the years. Mirow & McGovern, *supra* note 73, at 628-29. As Eisenstein summarizes:

> In the quarter-century between 1916 and 1944 the estate tax passed through several stages. . . . The first stage ended with the 1921 act. It was a period of rising rates followed by a relapse among the smaller estates. The governing objective was plainly revenue. The second stage was the Mellon era. It began with the 1924 act and closed with the 1932 act. In that unfortunate period the tax was almost destroyed and then revitalized as a source of revenue. The third stage started with the 1934 act and was continued by the 1935 act. Under these 2 acts the progression sharpened as the rates climbed from 45 percent to 70 percent. The dramatic emphasis was on leveling, but the continuing need for revenue in the face of deficits was also effective. The fourth stage was marked by the 1940 and 1941 acts. The larger burdens which they imposed derived entirely from the quest for revenue.

Eisenstein, *supra* note 23, at 830. Additionally, in 1918, a charitable deduction was included. Mirow & McGovern, *supra* note 73, at 628. In 1948, a marital deduction was added. *Id.* at 629-30.

[75] *See* Harriss, *supra* note 25, at 531-33 (discussing how the treatment of gifts was incidental to the treatment of income and estates prior to 1924).

[76] Klein, *supra* note 23, at 237.

[77] RATNER, *supra* note 30, at 420-21.

[78] *Id.*

taxpayers. Congress established the gift tax in 1924 to protect the estate tax and income tax from abuse by removing the inter vivos exemption.[79] Some commentators believe that it was also enacted in part as an instrument to equalize wealth.[80] In 1926, as a result of a "vigorous campaign" led by then-Secretary of the Treasury Andrew Mellon, Congress repealed the gift tax and dramatically reduced estate tax rates.[81] In 1932, however, facing mounting public debt caused by the Great Depression, Congress reenacted the gift tax, both to help balance the budget and to protect the estate tax.[82]

The transfer tax treatment of estates and gifts underwent a major overhaul with the 1976 Tax Reform Act, which integrated the treatment of estates and gifts into one system that taxed cumulative taxable transfers made during life and after death.[83] It also eliminated many loopholes.[84] The unified system combined the fair market value of the estate assets with the value of all inter vivos gifts (above the annual exclusion amount) executed while the decedent was alive.[85] Since the unified system totaled all taxable gifts made during life with bequests at death, the effect was to give an individual,

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[79] *Id.*; Revenue Act of 1924, ch. 234, 43 Stat. 313-16 (effective 1924-1926) [hereinafter 1924 Gift Tax].

[80] RATNER, *supra* note 30, at 420 (discussing the 1924 Gift Tax); *see* Eisenstein, *supra* note 23, at 828 (noting that "leveling of hereditary fortunes" became a formal objective of the estate tax in the Roosevelt administration).

[81] Revenue Act of 1926, ch. 27, 44 Stat. 125 (effective 1926-1932); RATNER, *supra* note 30, at 424-30 (discussing the repeal of the 1924 Gift Tax); *see* Harriss, *supra* note 25, at 538 (stating that only a few members of Congress led the fight against the wealth transfer taxes, and several wealthy citizens and large corporations funded the fight).

[82] Revenue Act of 1932, ch. 209, 47 Stat. 245 (1932) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter 1932 Gift Tax]. For a discussion of the 1932 Gift Tax, see RATNER, *supra* note 30, at 420, and PAUL, *supra* note 25, at 155-56, 162. The 1932 Gift Tax was based on the donor's cumulative taxable gifts. RATNER, *supra* note 30, at 420. Congress reenacted the gift tax to help balance the federal budget, prevent avoidance of the estate tax by the wealthy, and decrease "the tax burden of the masses." *Id.* at 449-50. The 1932 Gift Tax differed from the 1924 Gift Tax because the 1932 Gift Tax taxed individuals, while the 1924 Gift Tax only taxed "gifts made by corporations, trusts, and estates." *Id.* at 450. Supposedly, Congress did not discuss important details and specific features of the 1932 Gift Tax. Harriss, *supra* note 25, at 538.

[83] Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 259, 261-63 (1983).

[84] *Id.* ("[I]n 1976, after nearly thirty years of neglect, Congress adopted a series of revisions intended to make the estate and gift taxes apply on a more regular and uniform basis."); Mary R. Wampler, *Repealing the Federal Estate Tax: Death to the Death Tax, or Will Reform Save the Day?*, 25 SETON HALL LEGIS. J. 525, 529, 531 (2001) ("In 1976, the estate and gift taxes were unified into one system in an attempt to reduce loopholes and simplify the wealth transfer tax system.").

[85] McCaffery, *supra* note 2, at 1434.

and in turn an estate, only one run up the "rate ladder."[86]

The 1976 Tax Reform Act also abolished the fair market value basis with respect to inheritances and instead adopted a carryover basis.[87] As a carryover basis already existed for gifts, Congress intended to remove the income tax bias against lifetime transfers created by the fair market value basis for inheritances.[88] Congress later repealed this carryover basis provision and readopted the prior rule of a stepped up basis to fair market value at death.[89]

The 1976 Tax Reform Act also added a generation-skipping tax to the transfer tax system.[90] A generation-skipping tax became necessary in order to prevent wealthy taxpayers from eliminating an entire layer, sometimes two layers, of transfer tax by simply skipping a generation when transferring wealth.[91] After the Tax Reform Act of 1976, the wealth transfer system remained relatively unchanged, until

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[86] *Id.* Taxpayers were forced to make only one run up the "rate ladder" because all taxable gifts and, finally, the estate were added together and taxed at progressively higher rates. *Id.*

[87] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1874 (1976) (codified as amended in scattered sections of 26 U.S.C.). A "carryover basis" is "the basis of property transferred by gift or in trust, equaling the transferor's basis." BLACK'S LAW DICTIONARY 145 (7th ed. 1999).

[88] Schlachter, *supra* note 15, at 783.

[89] *Id.* Many commentators have criticized the carryover basis. *See, e.g.*, Joseph Dodge, *What's Wrong With Carryover Basis Under H.R. 8*, 91 TAX NOTES 961, 971-72 (2001) (stating that a carryover basis would "violate the principle that income should be attributed to the person who earned it" and that "tax avoidance through gain shifting would still be a problem for estate-transferred property, which could be allocated among legatees following death so as to lower aggregate income tax burdens"); Lee A. Sheppard, *The Tax Bill—News Analysis—Debt in Contemplation of Death*, 91 TAX NOTES 1655, 1659-60 (2001) ("Carryover basis presents a host of administrative problems . . . ."). *See generally Stepping Up to the Repeal of the Estate Tax: New Ways are being Looked at to Value Gains When You Die*, FIN. TIMES (London), Apr. 7, 2001, at 25 (discussing the carryover basis). Interestingly, the 2001 Tax Act applies the carryover basis. 2001 Tax Act, *supra* note 1, § 542.

[90] Graetz, *supra* note 83, at 261. The tax was simplified in 1986 to tax "skip persons." Glendall Jones Jr., *Repeal the Estate Tax? Bad Move: The Transfer Tax System Paradigm,* 89 TAX NOTES 793, 794 (2000). "Skip persons" include "heirs two or more generations below the transferor . . . [or] a trust, where the trust operates exclusively for the benefit of grandchildren or a younger generation." *Id.* (stating that the aim of the generation-skipping tax is to tax intergenerational wealth transfers through trusts, thus taxing "assets held by a trust as they pass" through generations).

[91] *Id.* The House of Representatives describes the generation-skipping tax:

> A generation-skipping transfer tax generally is imposed on transfers, either directly or indirectly or through a trust or similar arrangement, to a 'skip person' (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

H.R. REP. NO. 107-84, at 180 (2001).

the enactment of the 2001 Tax Act.[92]

II. THE CASE FOR AND AGAINST ESTATE AND GIFT TAXES

The debate regarding the desirability of estate and gift taxes ("EGT") has raged for over eighty-five years.[93] During that time, the policy justifications both in favor and against such taxes have remained the same.[94] With the 2001 Tax Act, the estate tax opponents triumphed, albeit temporarily.[95] Yet, considering the possibility that estate tax repeal may become permanent,[96] the policy arguments should be reexamined in order to ascertain whether other modifications to the tax treatment of gifts and inheritances would be required. Specifically, should either the gift tax or the exclusion under § 102, or both, be retained in an estate tax-free world?

A. Arguments for the Retention of Estate and Gift Taxes

1. Revenue

The most important historical justification for the EGT is the justification for all taxes: revenue. The EGT generates $20 to $30 billion per year, approximately 1.4-percent of the federal government's total revenue.[97] Only two-percent of estates incur estate

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[92] *See* 2001 Tax Act, *supra* note 1.

[93] Schmalbeck, *supra* note 16, at 749; *see supra* Part I (discussing the enactment of the modern wealth transfer system).

[94] *See generally* William G. Gale & Joel B. Slemrod, *A Matter of Life and Death: Reassessing the Estate and Gift Tax*, 88 TAX NOTES 927 (2000) (arguing for reform of the estate and gift taxes ("EGT")); Christopher E. Erblich, *To Bury Federal Transfer Taxes Without Further Adieu*, 24 SETON HALL L. REV. 1931 (1994) (arguing for repeal of the EGT).

[95] 2001 Tax Act, *supra* note 1, §§ 511, 521. Nevertheless, this repeal is only temporary as the tax system is to return to its pre-2001 Tax Act status in 2011. *Id.* § 901. In other words, without further legislation the 2001 Tax Act does not apply after December 31, 2010. Campbell, *supra* note 8, at 623.

[96] See *supra* note 16 for a discussion of congressional bills calling for the permanent repeal of the estate tax.

[97] Joint Econ. Comm., *The Economics of the Estate Tax*, *at* http://www.house.gov/jec/fiscal/tx-grwth/estattax/estattax.htm (Dec. 1998) (on file with author). Literature differs on the exact impact of the EGT on federal revenues. One source states that from 1990 to 1998, the estate tax averaged $15.3 billion, about one-percent of federal revenues. Schlachter, *supra* note 15, at 789. The Congressional Budget Office projected that the estate tax would raise $30 billion in 2000, $37 billion in 2005, and $48 billion in 2010 (based on the estate tax system as existed in 2000). Richard L. Heaton, *The Death of the Death Tax?*, 42 ORANGE COUNTY LAW. 6 (Nov. 2000). Another source forecasted $331 billion in revenues from 1999-2008. James R. Repetti, *The Case for the Estate and Gift Tax*, 86 TAX NOTES 1493, 1495, 1497 (2000) (recommending that Congress retain the EGT). Most

tax liability.[98] Considering the EGT's small contribution to government revenues, and that the federal government sustains trillions of dollars in outlays a year, the revenue generated by the EGT appears negligible.[99] And yet, many argue that $25 billion is still a substantial amount.[100]

The revenue loss, however, is not just that of the federal government. States will feel part of the brunt of EGT repeal due to the State Death Tax Credit (the so-called "soak up" provision), which includes a federal estate tax credit for any estate tax paid to a state.[101] In 2001, the total revenue generated by the fifty states through the soak up provision was approximately $5 billion.[102] When the EGT is

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scholars agree that the EGT contributes about one to two-percent of all federal revenues. McCaffery, *supra* note 2, at 1433. See Martin A. Sullivan, *News Analysis—Goodbye Estate Tax?*, 90 TAX NOTES 423 (2001), for a detailed summary of estate tax returns. Supporters note that revenue from the EGT doubled between 1993 and 1998. *See also* Charles Davenport & Jay Soled, *Enlivening the Death-Tax Death-Talk*, 84 TAX NOTES 591, 625 (1999) (discussing the costs of the EGT and finding the estate tax efficient).

[98] William G. Gale & Joel B. Slemrod, *The Estate Tax Plays a Key Role*, AARP BULL. (Apr. 2001), *available at* http://www.brook.edu/views/op-ed/gale/200104.htm (on file with author); *see* Leonard E. Burman & William G. Gale, *The Estate Tax is Down, But Not Out*, 94 TAX NOTES 1039 (2002) (discussing the small percentage of taxpayers that actually incur estate tax liability).

[99] U.S. Census Bureau, *Statistical Abstract of the United States: 2002* (stating the costs of government programs), *at* http://www.census.gov/prod/www/statistical-abstract-02.html (2002) (on file with author). The United States spends approximately $2 trillion a year in outlays. *Id.* at 305. The Joint Committee on Taxation predicts that permanent repeal of the estate would result in the loss of $56 billion in revenue in 2012. Friedman, *supra* note 16, at 1984. Furthermore, permanent repeal of the estate tax would result in the loss of approximately $740 billion in revenues from 2013 through 2022. *Id.*

[100] Repetti, *supra* note 97, at 1495-97. See *infra* notes 128-34 and accompanying text for the counterarguments set forth by the opponents of the EGT.

[101] I.R.C. § 2011 (2003). The House of Representatives describes the State Death Tax Credit:

> A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table. . . . Most States impose a "pick-up" or "soak-up" estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

H.R. REP. NO. 107-84, at 180 (2001). Thus, the taxpayer is not burdened by a state estate tax, rather the system simply shifts revenue from the federal government to the state. Schlachter, *supra* note 15, at 799-801; Jonathan G. Blattmachr & Mitchell M. Gans, *Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 90 TAX NOTES 393, 397 (2001) ("[T]he biggest losers of all of the elimination of the federal wealth transfer tax system will be the several states.").

[102] Iris J. Lav & Joel Friedman, *Estate Tax Repeal: A Costly Windfall for the Wealthiest Americans* (including a chart of each state's revenue received from the federal estate

repealed, this source of revenue for states will be lost.[103] To replace this revenue, states would need to increase the amount of revenue they currently derive from inheritance taxes. But, since thirty-six states have repealed or modified their inheritance taxes, some commentators fear a "race to the bottom."[104]

2. Progressivity

Recognizing the limited revenue generated by the tax,[105] some supporters of the EGT emphasize instead the progressive[106] nature of the tax.[107] These scholars claim that the EGT plays a pivotal role in maintaining a progressive tax system.[108] By falling on the wealthiest one to two-percent of the public, the EGT provides approximately one-third of the tax system's progressivity, somewhat surprising given that the EGT only contributes about 1.4 percent of the federal revenue.[109] Opponents insist that an income tax could provide sufficient progressivity to the American tax system if Congress were to adjust rates and brackets accordingly.[110] Moreover, they argue that

tax credit), *at* http://www.cbpp.org/5-25-00tax.htm 12-13 (Feb. 6, 2001) (on file with author).

[103] States collect approximately one-quarter of the revenue raised by the estate tax. Wampler, *supra* note 84, at 538. The Center for Budget and Policy Priorities estimates that the states would lose approximately $16 billion from 2003 to 2007 due to the 2001 Tax Act. Marilyn Geewax, *Plan to Eliminate Estate Tax Attracts Unlikely Opposition*, HOUS. CHRON., Jan. 20, 2003, at 6.

[104] It is unlikely that states will act quickly to increase inheritance taxes. Schlachter, *supra* note 15, at 800 (arguing that states have engaged in a race to the bottom). See Oskar R. Harmon, *The Estate Tax: Repeal or Reform?*, 91 TAX NOTES 2072 (2001), for a discussion of the effect of estate tax repeal on the states.

[105] See infra notes 128-34 and accompanying text for a discussion of the limited revenue raised by the EGT.

[106] Progressivity involves the wealthy paying a higher percentage of taxes than the poor, justified by notions of fairness, ability to pay, and preventing large accumulations of wealth. Schlachter, *supra* note 15, at 806. Associated with progressivity, supporters claim the EGT is essential to vertical equity, which involves taxing the wealthy more than lower income individuals. Jones, *supra* note 90, at 794.

[107] Graetz, *supra* note 83, at 269-72; *see* Barbara Redman, *Rethinking the Progressive Estate and Gift Tax*, 15 AKRON TAX J. 35 (2000) (including a brief description of the historical and judicial treatment of progressive taxation).

[108] Graetz, *supra* note 83, at 272.

[109] *Id.*; Schlachter, *supra* note 15, at 808. "About 96 percent of those who die in a given year do not have to file estate tax returns, and half of those who file owe no taxes once credits and deductions are claimed." Burman & Gale, *supra* note 98, at 1041. Furthermore, "only about 2 percent of deaths result in estate tax liability, and payments are highly concentrated within that group." *Id.* In *Dickman v. United States*, 465 U.S. 330, 338-39 (1984), the United States Supreme Court upheld the gift tax due to the progressive nature of the tax.

[110] Some scholars argue that the repeal of the estate tax and adoption of a carryover basis regime "can be structured to include a substantial element of

the progressivity of the EGT is more psychological than real and that studies demonstrate that the wealthiest taxpayers often pay lower effective rates than taxpayers in lower brackets because of sophisticated tax planning techniques.[111] Conversely, supporters claim Congress should reform the current EGT system to eliminate loopholes, thus enabling the tax to provide an efficient mechanism to add progressivity to the American tax structure.[112]

3. Social Policy

Another popular argument in favor of the EGT is that it promotes a social policy of decentralizing and redistributing wealth.[113] Scholars have long argued that large concentrations of wealth endanger democratic society and conflict with the American ideal of equal opportunity.[114] The EGT is necessary to combat these inequities.[115]

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progressivity." *See, e.g.*, Schlachter, *supra* note 15, at 788.

[111] *Id.* at 809.

[112] *Id.* at 788.

[113] Repetti, *supra* note 97, at 1498 (finding that the estate tax does help reduce dynastic wealth).

[114] *See* Dennis Kessler & André Masson, *On Five Hot Issues on Wealth Distribution*, 32 EUR. ECON. REV. 644, 646-47 (1988) (discussing the debate regarding the importance of inheritance on wealth accumulation and inequality); Alan S. Blinder, *Distribution Effects and the Aggregate Consumption Function*, 83 J. POL. ECON. 447 (1975) (finding that even if the distribution of income is equalized, aggregate consumption would remain the same or diminish only slightly); *see also* John G. Steinkamp, *Case for Federal Transfer Taxation*, 55 ARK. L. REV. 1, 82-84 (2002) (arguing in favor of the EGT because it helps reduce concentrations of wealth). Andrew Carnegie believed that large inheritances conflicted with the democratic ideal of equal opportunity. ANDREW CARNEGIE, THE GOSPEL OF WEALTH 10 (1933). Recently, "[a] group of 120 wealthy Americans—including investors George Soros and Warren E. Buffet and Bill Gates' father—have signed a petition urging Congress to keep the estate tax . . . ." William Neikirk, *Estate-Tax Issue Sparks Wealth of Arguments*, CHI. TRIB., Apr. 2, 2001, at 1. For a discussion of social policy associated with the estate tax, see Geewax, *supra* note 103, at 6, and Dean Calbreath, *Death & Taxes; Not All Wealthy Americans Are In Favor Of Eliminating Inheritance Taxes*, SAN DIEGO UNION-TRIB., Nov. 15, 2002, at C1.

[115] Repetti, *supra* note 97, at 1498. Some scholars believe the real concern is whether the EGT affects wealth concentrations, rather than income concentrations, because wealth concentrations impact the political process by investments and consumption. *Id.* 149 of the 400 wealthiest individuals in the United States in 1999 began with inherited fortunes. *Id.* This number was even greater in 1984. *Id.* Other scholars believe concentrations of wealth still exist due to avoidance of the EGT by taxpayers. Jones, *supra* note 90, at 796; *see* Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 25 SYRACUSE L. REV. 1215, 1218-19 (1984) (stating that the estate tax does not break up concentrations of wealth because of tax avoidance). For an extreme view of how to equalize wealth, see Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990). Professor Ascher suggests that wealth transfer taxes should be used to curtail inheritances by selling property owned at death and giving the proceeds to the government, with certain exceptions. *Id.*

Although the estate tax is strongly supported as a tool to break up concentrations of wealth, statistics demonstrate that little has changed in the years since Congress enacted the EGT.[116] The Joint Economic Committee, a group consisting of both members from the House of Representatives and Senate, has found that the EGT has little impact on the distribution of wealth, mainly because of intangible advantages of high-income households.[117] Commentators argue that the inequality still existing in the United States demonstrates that "wealth is simply taken from one class and is never seen by the other" as concentrations of wealth continue to grow and redistribution programs are inefficient.[118] As the empirical studies reveal, the EGT has little effect on wealth concentration.[119]

4. Charitable Giving

In addition to revenue, progressivity, and social policy, a further justification of the EGT is that it promotes charitable giving.[120] The

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[116] A study showed the richest one-percent of the population had one-fourth to one-fifth of the total wealth over the last fifty years. Graetz, *supra* note 83, at 271. Even more so, the inequality of wealth may have increased since the 1970s, perhaps because only a small part of wealth is attributed to inheritances. Schlachter, *supra* note 15, at 792.

[117] Joint Econ. Comm., *supra* note 97, at 3 (stating that "the estate tax fails on liberal, progressive grounds because it discourages work and saving in favor of large-scale consumption . . . there is no empirical evidence to support the view that the estate tax is effective at reducing inequality . . . much of the research which suggests that the estate tax is a poor tool to address inequality has been done by economists who themselves are generally sympathetic to issues of income inequality"). Advantages of high income households include "human wealth," which is "derived from favorable educational and environmental opportunities, as well as 'connections' due to family background and marriage." Jacob Mikow & Darien Berkowitz, *Beyond Andrew Carnegie: Using a Linked Sample of Federal Income and Estate Tax Returns to Examine the Effects of Bequests on Beneficiary Behavior*, *at* http://www.irs.gov/taxstats/article/0,,id=106176,00.html (Oct. 2000) (on file with author).

[118] Jones, *supra* note 90, at 794; *see* Joseph E. Stiglitz, *Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence*, 86 J. POL. ECON. S137 (1978) (stating that the estate tax may actually increase inequality of income and wealth due to capital accumulation effects).

[119] Erblich, *supra* note 94, at 1936-37; *see* Joint Econ. Comm., *supra* note 97, at 5 (stating that inheritance is "not a major source of inequality" or that "government policies aimed at inheritance are likely to be ineffective" for three reasons: first, "there is only a weak correlation between wealth and income;" second, "efforts to curtail wealth transfers will induce wealth holders to increase their consumption;" and third, "the high degree of wealth and income mobility in the economy means that government efforts to redistribute wealth will necessarily meet with limited success").

[120] Charities receive around $150 billion in gifts annually and the repeal of the estate and gift taxes may cause a reduction of $15 to $20 billion. Schlachter, *supra* note 15, at 801.

EGT encourages charitable contributions by excluding bequests to charities from the decedent's estate.[121] Thus, many charitable organizations lobbied against repeal of the EGT, arguing that repeal would reduce charitable giving.[122]

Opponents of the EGT, however, argue that it is "costly, cumbersome, and [an] indirect way to assist charities."[123] Studies demonstrate that tax deductions have only "nominal effects" on charitable gifts; tax incentives, of course, are not the only motivating factors of charitable contributions.[124] Furthermore, the repeal of the estate tax may just shift bequests at death to gifts during life.[125]

B. Arguments for the Repeal of Estate and Gift Taxes

Opponents of the EGT have disputed each of the justifications—revenue, progressivity, social policy, and charitable giving—discussed above.[126] In addition, they have advanced quite different policy arguments to justify repeal of the EGT.[127]

1. Revenue

Opponents of the EGT contend that it is a relatively paltry source of revenue for the federal government.[128] After factoring in the costs of administration, including employing tax lawyers to combat tax avoidance, retaining large numbers of IRS agents, and maintaining government administration, opponents maintain that the EGT raises little revenue.[129] In contrast to the revenue raised

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[121] I.R.C. § 2055 (2003). See David Abel, *Estate Tax End May Hit Charity*, BOSTON GLOBE, Feb. 25, 2001, at A15, for a discussion of the impact of estate tax repeal on charitable contributions.

[122] David R. Francis, *Charities Harden Opposition To An Estate-Tax Repeal*, CHRISTIAN SCI. MONITOR, Nov. 25, 2002, at 17.

[123] McCaffery, *supra* note 2, at 1435.

[124] *See* Joint Econ. Comm., *supra* note 97, at 10 (stating that "charitable tax deduction exerts only a modest, if any, stimulative effect" and "although the charitable deduction affects the timing of donations, it may not significantly alter the overall level of giving").

[125] Schlachter, *supra* note 15, at 801-02.

[126] For a summary of arguments for and against the EGT, see Edward J. McCaffery et al., *Should We End Life Support for Death Taxes?*, 88 TAX NOTES 1373 (2000), and Edward J. McCaffery & Richard E. Wagner, *A Bipartisan Declaration of Independence from Death Taxation*, 88 TAX NOTES 801 (2000).

[127] *See supra* note 126.

[128] Repeal of the estate tax may actually boost gross domestic product to such an extent that within ten years, federal tax revenue would be higher than if the estate tax was maintained. Stephen J. Entin, *Why the Death Tax Lives*, WALL ST. J., June 19, 2002, at A18.

[129] Bruce Bartlett, *The End of the Estate Tax?*, 76 TAX NOTES 105, 109 (1997);

from the corporate tax, excise tax, and employment taxes, the contribution of the EGT is insignificant.[130] In 2000, the corporate taxes raised $236 billion, comprising 11.2-percent of total revenue.[131] Employment taxes raised $640 billion that year, or 30.5-percent of total revenue.[132] The EGT, by comparison, brought in approximately $30 billion, only 1.4-percent of total revenue.[133] Furthermore, the federal government collected more revenue from excise taxes than it did from the EGT: in 2000, the excise tax raised $55 billion, 2.6-percent of total revenue collected.[134] As these figures demonstrate, the EGT provides relatively little revenue for the federal government.

2. Double Taxation

One frequent argument against the EGT is that it results in double taxation.[135] Opponents assert that accumulations of wealth are first taxed under the income tax system and then again at death.[136] Although that may be true of wage income that becomes savings, a significant portion of a taxpayer's wealth at death consists of untaxed, unrealized appreciation in assets.[137] Furthermore, since the basis of assets transferred at death are stepped up to fair market value, these gains will never be taxed if all transfer taxes are

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Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation,* 104 YALE L.J. 283, 300-02 (1994) (discussing the high costs associated with the EGT); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 564 (1993) (stating that even with improvements of the transfer tax system, costs of the system are still unacceptable). Opponents argue revenue is low due to the narrow tax base. *See* Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413, 1414 (1991) ("The target population to which the wealth transfer system applies is only a miniscule percentage of the total population, and there is little probability of broadening that base.").

[130] U.S. Census Bureau, *supra* note 99, at 314.

[131] *Id.*

[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] Heaton, *supra* note 97, at 6. As Entin describes double taxation:

> Income is taxed when earned. If used for consumption, there is generally no further federal tax, except for a few excise taxes. If saved, the returns are taxed as interest, dividends and capital gains, and, if put into corporate shares, there is the corporate income tax too. Even if the saving was in a tax-deferred retirement account, it will be subject to the heirs' income tax in the years following inheritance. Consequently, every penny in an estate has either been subject to income taxes, often more than once, or is about to be subject to income taxes. The death tax is always an extra layer of punishment.

Entin, *supra* note 128, at A18.

[136] *Id.*

[137] Vasek, *supra* note 21, at 961-62.

repealed.[138] In addition, double taxation exists throughout the tax system; for example, sales tax imposed on consumed earnings that have already been subjected to an income tax.[139]

3. Effect on Behavior

One of the tenets of a good tax system is that, to the extent possible, it should minimize negative effects on behavior and economic activity.[140] The EGT may distort economic decisions by intruding on a parent's interest in providing for future generations.[141] Additionally, it is argued, the EGT may decrease capital stocks, reduce long-run growth, and encourage leisure, consumption, and lavish spending.[142] Indeed, opponents contend that the EGT deters labor and "intergenerational savings."[143]

There is conflicting empirical data regarding the actual effect the EGT has on saving behavior.[144] Because of the inability to isolate the EGT as a single factor due to other "intangible transfers," it is difficult to determine whether gifts and inheritances affect work ethic.[145] In addition, studies differ as to whether gifts and

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[138] Blattmachr & Gans, *supra* note 101, at 394. The stepped up basis existed in the EGT system before the 2001 Tax Act. *See* I.R.C. § 1014.

[139] *See* Louis Lyons, *GOP LawMakers Unveil National Retail Sales Tax Plan*, 70 TAX NOTES 1432, 1432 (1996) (stating that proponents of a national retail sales tax argue that the sales tax "would eliminate double taxation on savings and investment income, reduce hidden taxes passed on to consumers by corporations, increase economic growth, and reduce the cost of consumer goods").

[140] WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 11 (13th ed. 2003). "The principle of neutrality holds that the choice of a tax structure should not affect taxpayer behavior by favoring one form of wealth transmission over another." Schlachter, *supra* note 15, at 793-94.

[141] Jones, *supra* note 90, at 794-95. Some scholars believe that "to the extent that the estate tax reduces a parent's ability to leave an estate to his children, it will have a negative effect on his willingness to accumulate wealth through work, saving, and investing." Bartlett, *supra* note 129, at 107. The EGT basically "distort[s] behavior and investment decisions" of people who want to leave wealth to heirs. McCaffery, *supra* note 2, at 1435.

[142] *See* Edward J. McCaffery, *Rethinking the Estate Tax*, 67 TAX NOTES 1678, 1680 (1995) ("The estate tax discourages behavior that a liberal, democratic society ought to like—work, savings, bequests—and encourages behavior that such a society ought to suspect—the large-scale consumption, leisure, and inter vivos giving of the very rich.").

[143] *Id.*

[144] Repetti, *supra* note 97, at 1498. Some believe the estate tax falls on the wrong people; instead of taxing savers, it should tax spenders. McCaffery, *supra* note 2, at 1435. Yet, other scholars remark that it is not always beneficial to save. Jones, *supra* note 90, at 794-95. "The death tax also reduces revenues by weakening incentive to save and invest. Less investment means lower productivity and lower taxable wages, profits, interest, dividends and capital gains." Entin, *supra* note 128, at A18.

[145] Mikow & Berkowitz, *supra* note 117, at 1 (stating that one type of "intangible

inheritances actually decrease the labor force.[146]

4. Simplification and Fairness

Opponents of the EGT argue that its repeal will result in simplification and fairness.[147] The simplification argument is somewhat obvious; if no tax exists, it is certainly simpler than if a tax does exist.[148] Since only two-percent of Americans die with enough wealth to trigger the estate tax and because the EGT has the highest rate of taxation, people go to great lengths to avoid paying the tax.[149]

The fairness concern is more complex. The tremendous lengths taxpayers go to avoid the EGT may impair horizontal equity because the schemes developed form inequities in the tax system, preventing similarly situated individuals from being taxed alike.[150] Furthermore, the estate tax may violate vertical equity if the wealthy eliminate or defer taxes through estate planning, hindering the ability of the government to tax their wealth.[151] One scholar even remarked,

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transfer" is "human wealth," which is "derived from favorable educational and environmental opportunities, as well as 'connections' due to family background and marriage").

[146] For an overview of the EGT's potential impact on behavior, see William G. Gale & Joel B. Slemrod, *Rethinking the Estate and Gift Tax*, *available at* http://www.brookings.edu/comm/conferencereport/cr05.htm (last visited Feb. 27, 2003) (on file with author). *Compare* Douglas Holtz-Eakin et al., *The Carnegie Conjecture: Some Empirical Evidence*, 108 Q. J. ECON. 413 (1993) (finding that heirs work less after receiving an inheritance), *and* Douglas Holtz-Eakin, *The Death Tax: Investments, Employment, and Entrepreneurs*, 84 TAX NOTES 782 (1999) (finding that the EGT may discourage older taxpayers from working), *with* David Joulfaian & Mark D. Wilhelm, *Inheritance and Labor Supply,* 29 J. HUM. RESOURCES 1205, 1207 (1994) (finding that although inheritances increased consumption by heirs, the effect was insignificant).

[147] Erblich, *supra* note 94, at 1943-44, 1951-53, 1967-68.

[148] *Id.* at 1951-52 ("It is universally agreed that the federal transfer tax system is too complex.").

[149] McCaffery, *supra* note 2, at 1430, 1433. Some scholars believe that the EGT decreases income tax revenues because it encourages transfers to low income donees. *See, e.g.*, B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?*, *in* TAX POLICY AND THE ECONOMY 113, 135 (Lawrence H. Summers ed., 1987). Some scholars disagree with this theory. *See, e.g.*, Repetti, *supra* note 97, at 1497.

[150] Jones, *supra* note 90, at 794; *see* Erblich, *supra* note 94, at 1943 ("Horizontal equity requires that similarly situated taxpayers should be taxed alike. Thus, horizontal equity dictates that the transfer tax system taxes two individuals who have identical amounts of wealth and who make identical transfers the same. The federal transfer tax system does not meet this goal."). "Among donors with the same wealth, the taxes discriminate on the basis of how resources are spent, violating the notion that those with equal means should pay equal taxes." Gale & Slemrod, *supra* note 146, at 3.

[151] *Id.*

The principle of vertical equity states that people with a greater ability "during periods when estate tax rates were rising, revenue from the estate tax fell. Conversely, lower estate tax rates increased estate tax revenue, because it was no longer as profitable to engage in costly estate planning."[152]

A different fairness question arises with concerns about liquidity.[153] Opponents argue that many estates are forced to sell assets in order to pay the tax.[154] This argument may be more rhetorical than factual given the provisions allowing taxpayers, in certain circumstances, to extend payment of the tax for up to 16 years.[155]

5. Morality

Opponents of the EGT maintain that the EGT imposes numerous moral concerns.[156] They argue that it is immoral and irrational to tax the dead and burden the beneficiaries when they are grieving.[157] While the EGT taxes the estate, opponents of the EGT

> to pay taxes should pay a higher percentage of their income in taxes. Thus, vertical equity dictates that people who transfer a greater amount of wealth should pay a higher proportion of their wealth in taxes. The federal transfer tax system does not meet this fairness goal. Instead, people who have greater amounts of wealth to transfer simply have a greater incentive to visit an estate planner to avoid the transfer taxes.

Erblich, *supra* note 94, at 1944. Scholars have called the estate taxes mere "penalties" to those with poor estate planning, rather than taxes. Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 NAT'L TAX J., 119, 138 (1992). Some argue that a "disproportionate burden of the estate tax often falls on those with recently acquired, modest wealth: farmers, small businessmen and the like" because they are less familiar with estate planning. Bartlett, *supra* note 129, at 106.

152 *Id.*

153 "Liquidity" is "the quality or state of being readily convertible to cash." BLACK'S LAW DICTIONARY 942 (7th ed. 1999).

154 Repetti, *supra* note 97, at 1509. Opponents also claim that small businesses and farms do not pass from one generation to the next due to the high EGT. Bartlett, *supra* note 129, at 107. Furthermore, opponents allege that in order to finance the high tax liability, many farms and businesses need to merge or sell out. *Id.* Supporters of the EGT counter by arguing that the opponents use small business owners and farmers as "shills" because only a small percentage of farmers are actually taxed. Dennis J. Ventry Jr., *Straight Talk About the 'Death' Tax: Politics, Economics, and Morality*, 89 TAX NOTES 1159, 1162 (2000).

155 I.R.C. § 6166 (2003).

156 *See* McCaffery, *supra* note 2, at 1443 (stating that the biggest problem with the EGT is a moral one).

157 Gale & Slemrod, *supra* note 94, at 929 ("Opponents often view death as an illogical time to impose taxes at best, and a morally repugnant one at worst. Compounding the grief of a family with a tax, of all things, seems a bit heartless, and the mention of 'death tax' evokes queasiness."); Entin, *supra* note 128, at A18 ("The death tax is punitive and immoral, because it is an extra tax on hard work and

argue that the beneficiaries, in reality, are paying the tax since the assets already have passed to the beneficiaries by the time Congress collects the estate tax.[158] Additionally, some argue that the EGT is at odds with what makes us distinctly American, the idea that anything is possible through hard work and savings.[159] Furthermore, opponents contend that the EGT penalizes those who acquire wealth, taxing savers instead of spenders.[160]

Surveys also reveal that Americans dislike the EGT.[161] The low opinion may be due to the "lottery effect," that is, the hope of dying wealthy.[162] This low popularity, however, may be misleading because studies demonstrate that "most Americans do not understand the estate tax and underlying policies."[163]

III. 2001 TAX ACT

While previous attempts to repeal the estate tax failed, repeal proponents finally prevailed with the implementation of the 2001 Tax Act.[164] The election of President George W. Bush and the prospect of huge budget surpluses created a political climate that enabled Congress to pass the 2001 Tax Act, with its dramatic

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thrift.").

[158] Edward J. Gac & Sharon K. Brougham, *A Proposal for Restructuring the Taxation of Wealth Transfers: Tax Reform Redux?*, 5 AKRON TAX J. 75, 89 (1988).

[159] Jones, *supra* note 90, at 794-95; Donaldson, *supra* note 129, at 551.

[160] McCaffery, *supra* note 2, at 1434.

[161] *Id.* at 1440; *see* McCaffery, *supra* note 129, at 364-65 ("The people's opposition and seventy-five years of increasingly settled practices have shown that democratic society does not want any meaningful wealth transfer tax.").

[162] *Id.* For a discussion of the public reaction to the EGT, see Schlachter, *supra* note 15, at 810, and Jones, *supra* note 90, at 795.

[163] Jones, *supra* note 90, at 795. "[U]sing popularity as a basis for determining the legitimacy and effectiveness of any tax creates a skewed result given the predisposition of many Americans to oppose the payment of taxes." *Id.*

[164] President Clinton vetoed two attempts to repeal the EGT. *See* Joint Comm. on Tax'n, *JCT Provides Overview of Bush's Individual Income Tax Proposals*, 2001 TAX NOTES TODAY 55-5 (2001) (including a description of President Bush's income tax proposals). *See also* Jones, *supra* note 90, at 794 (discussing recent attempts to repeal the estate tax). The Taxpayer Refund and Relief Act of 1999 called for the gradual repeal of the estate and gift taxes beginning in 2001 and ending in 2009 with a complete repeal. Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. § 601 (1999). The Death Tax Elimination Act also involved a gradual elimination of the wealth transfer system over a ten-year period. Death Tax Elimination Act of 2000, H.R. 8, 106th Cong. § 101 (2000). The Act called for a repeal of the 55-percent rates in 2001. *Id.* §§ 201, 301. In 2002, the unified tax credit would have turned into an exemption and a new 50-percent rate would have replaced the 53-percent rate. *Id.* The rates would have continued to reduce by one to two percent each year until 2010 when the rates would reduce to zero. *Id.*

changes.[165] No doubt, Congress's efforts were aided by a successful rhetorical campaign that changed the public debate from a discussion of "estate" taxes to anger about "death" taxes.[166]

The 2001 Tax Act provides for a sweeping reduction of overall tax liability in the total amount of $1.35 trillion dollars.[167] The vast bulk of the revenue reduction resulted from income tax rate reduction.[168] Measured in dollar terms, the 2001 Act's estate tax provisions pale in comparison to the income tax.[169] In terms of tax policy, however, the effort to repeal the estate tax is perhaps the most significant change brought about by the 2001 Tax Act.

Although the 2001 Tax Act provides for a one-year repeal of the estate tax and generation-skipping tax in 2010, it does not repeal the gift tax.[170] The Act calls for a gradual reduction of estate, generation-skipping, and gift tax rates starting in 2002.[171] Between 2002 and 2007, the tax rates are reduced by one-percent each year, beginning with the repeal of the 50-percent tax rate in 2002.[172] Also in 2002, the five-percent surtax was repealed and the unified credit exemption was increased to $1 million.[173] In 2004, the unified credit exemption for estates increases to $1.5 million, but the unified credit exemption

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[165] *See supra* note 9 and accompanying text (discussing the political landscape surrounding the enactment of the 2001 Tax Act). "In January 2001, when President Bush took office and the debate [the 2001 Tax Act] began, the Congressional Budget Office (CBO) projected a ten-year surplus of $5.6 trillion . . . ." William G. Gale & Samara R. Potter, *The Bush Tax Cut: One Year Later*, *at* http://www.brook.edu/comm/policybriefs/pb101.htm (June 2002) (on file with author); *see also* Citizens for Tax Justice, *Year-by-year Analysis of the Bush Tax Cut Shows Growing Tilt to the Very Rich* 4 (arguing that in order to "squeeze Bush's $2.5 trillion ten-year tax cut into a $1.3 trillion budget target" Congress strategically made the most expensive provisions arrive on different dates), *at* http://www.ctj.org/html/gwb0602.htm (June 12, 2002) (on file with author); *Fiscal Balance and the President's Tax Proposal: Hearings Before the Senate Budget Committee*, 108th Cong. (2001) (statement of Gene Sperling), *available at* http://www.senate.gov/~budget/republican/about/hearing2001/sperling.htm (on file with author).

[166] Neikirk, *supra* note 114, at 1; *see* Ventry, *supra* note 154, at 1163 ("Even the term critics use to describe all forms of transfer taxes—'death' taxes—is seriously misleading.").

[167] Kessler & Eilperin, *supra* note 9, at A01.

[168] *See* Cong. Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012*, ch. 3, *at* http://www.cbo.gov/showdoc.cfm?index=3277&sequence=4 (Jan. 2002) (on file with author).

[169] *Id.*

[170] 2001 Tax Act, *supra* note 1, §§ 511, 521.

[171] *Id.*

[172] *Id.*

[173] *Id.*

for gifts remains at $1 million.[174] In 2006, the unified credit exemption for estates increases to $2 million, and in 2009 it increases to $3.5 million; the gift tax exemption, however, remains at $1 million.[175] Then, in 2010, the 2001 Tax Act provides for the one-year repeal of the estate and generation-skipping taxes.[176] In 2011, the EGT returns to its pre-2001 Tax Act form.[177]

As stated above, the 2001 Tax Act retained the gift tax.[178] By 2010, a $1 million dollar lifetime gift exclusion will apply and the gift tax rates will equal the highest individual income tax rates.[179] Congress retained the gift tax to prevent taxpayers from gifting large amounts of wealth during the 2010 window, resulting in no estate left to tax in 2011 when the estate tax returns.[180] Additionally, Congress maintained the gift tax to prevent income tax avoidance.[181] Specifically, the rich could transfer wealth to lower-bracketed individuals and individuals with unused capital losses.[182] Furthermore, the rich could transfer wealth to foreigners since non-U.S. citizens have lower maximum income tax rates than the wealthiest Americans, and foreigners pay only capital gains tax on real-estate.[183] Wealthy families could even encourage the poorest family member to expatriate.[184] The recipient would then sell the

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[174] *Id.*

[175] *Id.*

[176] 2001 Tax Act, *supra* note 1, §§ 511, 521.

[177] *Id.* § 901.

[178] *Id.* §§ 511, 521.

[179] *Id.*; Sheppard, *supra* note 89, at 1655.

[180] Lav & Friedman, *supra* note 102, at 8-9. If Congress repealed the gift tax, "government losses will be some $100 billion annually after 2012, half of that amount in tax evasion." Goldsborough, *supra* note 9, at B13.

[181] Charles D. Fox & Svetlana V. Bekman, *Gift Tax Repeal: Responding to Opponents' Concerns*, 92 TAX NOTES 1733 (2001). "[T]he Joint Tax Committee estimated that repeal of both the estate and gift tax would result in a revenue loss of $97 billion in 2011, of which $44 billion reflected a reduction in income tax revenues due to income tax evasion." Friedman, *supra* note 16, at 1986; *see* Martin A. Sullivan, *Economic Analysis—JCT Estimates Widespread Evasion with Estate Tax Repeal*, 91 TAX NOTES 10 (2001) (discussing income tax avoidance). The Joint Committee on Taxation even acknowledged that massive income tax evasion might result from gift tax repeal. Sullivan, *supra*, at 10. See Blattmachr & Gans, *supra* note 101, at 393, for a discussion of potential income tax avoidance if Congress repealed the gift tax. There are also difficulties (administratively and politically) in policing income tax avoidance by gifting within the family. John Buckley, *Transfer Tax Repeal Proposals: Implications for the Income Tax*, 90 TAX NOTES 539 (2001).

[182] Blattmachr & Gans, *supra* note 101, at 396.

[183] *Id.*

[184] *Id.* On the other hand, expatriation is an extreme step considering recipients are receiving the benefits and expatriates are taxed for ten years after leaving America. Fox & Bekman, *supra* note 181, at 1733-34.

assets and after a certain time period return the proceeds to the transferor, with appropriate compensation.[185] Also, taxpayers could create trusts that are not grantor trusts, but still benefit the grantors.[186] Moreover, Congress was concerned that the repeal of the gift tax would harm the progressivity of the tax system.[187]

Along with the repeal of the estate and generation-skipping taxes in 2010, the 2001 Tax Act established a modified carryover basis for inheritances.[188] The recipient's basis is the decedent's basis in the asset or the fair market value of the property at the date of the decedent's death, whichever is less.[189] The new scheme also allows a "free" basis adjustment of $1.3 million, which the executor can allocate to appreciated assets at his discretion.[190] The Act provides a property basis increase to spouses of $3 million, in addition to the $1.3 million basis adjustment, which the executor can allot to "qualified spousal property."[191] The Act, however, stipulates that all adjustments cannot increase the basis in excess of the assets' value at death (fair market value), ensuring that the basis adjustments cannot produce a loss or increase an existing loss.[192] The 2001 Tax Act also reduced the state death tax credit in 2002, culminating in its repeal in 2005.[193]

[185] Blattmachr & Gans, *supra* note 101, at 396. Some claim that income tax avoidance would not have occurred even with the repeal of the gift tax. Fox & Bekman, *supra* note 181, at 1733-36. The transferor is taking a big risk in transferring assets because there are strong incentives for the recipient to keep the sale proceeds. *Id.* Moreover, Congress could adopt time periods in which transfers of sale proceeds could still produce gain to the transferor. *Id.* Supporters of retaining the gift tax also claim that wealthy taxpayers could create nongrantor trusts, foreign nongrantor trusts, and out-of-state nongrantor trusts to avoid income tax. Blattmachr & Gans, *supra* note 101, at 396. Some commentators have rejected this argument. Fox & Bekman, *supra* note 181, at 1734-36.

[186] Blattmachr & Gans, *supra* note 101, at 396.

[187] Steinkamp, *supra* note 114, at 3 (stating that Congress maintained the gift tax out of concern that its repeal would adversely impact the progressivity of the income tax).

[188] 2001 Tax Act, *supra* note 1, §§ 541, 542 (replacing § 1014 with § 1022 of the Internal Revenue Code).

[189] *Id.* The carryover basis will replace the current system, which uses the fair market value at date of death to determine the basis of inherited property. I.R.C. § 1014.

[190] Dodge, *supra* note 89, at 963. The basis adjustment was enacted as a partial replacement of the repealed fair market value basis. *Id.* at 962.

[191] *Id.*

[192] *Id.*

[193] 2001 Tax Act, *supra* note 1, §§ 531, 532.

IV. AN INTEGRATED TAX TREATMENT OF GIFTS AND INHERITANCES IN A POST-ESTATE TAX WORLD

Since the passage of the 2001 Tax Act, several members of Congress introduced bills to make the repeal of the estate tax permanent.[194] None of these bills, however, provides a comprehensive approach to the tax treatment of gifts and inheritances under the Internal Revenue Code;[195] all leave the gift tax in place.[196] Nor do any of the proposals address whether the income tax exclusion of gifts and inheritances under § 102 would be justified in a post-estate tax world.[197] The repeal of § 102 is the more important step in providing a sound, comprehensive treatment of gifts and inheritances. However, this only makes sense in an environment free of transfer taxes. Therefore, this Comment will first discuss the repeal of the gift tax.

A. *Gift Tax Repeal*

Congress's decision to retain the gift tax under the 2001 Tax Act makes sense in view of the reemergence of the estate tax in 2011.[198] In a world devoid of estate taxes, however, consistent tax policy calls for the repeal of the gift tax.[199]

The gift tax was, first and foremost, a mechanism designed to protect the estate tax.[200] Only after Congress realized taxpayers were

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[194] In 2002, the House voted to permanently repeal the estate tax; however, the Senate failed to muster the 60 votes required in order to make the repeal permanent. Goldsborough, *supra* note 9, at B13. Nevertheless, in January 2003 alone, three bills were introduced in Congress calling for the permanent repeal of the estate tax. See *supra* note 16 and accompanying text for a discussion of these recent bills. Some have argued that the repeal of the estate tax should not become permanent, stating that "[d]uring the subsequent decade, if repeal becomes permanent, the loss to the federal government would be $740 billion." Goldsborough, *supra* note 9, at B13. Furthermore, according to the Joint Committee on Taxation, "full repeal of the estate tax would cost the federal government $53.4 billion in 2011, with the figure increasing in subsequent years." Deborah McGregor, *The Americas*, FIN. TIMES LIMITED, May 17, 2002, at 3. Others, however, claim that the repeal should become permanent and as quickly as possible. Lawrence H. Whitman, *Heritage Foundation Report on Making 2001 Tax Cuts Permanent*, 2002 TAX NOTES TODAY 230-36 (2002).

[195] *See* Permanent Death Tax Repeal Act of 2003, S. 169, 108th Cong. § 2 (2003); H.R. 139, 108th Cong. § 2 (2003); The Death Tax Permanency Act of 2003, H.R. 57, 108th Cong. § 2 (2003).

[196] *See supra* note 195.

[197] *Id.*

[198] See *supra* Part III for a discussion of the 2001 Tax Act.

[199] *See* AICPA Tax Div., *Reform of the Estate and Gift Tax System*, 91 TAX NOTES 307 (2001) (discussing different tax systems other than the EGT).

[200] Klein, *supra* note 23, at 237; *see* Robert B. Smith, *Burying the Estate Tax without*

avoiding the estate tax did Congress adopt the gift tax in 1924, and readopt it in 1932, as "*necessary* to prevent wholesale avoidance of the federal estate tax by the rich."[201] If the estate tax repeal becomes permanent, mechanisms designed to ensure compliance with it are obviously no longer necessary.

One could argue that the gift tax should remain as an important bulwark against income tax avoidance.[202] As one commentator states, however, it is doubtful "whether retention of the gift tax in an environment with no estate tax is a politically viable answer to the income tax avoidance issue."[203] Congress will find it difficult to explain that "as a result of the 'tax relief' provided by [the 2001 Tax Act], the constituent has to wait until death to give his farm or small business to his children" tax-free.[204] Furthermore, concerns regarding income tax avoidance would be negated if Congress also repeals the income tax exclusion of gifts and inheritances under § 102 as discussed below, and includes gifts and inheritances in the income base of the recipient.

While the permanent repeal of the estate tax is the chief justification for repeal of the gift tax, there is additional policy to support its repeal. It is useful to review the arguments discussed earlier[205] in favor of an estate tax in order to determine if any justifications lend continuing support to the retention of the gift tax, even in the absence of an estate tax.

The gift tax may retain some purpose as an instrument to reduce concentrations of wealth.[206] But, if the estate tax was unsuccessful in equalizing distributions of wealth, it is improbable that the gift tax, standing alone, would accomplish that goal.[207] Indeed, it is difficult to understand why any rational taxpayer, when considering only tax consequences, would make a gift during life and incur tax liability when, by waiting until death to transfer assets, she could avoid a tax

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Resurrecting its Problems, 55 TAX NOTES 1799, 1811 n.31 (1992) ("I would eliminate the gift tax too. It is only in the law in order to limit the avoidance of estate tax. If there is no estate tax, there is no reason to have a gift tax."). See John Buckley, *Estate and Gift Taxes: What Will Congress Do Next?*, 91 TAX NOTES 2069 (2001), for a discussion of the protections afforded by the gift tax.

201 RATNER, *supra* note 30, at 449-50 (emphasis added).

202 Blattmachr & Gans, *supra* note 101, at 396.

203 Buckley, *supra* note 200, at 2070.

204 *Id.*

205 See *supra* Part II.A. for a discussion of the arguments in favor of the estate tax.

206 See *supra* note 114 and accompanying text for a discussion of the impact of the EGT on concentrations of wealth.

207 *Id.*

burden.[208]

It is also highly doubtful that retaining the gift tax would be a viable vehicle to generate revenue and help balance the federal budget.[209] Estate and gift taxes together raise approximately 1.4 percent of total federal revenue, with the gift tax accounting for only a small portion.[210] Again, retention of the gift tax, with the simultaneous repeal of the estate tax, would bring in even less revenue as individuals would wait until death to transfer assets in order to avoid tax liability.[211] In contrast, if Congress repeals the income tax exclusion of gifts and inheritances as proposed below,[212] the revenue gain from the inclusion of gifts in gross income may offset the loss from the gift tax.[213]

The gift tax also does very little to add progressivity to the tax system if taxpayers can largely avoid the gift tax.[214] Besides, the income tax system could provide sufficient progressivity with the adoption of higher tax rates and brackets.[215]

Ultimately, retention of the gift tax is impossible to justify. The repeal of the estate tax, therefore, necessitates the repeal of the gift tax. Many wealthy individuals may still desire to gift during life regardless of tax burdens or incentives.[216] These individuals will view gift tax retention as "highly inequitable."[217] Further, the repeal of the gift tax will prevent any double taxation, real or perceived, that results from a federal tax system that includes both an income tax and wealth transfer tax.[218] The repeal will also add simplicity to the current tax system by eliminating the complexities associated with the gift tax.[219]

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208 Lav & Friedman, *supra* note 102, at 8.

209 RATNER, *supra* note 30, at 449-50.

210 In 1995, the gift tax, as part of the unified EGT, raised $1.8 billion. Bruce R. Bartlett, *Estate Tax Should be Abolished: NCPA Argues*, 97 TAX NOTES TODAY 127-36 (1997).

211 *Id.*; Lav & Friedman, *supra* note 102, at 8.

212 See *infra* Part IV.B. for a discussion of § 102 repeal.

213 See *infra* notes 240-45 and accompanying text for a discussion of revenue and the EGT.

214 Schlachter, *supra* note 15, at 809; Lav & Friedman, *supra* note 102, at 8.

215 Commentators admit that "[t]axation at death could be avoided by replacing the estate tax with equally progressive taxes imposed during life." Gale & Slemrod, *supra* note 146, at 4. Similarly, progressivity in the income tax system could offset the progressivity that results from the gift tax. Schlachter, *supra* note 15, at 788.

216 Friedman, *supra* note 16, at 1986.

217 *Id.*

218 Entin, *supra* note 128, at A18.

219 Donald M. Schindel, *What To Do With the Transfer Tax System*, 95 TAX NOTES 1819, 1820 (2002).

Another important justification for gift tax repeal is that it encourages the mobility of capital.[220] Retaining the gift tax in an estate tax-free world will result in a "lock-in" effect because taxpayers will be deterred from gifting assets during life, causing economic inefficiency.[221] Having reviewed the arguments in favor of an estate tax, the investigation of current tax policy calls for the repeal of the gift tax in an estate tax-free world.

B. *Repeal of the Income Tax Exclusion of Gifts and Inheritances Under § 102*

In *Commissioner v. Glenshaw Glass*,[222] the Supreme Court defined income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[223] Despite this broad concept of income, the income tax has excluded gifts and inheritances since the beginning of the modern income tax in 1913.[224] This exclusion dates back to the Civil War tax legislation.[225] The legislative record is silent as to the original justification for this exclusion,[226] but, since the advent of the estate tax in 1916, the existence of this transfer tax has provided a justification for the income tax exclusion of gifts and inheritances.[227] Eliminating the EGT shakes the foundation supporting the income tax exclusion of gifts and inheritances and allows for a reexamination of the exclusion under modern notions of what constitutes income.[228] Upon close inspection, it is difficult to find any clear argument that supports the continuation of the income tax exclusion of gifts and inheritances in an estate and gift tax-free world.[229]

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[220] Erblich, *supra* note 94, at 1953-56.

[221] "A gift tax without an estate tax would favor using one's estate as the vehicle for transferring wealth." Lav & Friedman, *supra* note 102, at 8. It must be noted that the impact of the gift tax on the donor's behavior depends heavily on the gift motive. Wojciech Kopczuk & Joel Slemrod, *The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior*, *in* RETHINKING ESTATE AND GIFT TAXATION, 299, 300 (William G. Gale et al. eds., 2001).

[222] 348 U.S. 426 (1955).

[223] *Id.* at 431.

[224] See *supra* Part I for a historical overview of gifts and inheritances in American history.

[225] Klein, *supra* note 23, at 231.

[226] Harriss, *supra* note 25, at 532.

[227] Vasek, *supra* note 21, at 961.

[228] *Id.* (stating that one justification for § 102 is the EGT); *see Glenshaw Glass*, 348 U.S. at 431 (defining today's notion of income).

[229] Some believe that the tax system should not distinguish gifts from other receipts and should treat all enrichment the same. HENRY C. SIMONS, PERSONAL INCOME TAXATION 30 (1938). Several scholars have specifically called for the repeal

The inclusion of gifts and inheritance in gross income would increase the tax base and result in a comprehensive tax system, in which taxes are based on the ability to pay.[230] Although gifts and inheritances may not represent new wealth from an economic standpoint, the recipient still receives an "undeniable accession to wealth."[231] Likewise, regardless of the motive, the transfer increases the recipient's "economic power to control society's scarce resources."[232] Moreover, as gifts and inheritances are unearned, horizontal equity would dictate that this unearned income be treated similar to earned income.[233] There has never been any apparent justification why donative transfers should be treated any differently than windfalls, which are included in gross income.[234] Simply put, if a taxpayer has an accession to wealth, no matter the source, the taxpayer should include that accession in gross income.[235]

The inclusion of gifts and inheritances in gross income will also match the "official" incidence of taxation of wealth transfers with the

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of § 102. *See* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978) (arguing for the repeal of § 102 but not for the repeal of the estate tax); Galvin, *supra* note 129, at 1413 (arguing for the repeal of § 102); Gac & Brougham, *supra* note 158 (arguing for the repeal of the estate and gift taxes along with the repeal of § 102); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 54 (1992) (arguing for the repeal of § 102). Professor Kornhauser suggests:

> The time is ripe for a three-prong change in our current treatment of gifts: (1) A new provision should be enacted stating that a gift, bequest, legacy, or devise is a realization event to the donor/decedent and thus taxable to him; (2) Section 102 should be repealed and a new section passed explicitly including in the income of a donee or inheritor the fair market value of the money and property received; and (3) Section 1014 and 1015 should be repealed and a new basis provision enacted that would provide for a fair market value basis.

Id. See Donaldson, *supra* note 129, at 560-63, for an overview of the pros and cons of the repeal of § 102.

230 Kornhauser, *supra* note 229, at 32.

231 *Glenshaw Glass*, 348 U.S. at 431. Dodge goes as far as stating: "[G]ratuitous wealth transfers (as compared to transferred consumption, i.e., 'support' in kind) represent consumption power of both the transferor and transferee. Indeed, receipts of gifts and bequests, along with other windfall receipts (such as life insurance proceeds and lottery winnings), should probably be subject to a surtax." Joseph M. Dodge, *A Democratic Tax Manifesto*, 66 TAX NOTES 1313, 1325 (1995).

232 Kornhauser, *supra* note 229, at 32.

233 Jones, *supra* note 90, at 794.

234 I.R.C. § 61 (2003) (including windfalls in gross income).

235 Jones, *supra* note 90, at 794. "When a person receives a gift or inheritance, she undeniably increases her personal net worth; she is better off with the gift than without it." Kornhauser, *supra* note 229, at 1. "[A]ccessions to wealth, or income—whether personally consumed, gifted to others, or saved—confer power on the owner." *Id.* at 32.

"emotional" incidence.[236] First, studies demonstrate that most taxpayers already believe that gifts and inheritances are included in income and that an estate does not comprise a separate taxpaying entity.[237] Additionally, heirs claim that they, not the estate, pay the tax because "[b]y the time the estate tax return is filed, title and possession of the property have often passed; the property is 'theirs;' 'they' write the check; it is 'their' bank balance which decreases."[238] In other words, the estate tax can be viewed not as taxing the estate as a separate taxpaying entity, but rather as taxing the recipients.[239]

Including gifts and inheritances in gross income would result in a significant increase in tax revenue, more than offsetting the loss due to repeal of the EGT.[240] Although tax reporting requirements and enforcement obligations will arise as a result of § 102 repeal, these costs are minimal when compared to the costs associated with the current wealth transfer system.[241] Specifically, studies have demonstrated that the repeal of § 102 would increase adjusted gross income by approximately 3-percent by increasing the income tax base.[242] Assuming an estimated adjusted gross income of approximately $3 trillion, the repeal of § 102 would add approximately $90 billion to adjusted gross income.[243] If the government taxed the $90 billion at an average of 20-percent, the government would receive $18 billion in additional revenue.[244] The inclusion of gifts and inheritances, therefore, has a "built-in, measurable revenue replacer."[245]

Although the repeal of the estate tax would eliminate revenue sharing between the federal government and states utilizing the State Death Tax Credit, the inclusion of gifts and inheritances in gross income may actually increase states' revenues.[246] The income tax

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[236] Gac & Brougham, *supra* note 158, at 89.

[237] *Id.*

[238] *Id.*

[239] *Id.*

[240] AICPA Tax Div., *supra* note 199, at 334.

[241] See *supra* note 129 and accompanying text for a discussion of the costs associated with the EGT. "Repeal of § 102 might wholly or partially supersede other revenue measures, such as the income tax on estate and trusts and the estate and gift taxes . . . ." Dodge, *supra* note 231, at 1325.

[242] Galvin, *supra* note 129, at 1419. Galvin determined these results utilizing the data obtained by the Commission to Revise the Tax Structure. *Id.*

[243] *Id.*

[244] *Id.*

[245] Jones, *supra* note 90, at 797.

[246] Gac & Brougham, *supra* note 158, at 100.

system of many states mirrors the federal tax system.[247] Thus, if the federal tax system includes gifts and inheritances in gross income, many states may also adopt this inclusion.[248]

As discussed earlier, the EGT has failed to reduce concentrations of wealth.[249] Nevertheless, the inclusion of gifts and inheritances in income may succeed where the EGT has failed.[250] The EGT "uses a delayed penalty on the accumulation of wealth" by focusing on the transferor, while the inclusion of gifts and inheritances in the recipient's gross income focuses on the immediate acquisition of wealth.[251] Additionally, the repeal of the income tax exclusion of gifts and inheritances may reduce concentrations of wealth by reaching all assets "earned, received, or saved."[252] The disincentives of taxation may motivate individuals not to earn income; however, the repeal of § 102 involves unearned income.[253] Since gifts and inheritances involve unearned income, there is no adverse effect on the accumulation of earned wealth.[254]

The repeal of the income tax exclusion of gifts and inheritances also may encourage charitable contributions. The recipients of gifts and inheritances may donate to charities in the year the payment is received in order to take a deduction on their income tax returns.[255] Further, without a gift or estate tax, the wealthy may donate earlier.[256]

Even if a proposed tax system is sound in theory, a good tax system can only be successful if it is administratively feasible.[257] An income tax that includes gifts and inheritances facilitates compliance and enforcement by incorporating the inclusion into the basic annual income tax return.[258] In order to maximize compliance, the

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247 *Id.*

248 *Id.*

249 See *supra* notes 116-19 and accompanying text for a discussion of the failure of the EGT to reduce concentrations of wealth.

250 Jones, *supra* note 90, at 798; *see* Gac & Brougham, *supra* note 158, at 102 (stating that the repeal of § 102 may reduce concentrations of wealth); *see also supra* notes 114-19 and accompanying text (discussing the failure of the EGT to combat inequalities in wealth).

251 AICPA Tax Div., *supra* note 199, at 331.

252 Jones, *supra* note 90, at 798.

253 "Unearned income" involves receiving income through means other than labor. BLACK'S LAW DICTIONARY 768 (7th ed. 1999).

254 Gac & Brougham, *supra* note 158, at 102.

255 Dodge, *supra* note 229, at 1209.

256 *Id.* Congress may want to further limit the deduction of charitable contributions from income. Gac & Brougham, *supra* note 158, at 97.

257 KLEIN ET AL., *supra* note 140, at 16-22.

258 AICPA Tax Div., *supra* note 199, at 334.

government could utilize third party reporting.[259] The annual inclusion of gifts and inheritances in gross income also results in the elimination of cumulative computations, promoting the annual accounting principle.[260]

A comprehensive income tax system that includes gifts and inheritances in gross income is simpler than having two systems, one for income tax and one for wealth transfer.[261] The repeal of the income tax exclusion of gifts and inheritances, along with the repeal of the EGT, would also simplify the tax system and decrease administrative costs by eliminating rate differentials between income and wealth transfers.[262] Further, the inclusion of gifts and inheritances in gross income does not necessitate the intricate complexities in legal form, deductions, and credits that are associated with the wealth transfer system.[263]

The repeal of the income tax exclusion under § 102 may raise potential administrative obstacles.[264] The greatest difficulty is valuation.[265] Every asset received would need to be valued, resulting in more conflicts between the government and taxpayers.[266] Although valuation problems exist in every tax system, Congress could address these concerns in part by enacting an annual exclusion

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[259] Most assets are held in some kind of account (i.e., a real estate transfer is finalized through deeds). Andrew J. Hoerner & Lynn V. Edminston, *More From the NTA: Compliance, Revenue Estimates, Fiscal Federalism, Property Taxes, and Sin Taxes*, 45 TAX NOTES 398, 400 (1989). Third party reporting could help ensure compliance with the repeal of § 102. *See* George Guttman, *Why Did the K-1 Matching Program Go Awry?*, 97 TAX NOTES 736, 736 (2002).

> Currently, the most successful information matching program deals with Form 1099 information returns concerning interest and dividends. To facilitate the program, the IRS redesigned forms and procedures. Also, changes in the law required that standardized information documents from third-party payers such as financial institutions had to be submitted in electronic form. Most of the initial matching work has been done through automated computer programs.

Id. For example, a brokerage company could complete a form every time real estate is transferred (much like the current system associated with dividends). See George Guttman, *Current Audit Statistics Make IRS Look Less Effective Than It Is*, 90 TAX NOTES 1593 (2001), for information regarding third party reporting.

[260] Gac & Brougham, *supra* note 158, at 91.

[261] AICPA Tax Div., *supra* note 199, at 333.

[262] Gac & Brougham, *supra* note 158, at 91.

[263] AICPA Tax Div., *supra* note 199, at 333.

[264] See Smith, *supra* note 200, at 1804, for detailed criticism of the repeal of § 102.

[265] *Id.* at 1804.

[266] *Id.* at 1800 ("Where the assets transferred include real estate, closely held business interests, art, jewelry or other such unique or rarely traded assets, the range of value estimates is often huge.").

similar to that currently provided in the gift tax.[267] This would also eliminate taxpayers' concerns about the necessity of including transfers such as birthday presents or wedding gifts.

Liquidity is another potential complication as all transferred assets, cash and non-cash, including nonmarketable or difficult-to-market assets, would be subject to an income tax.[268]

These potential problems are minimal when compared to the complexities associated with the current wealth transfer system.[269] Deferred tax payments through installment plans could relieve some of the immediate tax burden.[270] Further, the same liquidity concerns are associated with the EGT since the estate may have no choice but to sell assets in order to pay the estate tax.[271] Yet, at least in the case of an income tax inclusion, the recipient can choose whether to borrow against and retain the assets, or to sell the assets in order to pay the resulting tax liability.[272] So while the inclusion of gifts and inheritances in gross income raises potential administrative obstacles, none of these concerns outweighs the societal benefits that would flow from § 102 repeal.

In order to avoid administrative feasibility concerns, a generous exclusion would ensure that only major transfers of wealth are included in gross income. One possibility is the adoption of a $10,000 annual exclusion (increased by the cost of living adjustment each year), the same amount as the current annual gift tax exclusion, because both taxpayers and attorneys are familiar with this level of exclusion.[273] The exclusion would not only aid in minimizing administrative expenses,[274] but would also protect lower income individuals from being overly burdened by the inclusion.[275] In

[267] *Id.* (recognizing that valuation problems can be "lessened by providing an exclusion similar to the present annual exclusion from gift tax"); Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls out of the Cemetery: A Reply to Professor Smith*, 56 TAX NOTES 951, 952 (1992) (responding to criticisms of § 102 repeal). It must be noted that if the exclusion were too high, the tax system would again violate horizontal equity. Smith, *supra* note 200, at 1804.

[268] Donaldson, *supra* note 129, at 562.

[269] See Smith, *supra* note 200, at 1799, for a detailed criticism of the repeal of § 102.

[270] Donaldson, *supra* note 129, at 562.

[271] Galvin, *supra* note 267, at 952.

[272] *Id.* Furthermore, if only the gain is included in gross income, the resulting tax liability will be even less. *Id.*

[273] I.R.C. § 2503 (2003) (authorizing a $10,000 gift tax exclusion with increases for inflation and cost of living); Rev. Proc. 2002-70, 2002-2 C.B. 845 (authorizing a $11,000 gift tax exclusion for 2003).

[274] Galvin, *supra* note 267, at 952.

[275] Gac & Brougham, *supra* note 158, at 90.

addition, unlimited transfers to spouses would continue to exist without taxation because spouses are considered one taxpaying entity.[276]

While some argue that the repeal of the income tax exclusion of gifts and inheritances would violate neutrality by affecting taxpayers' investment decisions, the repeal may actually avoid neutrality problems by focusing on the transferee.[277] In fact, the exclusion of gifts and inheritances actually violates neutrality because sales are taxable, while gifts are not taxable to the recipient; thus, more taxpayers are induced to make the nontaxable gift disposition than if gifts were also taxable.[278] This distortion prevents an efficient allocation of resources.[279] Therefore, the inclusion of gifts and inheritances in the recipient's gross income will promote economic efficiency.[280]

Since the repeal of the income tax exclusion of gifts and inheritances would effect many more people than are currently paying the estate tax, the American public may resist the repeal.[281] If Congress eliminated the entire wealth transfer system, however, the repeal of § 102 would be more "palatable and politically acceptable."[282] The public seems to object much more to so called "death taxes" than an income tax which they already pay annually.

The argument for repeal of the income tax exclusion of gifts and inheritances can also be viewed from a standpoint of timing. The 2001 Tax Act eliminates the stepped-up basis for inheritances in 2010 with the adoption of a carryover basis.[283] Thus, the post-estate tax regime brought about by the 2001 Tax Act eventually subjects transferred gains to the income tax.[284] But the Treasury would need

[276] AICPA Tax Div., *supra* note 199, at 331 ("[B]equests would be entirely tax-free since the surviving spouse is a continuation of the original tax unit.").

[277] *Compare* Smith, *supra* note 200, at 1802 (arguing against the repeal of § 102 because of neutrality violations), *with* Donaldson, *supra* note 129, at 561 (stating benefits of § 102 repeal).

[278] Kornhauser, *supra* note 229, at 190.

[279] *Id.*

[280] *Id.*

[281] If Congress repealed § 102, it would need to decide how to handle life insurance, employer deferred compensation plans, support payments, and other issues associated with trusts. *See generally* K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395 (1988) (responding to the Treasury Department's request for suggestions to reform the transfer tax system).

[282] Galvin, *supra* note 129, at 1419.

[283] 2001 Tax Act, *supra* note 1, §§ 541, 542 (eliminating I.R.C. § 1014).

[284] Jones, *supra* note 90, at 797.

to wait for a realization event to occur.[285] Hence, without a realization event, the government would never collect taxes.[286] The repeal of the income tax exclusion of gifts and inheritances would make the transfer the realized event.

From a tax policy standpoint, every individual is a separate taxpaying entity; thus, Congress should require the recipient of the gift or inheritance to include the full fair market value of the transferred asset in gross income.[287] Sound tax policy necessitates a full fair market value inclusion because the transfer of gifts and inheritances should be treated as an accession to wealth, rather than a sale or exchange of capital asset.[288] By including the full fair market value in gross income, the complexities associated with determining the transferor's basis are avoided.[289] As a result of including the full fair market value in gross income, the taxpayer would have a full fair market value basis going forward.[290]

The inclusion of gifts and inheritances in income should not result in capital gain treatment. If gifts and inheritances are treated

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[285] *Id.*

[286] *Id.*

[287] Gac & Brougham, *supra* note 158, at 93. It should be noted that a married couple could choose to be viewed as a single taxpaying entity and file their income tax return as married filing jointly. I.R.C. § 1 (2003). Even if a fair market value basis is adopted, a carryover basis may be appropriate for spousal transfers and untaxed transfers due to exemption amounts. Gac & Brougham, *supra* note 158, at 93.

[288] *Id.*

[289] *Id.* Alternatively, Congress could require the recipient to include only the appreciation of the gratuitous transfer in income, in effect taxing the recipient on the excess of the fair market value of the transferred asset over its adjusted basis in the donor's hands. Galvin, *supra* note 129, at 1418 (arguing for an income tax on appreciation of gifts or inheritances, but arguing against a carryover basis). While taxpayers prefer a stepped-up basis to carryover basis, taxpayers may prefer a carryover basis to the inclusion of inheritances in income in order to maximize deferral of taxes. Vasek, *supra* note 21, at 966. Some may argue that adopting a full fair market value inclusion results in double taxation of the transferor's basis. *Id.* Some believe that the repeal of § 102, without the donor receiving a deduction, is not double taxation:

> [I]t is not accurate to say that the gift is taxed twice. What is taxed is, first, the amount earned by the donor and, second, the amount transferred to the donee. The gift is taxed only once, to the donee. Thus, a gift is no more subject to double taxation than is a payment for personal services, which is also 'taxed twice'—once when earned by the payor and again when received by the payee.

Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 74 (1990). To avoid double taxation, the recipient could only be taxed on the gain of the asset, allowing the recipient a credit for the donor or decedent's basis. Gac & Brougham, *supra* note 158, at 93.

[290] *Id.*; Galvin, *supra* note 129, at 1418.

as windfalls and lottery winnings, the accession should be taxed as ordinary income.[291] Ordinary tax treatment avoids the difficulties associated with deciphering between ordinary and capital treatment and other complex distinctions involving current income, accumulated income, and gift or bequest corpus.[292]

There is no constitutional bar to repealing the income tax exclusion of gifts and inheritances dictated by § 102.[293] "[T]he fact that § 102 is written into the code as an exclusion indicates a long-standing position of Congress that gifts and bequests could be taxed within the purview of the Sixteenth Amendment but for the specific statutory expression."[294] Likewise, scholars have demonstrated that arguments based on "text, intent, constitutional theory of purpose, precedent, and social and policy values" all indicate a willingness to include gifts in income due to the broad economic meaning of income that has developed in America.[295]

CONCLUSION

The 2001 Tax Act will bring about the temporary repeal of the estate tax.[296] Strong sentiment exists for making this repeal permanent. If achieved, it will necessitate a complete reexamination of the tax treatment of wealth transfers. It is clear from a historical and policy standpoint that repealing the estate tax and not addressing the gift tax or income tax exclusion of gifts and inheritances under § 102 would result in an inconsistent tax structure for the treatment of wealth transfers.

The gift tax is not necessary to protect a repealed estate tax. Ultimately, estate tax repeal, with gift tax retention, will result in avoidance of any inter vivos gifting. This avoidance will prevent the reduction of wealth concentrations, restrict progressivity, and hinder the raising of revenue. In addition, the mobility of capital and prevention of a lock-in effect demand the repeal of the gift tax.

The permanent repeal of the estate tax, along with the gift tax, necessitates the repeal of the income tax exclusion of gifts and inheritances under § 102. Based on sound tax policy, including

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[291] I.R.C. § 61 (authorizing the inclusion of windfalls in income).

[292] Dodge, *supra* note 229, at 1180. On the other hand, capital gain treatment may make sense if the recipient is taxed only on the appreciation of the gratuitous transfer. If the asset while in the donor or decedent's hand would have received capital gain treatment, the recipient should also receive capital gain treatment.

[293] Galvin, *supra* note 129, at 1419.

[294] *Id.*

[295] Kornhauser, *supra* note 229, at 52.

[296] 2001 Tax Act, *supra* note 1, §§ 511, 521.

ability to pay, fairness, and neutrality, the recipient's income should include gifts and inheritances. Section 102 repeal may also reduce concentrations of wealth, encourage charitable contributions, and increase federal tax revenue. Despite any obstacles presented by administrative concerns or political opposition, the repeal of § 102 is essential to ensure horizontal equity. Most importantly, without the support of a wealth transfer system, the rationale underlying the income tax exclusion of gifts and inheritances collapses.